Bank Holding Company Supervision Manual

On June 23, 2025, the Board announced that reputational risk will no longer be a component of examination programs in its supervision of banks.

Division of Supervision and Regulation

Prepared by:
Division of Supervision and Regulation
Board of Governors of the Federal Reserve System

Send comments to:
Director, Division of Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

In addition, comments may be sent via the Board's public website.

General Table of Contents
Bank Holding Company Supervision Manual

This general table of contents lists the major section heads for each part of the manual:

Bank Holding Company Supervision Manual
Supplement 57—November 2024

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the February 2023 supplement.

Section 1045.0, "Supervision of Holding Companies with Less Than $10 Billion in Total Consolidated Assets"

This section was revised to describe the inspection report content for all holding companies in the community banking organization (CBO) supervisory portfolio. The section describes three ways that ratings are presented in inspection reports for CBO holding companies. First, the section explains the inspection report content for noncomplex holding companies with less than $3 billion in total consolidated assets (small noncomplex holding companies). Small noncomplex holding companies are only assigned a risk-management rating (R) and a composite rating (C) from the RFI/C(D) rating system. Second, the section refers examiners to section 1050.2.6, "Inspection Report Content for Certain Holding Companies in the Regional Banking Organization Portfolio," for inspection report instructions for CBO holding companies receiving the full RFI/C(D) rating. Lastly, the section describes the optional inspection report format that examiners can utilize for inspections of complex CBO holding companies that result in a composite RFI/C(D) supervisory rating of "4" or "5."

Section 1050.2, "Consolidated Supervision of Regional Holding Companies"

This section was revised to include an outline of the "Combined Roll-Up Report" for certain regional banking organizations. The Combined Roll-Up Report is an inspection report that examiners can use for conveying the supervisory assessment of bank holding companies (BHCs) with a lead bank subsidiary that is a state member bank. The section also provides detailed instructions that examiners should follow when completing the various sections of the Combined Roll-Up Report.

Section 2010.11, "Supervision of Subsidiaries (Private-Banking Functions and Activities)"

This section has been removed from the manual. Additional information on the assessment of private banking activities is provided in the *Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual* as well as in the *Commercial Bank Examination Manual* (CBEM), section 5210.1.

Section 2065.1, "Nonaccrual Loans and Loan Modifications to Borrowers Experiencing Financial Difficulty"

This section was previously called "Nonaccrual Loans and Restructured Debt (Accounting, Reporting, and Disclosure Issues)." This section was updated to remove references to troubled debt restructurings (TDRs). In March 2022, the Financial Accounting Standards Board issued Accounting Standards Update No. 2022-02, "Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures," which amended Accounting Standards Codification Topic 326, Financial Instruments – Credit Losses. This guidance eliminated the recognition and measurement accounting guidance for TDRs by creditors in Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Other outdated accounting references were either removed or updated in the section.

Section 2124.3, "Risk Management of Third-Party Relationships"

This section was previously called, "Managing Outsourcing Risk," and was based on inactive guidance in SR-13-19/CA-13-21, "Guidance on Managing Outsourcing Risk." SR-13-19/CA-13-21 was superseded by SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management." The revised section briefly describes the guidance in SR-23-4 and provides hyperlinks to resources that provide more information and supervisory guidance on third-party relationships and the risk management of these relationships. See also the CBEM's section 4062.1, "Risk Management of Third-Party Relationships."

Sections 5010.0 through 5030.0—BHC Inspection Report Template Pages

The following sections have been removed from this manual:

- 5010.0 Procedures for Inspection Report Preparation—Inspection Report References
- 5010.1 General Instructions to FR 1225
- 5010.2 Cover
- 5010.3 Page i—Table of Contents
- 5010.4 Core Page 1—Examiner's Comments; Matters Requiring Special Board Attention
- 5010.5 Core Page 2—Scope of Inspection and Abbreviations
- 5010.6 Core Page 3—Analysis of Financial Factors
- 5010.7 Core Page 4—Audit Program
- 5010.8 Appendix Page 5—Parent Company Comparative Balance Sheet
- 5010.9 Appendix Page 6—Comparative Statement of Income and Expenses (Parent)
- 5010.10 Appendix Page 7—Consolidated Classified & Special-Mention Assets
- 5010.11 Appendix Page 8—Consolidated Comparative Balance Sheet
- 5010.12 Appendix Page 9—Comparative Consolidated Statement of Income and Expenses
- 5010.13 Capital Structure
- 5010.14 Page—Policies and Supervision
- 5010.15 Page—Violations
- 5010.16 Page—Other Matters
- 5010.17 Page—Classified Assets and Capital Ratios of Subsidiary Banks
- 5010.18 Page—Organization Chart
- 5010.19 Page—History and Structure
- 5010.20 Page—Investment in and Advances to Subsidiaries
- 5010.21 Page—Commercial Paper (Parent)
- 5010.22 Page—Lines of Credit (Parent)
- 5010.23 Page—Questions on Commercial Paper and Lines of Credit
- 5010.24 Page—Contingent Liabilities and Other Accounts
- 5010.25 Page—Statement of Changes in Stockholders' Equity (Parent)
- 5010.26 Page—Income from Subsidiaries
- 5010.27 Page—Cash Flow Statement (Parent)
- 5010.28 Page—Parent Company Liquidity Position
- 5010.29 Page—Classified Parent Company and Nonbank Assets
- 5010.30 Page—Bank Subsidiaries
- 5010.31 Page—Nonbank Subsidiary
- 5010.32 Page—Nonbank Subsidiary Financial Statements
- 5010.33 Page—Fidelity and Other Indemnity Insurance
- 5010.35 Page—Other Supervisory Issues
- 5010.36 Page—Extensions of Credit to BHC Officials
- 5010.37 Page—Interest Rate Sensitivity—Assets and Liabilities
- 5010.38 Page—Treasury Activities/Capital Markets
- 5010.40 Confidential Page A—Principal Officers and Directors
- 5010.41 Confidential Page B—Condition of Bank Holding Company
- 5010.42 Confidential Page C—Liquidity and Debt Information
- 5010.43 Confidential Page D—Administrative and Other Matters
- 5020.1 Page—Bank Subsidiary (FR 1241)
- 5020.2 Page—Other Supervisory Issues (FR 1241)
- 5030.0 Inspection Report Forms

These sections were removed from the manual because they conveyed BHC inspection report template pages and examiner instructions for completing these report pages that were outdated. Overall, many of these sections provided information that applied to past BHC rating systems and did not appropriately convey how holding company inspection reports are completed in the risk-focused supervisory framework. Information on the completion of holding company inspection reports can be found in the "About this Manual, Supervisory Process" sections (1000.0 through 1080.1) of this manual, which describe supervisory processes for the various portfolios. Specifically, see section 1045.0, "Supervision of Holding Companies with Less Than $10 Billion in Total Consolidated Assets," for more information on the completion of inspection reports for small noncomplex holding companies. Also see section 1050.2, "Consolidated Supervision of Regional Holding Companies," for information on the completion of inspection reports for holding companies that are subject to the full RFI/C(D) ratings.

Bank Holding Company Supervision Manual
Supplement 56—February 2023

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the November 2021 supplement.

Section 1000.0, "About this Manual"

This section was revised to remove a reference to SR letter 18-5/CA letter 18-7, "Interagency Statement Clarifying Role of Supervisory Guidance." The Board codified the 2018 "Interagency Statement Clarifying the Role of Supervisory Guidance," with clarifying changes, as appendix A to 12 C.F.R. 262, "Statement Clarifying the Role of Supervisory Guidance." The final rule superseded the 2018 statement. See 86 Fed. Reg. 18,173 (April 8, 2021).

Section 1020.0, "Supervision of Savings and Loan Holding Companies"

This new section contains guidance that was previously in section 2500.0, "Supervision of Savings and Loan Holding Companies." The material was moved closer to the manual's other sections that describe supervisory process guidance. In addition, this section was modified to provide an overview of the statutes, regulations, and guidance that apply to savings and loan holding companies (SLHCs). The section describes the supervisory approach for SLHCs, highlighting that the Federal Reserve employs a "portfolio approach" to consolidated supervision for most SLHCs to facilitate greater consistency of supervisory practices and assessments across comparable organizations. The section describes the ratings systems that apply to SLHCs. The Federal Reserve uses the "RFI/C(D)" rating system for non-insurance and non-commercial SLHCs with total consolidated assets less than $100 billion. The "Large Financial Institution" or "LFI" rating system is used for all non-insurance, non-commercial SLHCs with total consolidated assets of $100 billion or more. Supervised insurance institutions receive a unique rating. See 87 Fed. Reg. 60,160 (October 4, 2022). The section also describes guidance on qualified thrift lenders (see SR-17-9, "Supervisory Guidance for Examining Compliance with the Qualified Thrift Lender Test"), as well as covered savings associations (see SR-22-2, "Status of Covered Savings Associations and Holding Companies of Covered Savings Associations Under Statutes and Regulations Administered by the Federal Reserve").

Section 1045.0, "Supervision of Holding Companies with Less Than $10 Billion in Total Consolidated Assets"

Previously, this section was called "Supervision of Holding Companies with Total Consolidated Assets of $10 Billion or Less." The section's title and content have been revised to reflect minor technical applicability changes. Previously, the guidance in the section applied to the supervision of holding companies with $10 billion or less in total consolidated assets. The section was revised to reflect that the guidance applies to holding companies supervised by the Federal Reserve with less than $10 billion in total consolidated assets. For more information see SR-13-21, "Inspection Frequency and Scope Expectations for Bank Holding Companies and Savings and Loan Holding Companies that are Community Banking Organizations."

Section 1060.20, "Liquidity Planning and Positions (LFI Ratings System)

This new section provides an overview of key liquidity-related regulations and guidance issuances that apply to firms that are subject to the large financial institution (LFI) rating system. This section provides an overview of the "Interagency Policy Statement on Funding and Liquidity Risk Management" (see SR-10-6). The section introduces key liquidity-related requirements in Regulation YY, "Enhanced Prudential Standards" (12 C.F.R. part 252). Further, the section describes the liquidity coverage ratio requirements and the net stable funding ratio requirements in Regulation WW, "Liquidity Risk Measurement Standards" (12 C.F.R. part 249). The liquidity regulatory requirements in the *Complex Institution Liquidity Monitoring Report* (FR 2052a) are summarized. The FR 2052a is required to be submitted by top-tier BHCs, top-tier SLHCs, and FBOs subject to Category I, II, III, or IV standards under the Board's Regulation YY and Regulation LL. Lastly, the section describes the Federal Reserve's supervisory activities and approach for assessing liquidity at LFIs.

Section 1063.0, "Holding Company Ratings Applicability and Inspection Frequency"

This section was revised to update the inspection scope and frequency expectations for supervised insurance organizations. A "supervised insurance organization" is a depository institution holding company that is an insurance underwriting company, or that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries or has been otherwise designated as a supervised insurance organization by Federal Reserve staff. For more information on the ratings system that applies to supervised insurance organizations, see SR-22-8, "Framework for the Supervision of Insurance Organizations."

Section 1075.0, "Formal Corrective Actions"

This new section contains guidance that was previously in section 2110.0, "Formal Corrective Actions." The material was moved closer to the manual's other sections that describe supervisory process guidance. The section was revised to include the entities against which the Federal Reserve has the statutory authority to take formal enforcement actions. In particular, the section was revised to indicate which formal actions apply to SLHCs. Additional information was added to describe enforcement actions for Bank Secrecy Act and anti-money laundering compliance failures, as well as the interagency coordination activities of federal banking agencies on formal enforcement actions. Clarifying edits were made to the subsections describing civil money penalties, prohibited indemnification payments, and golden parachute payments, as well as prohibition and removal authority. The section highlights that the Board does not issue an enforcement action on the basis of a "violation" of or "non-compliance" with supervisory guidance.

Section 2010.6, "Supervision of Subsidiaries (Retail Sales of Nondeposit Investment Products)"

Previously, this section was called "Supervision of Subsidiaries (Financial Institution Subsidiary Retail Sales of Nondeposit Investment Products)." The section's title has been revised to reflect the significant changes that were made to the material. This section provides a summary of the relevant guidance on nondeposit investment products and directs readers to the key pieces of guidance, via hyperlinks, that the Board and other banking agencies have issued regarding this topic. The inspection objectives and inspection procedures have been removed. Relevant examination objectives and procedures on the retail sales of nondeposit investment products are in the *Commercial Bank Examination Manual*.

Section 2080.6, "Funding (Holding Company Funding from Sweep Accounts)"

Previously, this section was called "Funding (Bank Holding Company Funding from Sweep Accounts)." The section was renamed to reflect that the guidance in this section applies to SLHCs as well as bank holding companies (BHCs). The section was revised to reflect the expanded applicability of the guidance. Further, the section was revised to better align with the "Statement Clarifying the Role of Supervisory Guidance" (see 12 C.F.R. part 262, appendix A). Unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the Board does not take enforcement actions based on supervisory guidance.

Section 2090.2 "Control and Ownership (BHC Formations)"

This section contains information about the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (12 C.F.R. part 225, appendix C). Additional information was added to explain the calculation of equity, the denominator of the debt-to-equity ratio, as described in this policy statement. The components of total equity capital align with the components of equity that are listed in the *Parent Company Only Financial Statements for Small Holding Companies Report* (FR-Y-9SP). Total equity capital includes perpetual preferred stock (including related surplus); common stock (including related surplus); retained earnings; accumulated other comprehensive income; and all other equity capital components, including the total carrying value (at cost) of treasury stock and unearned Employee Stock Ownership Plan shares.

Section 2110.0, "Formal Corrective Actions"

The material in this section has been revised and moved to section 1075.0. As a result, this section has been removed from the manual. See the description above for section 1075.0 for more information.

Section 2128.02 Asset Securitization (Risk Management and Internal Controls)

This section was significantly revised. Much of the information that was previously in the section was removed because it conveyed outdated risk-based capital provisions affecting asset securitization, as well as outdated accounting references. The section refers readers to the Asset Securitization section of the *Commercial Bank Examination Manual* for more information. The inspection objectives and inspection procedures also were removed, as the Securitization Examination Documentation (ED) module provides more detailed examination procedures for examiners.

Section 2241.0, "Retail-Credit Classification"

This section was revised to reflect that the guidance in this section applies to BHCs as well as SLHCs. Outdated references were removed from the section. Minor edits were made to the definitions for the classifications used for retail credit: *Substandard*, *Doubtful*, and *Loss*. Edits were made to these definitions to ensure they align with the definitions that the federal bank regulatory agencies utilize for assets adversely classified for supervisory purposes. Further, edits were made to better align the guidance in the manual section with the "Statement Clarifying the Role of Supervisory Guidance."

Section 2500.0, "Supervision of Savings and Loan Holding Companies"

The material in this section has been revised and moved to section 1020.0. As a result, this section has been removed from the manual. See the description above for section 1020.0 for more information.

Section 3520.0, "Section 4(c)(10) of the BHC Act (Exemption from Section 4 for BHCs That Are Banks)"

This section, previously called "Section 4(c)(10) of the BHC Act (Grandfather Exemption from Section 4 for BHC's Which Are Banks)" was revised to note that at the time of the enactment of the BHC Act, the exemption described in the section accommodated only three BHCs and that these BHCs no longer exist. The section remains in the manual to provide historical background information.

Bank Holding Company Supervision Manual
Supplement 55—November 2021

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the February 2020 supplement.

Section 1050.2, "Consolidated Supervision of Regional Holding Companies"

This section was previously called "Guidance for the Consolidated Supervision of Regional Bank Holding Companies." The section was revised to note that it applies to domestic bank holding companies (BHCs) and savings and loan holding companies (SLHCs) having between $10 billion and $100 billion in total consolidated assets. Several discussions regarding supervisory findings were modified to align more closely with the "Statement Clarifying the Role of Supervisory Guidance" (12 CFR part 262, appendix A). Further, this section was revised to include an outline of the report of inspection that examiners should follow when assigning holding company rating components and subcomponents at full-scope or roll-up inspections of BHCs and SLHCs in the regional banking organization portfolio. The section explains the timing expectations for examination staff to complete safety-and-soundness examination and inspection reports for domestic regional financial institutions and the submission of the reports to the institution. Lastly, references to inactive guidance issuances were updated.

Section 1060.1, "Large Financial Institution Rating System: Capital Planning and Positions"

This new section provides an overview of key capital-related regulations and guidance issuances that apply to firms that are subject to the large financial institution (LFI) rating system. The section describes capital stress testing requirements for BHCs and covered SLHCs with total consolidated assets of $100 billion or more (Regulation YY and Regulation LL). The section also contains an overview of Regulation Q, which establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. A fuller discussion of Regulation Q is provided in the "Assessment of Capital Adequacy" section of the *Commercial Bank Examination Manual.* In addition, the section describes the applicability and purpose of the capital plan rule (Regulation Y and Regulation LL), which requires an LFI to develop an annual capital plan that is approved by its board of directors. This section contains updated information that was previously discussed in section 4060.5, "Capital Adequacy (Advanced Approaches)" and section 4061.0, "Consolidated Capital (Capital Planning)."

Section 1060.2, "Supervisory Assessment of Capital Planning and Positions for Category I Firms"

This new section contains guidance that was previously in section 4063.0, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms." This material was moved closer to the other sections in the manual that provide guidance on the assessment of capital planning and positions at LFIs. Further, this section was modified to cover U.S. BHCs that are subject to category I standards under the Board's tailoring framework. These applicability modifications align with the Board's tailoring rules. See 84 Fed. Reg. 59,032 (November 1, 2019) for more information. See also SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards."

Section 1060.3, "Supervisory Assessment of Capital Planning and Positions for Category II or III Firms"

This new section contains guidance that was previously in section 4065.0, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms." The material was moved closer to the other sections in the manual that provide guidance on the assessment of capital planning and positions at LFIs. Further, this section was modified to cover U.S. BHCs, U.S. intermediate holding companies of foreign banking organizations, and covered SLHCs that are subject to category II or III standards under the Board's tailoring framework. These applicability modifications align with the Board's tailoring rules. See 84 Fed. Reg. 59,032 (November 1, 2019); and SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards."

Section 1060.30, "Supervisory Guidance on Board of Directors' Effectiveness (Governance and Controls)"

This new section is based on SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness." The guidance in this section explains key attributes of effective boards at BHCs and SLHCs that are LFIs. Specifically, this guidance notes that boards of directors at LFIs should: (1) set clear, aligned and consistent direction regarding the firm's strategy and risk appetite; (2) direct senior management regarding the board's information needs; (3) oversee and hold senior management accountable; (4) support the independence and stature of independent risk management and internal audit; and (5) maintain a capable board composition and governance structure. The section also provides an explanation of supervisory considerations in assessing board effectiveness as part of the LFI rating system.

Section 1060.31, "Assessment of Risk-Management Processes and Internal Controls of BHCs Having $100 Billion or More in Total Assets"

This new section was previously section 4070.1. The material was moved closer to the manual's sections on the assignment of ratings for holding companies subject to the LFI rating system. The section was revised to cover the supervision of BHCs having $100 billion or more in total consolidated assets. Further, this section was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management.

Section 1062.1, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion"

This new section was previously section 4071.0. The material in this section was moved closer to the manual's sections on the assignment of ratings for holding companies with less than $100 billion in assets (RFI/C(D) rating system). In addition, the section was revised to cover the supervision of Federal Reserve-regulated institutions with total consolidated assets of less than $100 billion, including state member banks, BHCs, and SLHCs (including insurance and commercial SLHCs); as well as foreign banking organizations with consolidated U.S. assets of less than $100 billion. Previously, the guidance in the section generally applied to the supervision of Federal Reserve-regulated institutions with total consolidated assets of less than $50 billion. Outdated references to SR letters also were removed from the section. See SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 billion."

Section 1070.1, "Communication of Supervisory Findings"

This section was revised to include a reference to the "Statement Clarifying the Role of Supervisory Guidance." This statement, as codified in 12 CFR part 262, implements a September 2018 statement clarifying the differences between regulation and guidance. Unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the Board does not take enforcement actions based on supervisory guidance. Rather, guidance outlines expectations and priorities, or articulates views regarding appropriate practices for a specific subject. See 12 CFR part 262, appendix A; 86 Fed. Reg. 18,179, (April 8, 2021).

Section 1072.0, "Considerations in Assigning and Revising Supervisory Ratings"

This new section was previously section 4070.3, "Revising Supervisory Ratings." The material was moved closer to the other sections in the manual covering aspects of the Federal Reserve's supervisory process. The section was revised to describe considerations for upgrading supervisory ratings at community banking organizations. See SR-12-4, "Upgrades of Supervisory Ratings for Banking Organizations with $10 Billion or Less in Total Consolidated Assets." In addition, the section describes how examiners provide timely and accurate assessments of larger holding company through the LFI rating system.

Section 1080.0, "Federal Reserve System Holding Company Surveillance Program"

This section was formerly section 4080.0, "Federal Reserve System BHC Surveillance Program." The material was moved to be closer to the other sections in the manual covering aspects of the Federal Reserve's supervisory process. Minor technical edits were made to the section.

Section 1080.1, "Surveillance Program for Small Holding Companies"

This section was formerly section 4080.1, "Surveillance Program for Small Holding Companies." The material was moved closer to the other sections in the manual covering aspects of the Federal Reserve's supervisory process. Minor technical edits were made to the section.

Section 2010.12, "Fees Involving Investments of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest"

This section was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management with regards to this activity.

Section 2065.2, "Maintaining and Documenting the Allowance for Loan and Lease Losses"

Section 2065.2, "Determining an Adequate Level for the Allowance for Loan and Lease Losses (Accounting, Reporting, and Disclosure Issues)," was renamed "Maintaining and Documenting the Allowance for Loan and Lease Losses." Section 2065.2 was modified to summarize the contents of the following manual sections, which were based on several SR letters:

- Section 2065.3, "Maintenance of an Appropriate Allowance for Loan and Lease Losses (Accounting, Reporting, and Disclosure Issues)" (See SR-06-17);
- Section 2065.4, "ALLL Methodologies and Documentation (Accounting, Reporting, and Disclosure Issues)" (See SR-01-17); and
- Section 2065.5, "ALLL Estimation Practices for Loans Secured by Junior Liens" (See SR-12-3)

As a result of the changes to section 2065.2, sections 2065.4, and 2065.5 have been removed from the manual. Section 2065.3 "Maintenance of an Appropriate Allowance for Loan and Lease Losses (Accounting, Reporting, and Disclosure Issues)," has been replaced with entirely new content on the "Allowance for Credit Losses." In addition, references to the 2020 interagency guidance on credit-risk review systems were added to section 2065.2. See SR-20-13, "Interagency Guidance on Credit Risk Review Systems."

Section 2065.3, "Allowance for Credit Losses"

This new section provides an overview of the Financial Accounting Standards Board's (FASB) Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The section highlights the Interagency Policy Statement on Allowances for Credit Losses," which was issued by the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and National Credit Union Administration. (See SR-20-12.) The statement describes the measurement of expected credit losses under the current expected credit losses (CECL) methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB Accounting Standards Codification Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate allowances for credit losses (ACLs); the responsibilities of boards of directors and management; and examiners' review of a bank's ACLs. The section also explains the Board's rules providing institutions the option to phase in the day-one adverse effects on regulatory capital that may result transitioning from the incurred loss methodology to the CECL methodology.

Section 2065.4, "ALLL Methodologies and Documentation (Accounting, Reporting, and Disclosure Issues)"

This section has been removed from the manual. See the description above for section 2065.2 for more information on the removal of this section from the manual.

Section 2065.5, "ALLL Estimation Practices for Loans Secured by Junior Liens"

This section has been removed from the manual. See the description above for section 2065.2 for more information on the removal of this section from the manual.

Section 2090.0, "Control and Ownership (General)"

This section was revised to provide an overview of the concept of control as it is applied by the Federal Reserve under the relevant banking and savings and loan-related statutes. The section was revised to include key concepts from a final rule that the Board issued in 2020 on control and divesture proceedings. See 85 Fed. Reg. 12,398 (March 2, 2020).

Section 2122.0, "Internal Credit-Risk Ratings at Large Firms"

This section was renamed and updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management with regards to this activity. Outdated guidance references in the section were updated. In addition, the inspection objectives and procedures were removed.

Section 2124.01, "Risk-Focused Supervision Framework for Large Complex Banking Organizations"

Section 2124.01 was removed from the manual as SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," has been made inactive. Refer to SR-21-4/CA-21-2, "Inactive or Revised SR Letters Related to the Federal Reserve's Supervisory Expectations for a Firm's Boards of Directors."

Section 2124.07, "Compliance Risk-Management Programs and Oversight at Large Firms"

This section was renamed and updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management with regards to implementing compliance risk-management programs.

Section 2124.1, "Assessment of Information Technology in Risk-Focused Supervision"

This section was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management with regards to institutions' use of information technology. Outdated references to information technology tools or processes were removed. Further, the inspection objectives and inspection procedures were removed from the section. More information on inspection objectives and procedures is provided in the *FFIEC IT Examination Handbook.*

Section 2124.3, "Managing Outsourcing Risk"

This section was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management with regards to outsourcing risk.

Section 2125.0, Trading Activities of Banking Organizations (Risk Management and Internal Controls)

Section 2125.0 was removed from the manual as SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations," has been made inactive. Refer to SR-21-4/CA-21-2, "Inactive or Revised SR Letters Related to the Federal Reserve's Supervisory Expectations for a Firm's Boards of Directors."

Section 2126.5, "Volcker Rule (Section 13 of the Bank Holding Company Act)"

This section's title was revised from "Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds." Further, the section was revised to provide an overview of section 13 to the Bank Holding Company Act of 1956 (BHC Act), commonly referred to as the Volcker rule. The Volcker rule generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. The section provides background information on the applicability of the Volcker rule, as well as Regulation VV, which implements the Volcker rule. The section retained salient information related to the procedures that institutions could follow to request an extended transition period for illiquid funds.

Section 2129.05, "Risk and Capital Management—Secondary-Market Credit Activities (Risk Management and Internal Controls)"

This section was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." The material related to SR-97-21, "Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities," was removed from the section as this letter was made inactive. Refer to SR-21-4/CA-21-2, "Inactive or Revised SR Letters Related to the Federal Reserve's Supervisory Expectations for a Firm's Boards of Directors." SR-21-4/CA-21-2 notes that the expectations related to the responsibilities of board of directors will be revised in the *Bank Holding Company Supervision Manual* to be consistent with the guidance in SR-21-3/CA-21-1 as well as SR-16-11.

Section 3500.0, "Prohibitions Against Tying Arrangements"

This section was revised to provide an overview of section 106 of the BHC Act amendments of 1970 (section 106). Section 106, as implemented by the Federal Reserve Board's Regulation Y (12 CFR part 225), prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank. The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services. Several legal interpretations about the application of section 106 were removed from the section because legal interpretations are available on the Board's public website. The inspection objectives and inspections procedures were updated.

Section 3909.0, "Supervisory Guidance on Equity Investment and Merchant Banking Activities (Section 4(k) of the BHC Act)"

This section was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness," and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." Specifically, the section was revised to better reflect the roles and responsibilities of the board of directors and the roles and responsibilities of senior management with regards to this activity.

Section 4020.9, "Supervision Standards for De Novo State Member Banks of Bank Holding Companies"

This section was revised to incorporate updated guidance on the supervision program for de novo state member banks. The section was revised to explain that a state member bank is considered to be in the de novo stage until it has been operating for at least three years. In addition, the section was updated to note that as a condition of membership, the Federal Reserve typically requires each de novo to maintain a tier 1 leverage ratio of at least 8 percent for the first three years of its existence. See SR-20-16, "Supervision of De Novo State Member Banks."

Section 4060.3, "Consolidated Capital (Examiners' Guidelines for Assessing the Capital Adequacy of BHCs)"

Section 4060.3 has been removed from the manual. This section contained outdated information describing the capital adequacy guidelines for BHCs that was previously found in appendix A to Regulation Y (12 CFR part 225). Supervised institutions should refer to the Board's capital rule (12 CFR part 217 or Regulation Q) and the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (12 CFR part 225, appendix C). For more information on Regulation Q, see the *Commercial Bank Examination Manual*'s section entitled, "Assessment of Capital Adequacy." For more information on the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement, see this manual's section 2090.2, "Control and Ownership (BHC Formations)."

Section 4060.5, "Capital Adequacy (Advanced Approaches)"

Section 4060.5 has been removed from the manual. This section described the advanced approaches framework, which provides a risk-based capital framework that requires some bank holding companies to use an internal ratings-based approach to calculate credit-risk capital requirements and advanced measurement approaches in order to calculate regulatory operational-risk capital requirements. The relevant information on the advanced approaches framework is located in section 1060.1, "Large Financial Institution Rating System: Capital Planning and Positions," in the subsection entitled, "Regulation Q (12 CFR 217): Capital Positions." For more information on the advanced approaches framework see 12 CFR part 217, subpart E, as well as the Basel Coordination Committee Bulletins on the Board's public website.

Section 4061.0, "Consolidated Capital (Capital Planning)"

Section 4061.0 has been removed from the manual. Relevant guidance on the capital plan rule (12 CFR 225.8) is in section 1060.1, "Large Financial Institution Rating System: Capital Planning and Positions," in the subsection entitled, "Regulation Y: Capital Plan Rule and Stress Capital Buffer." Section 1060.1 explains the purpose of a firm's capital plan; the applicability of the rule; and the mandatory elements of a capital plan. The tailored capital plan rule sets forth requirements for firms that are subject to category IV standards.

Section 4063.0, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms"

This section has been removed from the manual. See the description above for section 1060.2 for more information on the removal of this section from the manual.

Section 4065.0, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms"

This section has been removed from the manual. See the description above for section 1060.3 for more information on the removal of this section from the manual.

Section 4070.1, "Rating Risk-Management Processes and Internal Controls of BHCs Having $50 Billion or More in Total Assets"

This section has been removed from the manual. See the description above for section 1060.31 for more information on the removal of this section from the manual.

Section 4070.3, "Revising Supervisory Ratings"

The content of this section was revised and moved to section 1072.0, "Considerations in Assigning and Revising Supervisory Ratings." As a result, this section has been removed from the manual. See the description above for section 1072.0 for more information.

Section 4071.0, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion"

This section has been removed from the manual. See the description above for section 1062.1 for more information on the removal of this section from the manual.

Section 4080.0, "Federal Reserve System BHC Surveillance Program"

The material in this section has been moved to section 1080.0. As a result, this section has been removed from the manual. See the description above for section 1080.0 for more information.

Section 4080.1, "Surveillance Program for Small Holding Companies"

The material in this section was moved to section 1080.1. As a result, this section has been removed from the manual. See the description above for section 1080.1 for more information.

Bank Holding Company Supervision Manual
Supplement 54—February 2020

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the February 2019 supplement.

Section 1045.0

The contents of this new section, "Supervision of Holding Companies with Total Consolidated Assets of $10 Billion or Less," were previously in this manual's section 5000.0, "BHC Inspection Program (General)." A standalone section was developed to help clarify the supervisory program for smaller holding companies. The content of the section was revised to modify inspection frequency and scope expectations for holding companies with total consolidated assets between $1 billion and $3 billion. The inspection frequency and scope expectations were modified for this population of holding companies to align with updated statutory requirements as authorized by the Economic Growth, Regulatory Relief, and Consumer Protection Act. References were also updated to reflect that non-commercial and non-insurance savings and loan holding companies (SLHCs) are assigned RFI ratings, effective February 1, 2019. See SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less."

Section 1063.0

This new section, "Holding Company Ratings Applicability and Inspection Frequency," provides an overview of the inspection scope and frequency expectations for bank holding companies (BHCs) and SLHCs supervised by the Federal Reserve. The section explains the applicability of the two rating systems Federal Reserve examiners use to assess the condition of BHCs and SLHCs. The section also provides a table illustrating the inspection scope and frequency expectations for holding companies with less than $10 billion in assets, which is described in more detail in section 1045.0. See also SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion"; SR-19-3/CA-19-2, "Large Financial Institution (LFI) Rating System"; and SR-13-21.

Section 1065.0

This new section, "Nondisclosure of Supervisory Ratings and Confidential Supervisory Information," was previously section 4070.5. The section was moved to section 1065.0 so it would be located closer to the manual's sections on the assignment of ratings for holding companies. In addition, the section was revised to reference the large financial institution (LFI) rating system as another example of confidential supervisory information. Superfluous historical background information was removed from the section. In addition, outdated references to the Office of Thrift Supervision and their holding company rating system were removed from the section.

Section 1070.1

The content of this new section was previously part of section 5000.0, "BHC Inspection Program (General)." The content of section 1070.1 primarily is based on the guidance in SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings." Section 1070.1 highlights that examiners should convey, if evident, both the root cause of the finding and the potential effect of the finding on the organization. The section also includes a reference to SR-18-5/CA-18-7, "Interagency Statement Clarifying the Role of Supervisory Guidance," which examiners should also consider when communicating supervisory findings. Lastly, the section describes key factors examiners should consider in determining whether to recommend additional formal or informal investigation or enforcement action for a holding company.

Section 2231.0

Section 2231.0, "Real Estate Appraisals and Evaluations," has been revised significantly. This section provides a brief summary of the Board's appraisal regulations and directs readers to the key pieces of guidance that the Board and other banking agencies have issued relating to real estate appraisals and evaluations. Previously, the section contained the entire contents of the December 2010 "Interagency Appraisal and Evaluation Guidelines." The revised manual section includes a brief summary of the December 2010 Interagency Appraisal and Evaluation Guidelines, as well as a hyperlink to the guidelines. (See SR-10-16.)

Section 4060.4

Section 4060.4, "Consolidated Capital (Tier 1 Leverage Measure)," has been removed from the manual. The section was outdated and based on regulations that no longer exist. For more information on the leverage ratio, including leverage ratio components and requirements, see the Board's Regulation Q (12 CFR part 217). In addition, the instructions to the FR Y-9C, "Consolidated Financial Statements for Holding Companies," (Schedule HC-R) outline the reporting requirements for the leverage capital ratios.

Section 4070.5

This section, "Nondisclosure of Supervisory Ratings," has been removed from the manual. See the description above for section 1065.0 for more information on the removal of this section from the manual.

Section 4080.1

This section, "Surveillance Program for Small Holding Companies," was modified to alter the applicability of the Federal Reserve's surveillance program for holding companies. The small holding company surveillance program covers holding companies having total consolidated assets of less than $3 billion. Previously, the program covered holding companies having total consolidated assets of less than $1 billion. (See SR-13-21.)

Section 5000.0

Section 5000.0, "BHC Inspection Program (General)," has been revised significantly and is now focused on the coordination of holding company supervisory activities. Much of the relevant content in section 5000.0 was moved to other sections to improve the manual's organization. More specifically, information related to the supervision of holding companies with total consolidated assets $10 billion or less was removed, revised, and incorporated into section 1045.1 of the manual. The section's content related to the communication of supervisory findings was removed and incorporated into section 1070.1 of the manual. In addition, outdated content on the frequency and scope of holding company inspections was removed from this section. Section 1063.0 contains consolidated and updated inspection frequency and scope expectations for holding companies.

Section Tables of Contents

The detailed tables of contents sections, which listed the subheadings within each major part of the manual (parts 2000, 3000, 4000, and 5000) have been removed. Because the Board no longer offers print versions or subscriptions for the manual, these detailed tables of contents sections are obsolete. Manual readers can use the search function within the online version of the manual to find material. The General Table of Contents (section 1010.0) at the beginning of the manual, which provides a broad overview, has been retained.

Bank Holding Company Supervision Manual
Supplement 53—February 2019

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the September 2017 supplement.

Section 1000.0

This section was renamed from "Foreword" to "About this Manual" and now includes the relevant content from sections 1020.0 and 1030.0. In addition, the section clarifies the role of supervisory guidance. A statute or regulation has the force and effect of law. Unlike a law or regulation, supervisory guidance does not have the force and effect of law. Rather, supervisory guidance outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area. See SR letter 18-5/CA letter 18-7, "Interagency Statement Clarifying Role of Supervisory Guidance," for more information.

Section 1020.0

The relevant content of this section, "Preface," was moved to section 1000.0 of this manual. As a result, section 1020.0 was removed from the *Bank Holding Company Supervision Manual.*

Section 1030.0

The relevant content in this section, "Use of the Manual," has been moved to section 1000.0 of this manual. As a result, section 1030.0 was removed from the *Bank Holding Company Supervision Manual.*

Section 1060.0

This new section, "Large Financial Institution Rating System," presents the supervisory rating system adopted in November 2018 for

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

The large financial institution (LFI) rating system represents a supervisory evaluation of whether a firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations and comply with laws and regulations, including those related to consumer protection, through a range of conditions. The LFI rating system is composed of the following three components: (1) Capital Planning and Positions; (2) Liquidity Risk Management and Positions; and (3) Governance and Controls. The Federal Reserve will assign initial LFI ratings to firms in the Large Institution Supervision Coordinating Committee portfolio in early 2019. For all other firms subject to the LFI rating system, the Federal Reserve will assign initial LFI ratings in early 2020. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019). See also SR letter 19-3/CA letter 19-2, "Large Financial Institution (LFI) Rating System."

Section 1062.0

This new section, "RFI Rating System," primarily clarifies which supervisory rating system applies to holding companies with total consolidated assets less than $100 billion. In 2018, the Board adopted the LFI rating system for bank holding companies and non-insurance and non-commercial savings and loan holding companies (SLHCs) with total consolidated assets of $100 billion or more (see section 1060.0). Also in 2018, the Board adopted the RFI rating system for non-insurance and non-commercial SLHCs with total consolidated assets less than $100 billion. See 83 Fed. Reg. 56,081 (November 7, 2018). This section notes all of the bank holding companies and savings and loan holding companies that are subject to the RFI rating system. The elements of the RFI rating system and the ratings' definitions have not changed. The majority of the content in this section, was previously in section 4070, "Bank Holding Company Rating System." See also 69 Fed. Reg. 70,444 (December 6, 2004). However, the RFI rating system guidance was revised to provide current references to regulations and guidance. The manual references have also been revised. See SR letter 19-4/CA letter 19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion," for more information.

Section 2020.7

This section was renamed from "Intercompany Transactions (Transfer of Low-Quality Loans or Other Assets)" to "Intercompany Transactions (Transfer of Low-Quality Assets)." The section was updated to provide the current definition of low-quality assets, as per the Federal Reserve Board's Regulation W (12 CFR 223.3(v)). Outdated references were removed from the section.

Section 2090.2

This section, "Control and Ownership (BHC Formations)," was revised to reflect the Board's August 30, 2018 (effective date) amendment of the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (12 CFR 225, appendix C) to expand the applicability of the policy statement. The interim final rule raised the asset threshold of the policy statement from $1 billion to $3 billion in total consolidated assets. All firms covered by the policy statement must meet certain qualitative requirements, including those pertaining to nonbanking activities, off-balance sheet activities, and publicly registered debt and equity. For the interim final rule, see 83 Fed. Reg. 44,195 (August 30, 2018).

Section 2100.0

This section, "International Banking Activities," was revised to remove outdated information from year-end 2009 regarding the number of member banks, Edge Act corporations and agreement corporations operating in foreign countries and overseas areas of the United States, and entities representing foreign banking organizations operating in the United States. The section also was revised to note that in 2014, the Federal Reserve Board approved a final rule required by section 165 of the Dodd-Frank Act, which requires enhanced prudential standards for large U.S. bank holding companies. Section 165 directed the Board to strengthen supervision and regulation of foreign banking organizations. The section also includes a reference to the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which amended section 165 of the Dodd-Frank Act.

Section 2170.0

This section, "Purchase and Sale of Loans Guaranteed by the U.S. Government," has been removed from the manual. The contents of the section were based on a Federal Financial Institutions Examination Council (FFIEC) policy statement from 1985 on supervising banking organizations that participate in the purchase and sale of loans guaranteed by the U.S. government. The 1985 FFIEC policy statement was rescinded in 1997. See 62 Fed. Reg. 16,158 (April 4, 1997) for more information.

Section 2178.0

This section, "Support of Bank-Affiliated Investment Funds," was revised to clarify that a state member bank's management should notify and consult with the Federal Reserve prior to the bank providing material financial support to its advised funds. The section also was revised to remove a reference to the abolished Office of Thrift Supervision and to update an accounting standards reference. The inspection objectives and inspection procedures were removed from the section. Examination objectives and procedures to review banks providing financial support to advised funds are available in the "Investment-Funds Support" section of the *Commercial Bank Examination Manual.*

Section 4000.0 and section 4020.5

Section 4000.0, "Financial Factors (Introduction)," and section 4020.5, "Banks (Summary Analysis)," were updated to remove references to section 4070.0, which is no longer a section in the *Bank Holding Company Supervision Manual.*

Section 4060.8

Section 4060.8 has been significantly revised. The section was renamed from "Consolidated

Risk-Based Capital—Direct-Credit Substitutes Extended to ABCP Programs" to "Overview of Asset-Backed Commercial Paper Programs." The section was substantially revised because the material did not reflect the current capital rules. The previous capital rules permitted banking organizations with qualifying internal risk-rating systems to use those systems to apply the internal-ratings approach to their un-rated direct-credit substitutes extended to asset-backed commercial paper programs that they sponsored by mapping internal risk ratings to external rating equivalents. The revised capital rules (78 Fed. Reg. 62,018 (October 11, 2013)) replaced references to credit ratings with new measures of credit-worthiness.

Section 4069.0

Section 4069.0, "Dodd-Frank Act Company-Run Stress Testing for Banking Organizations with Total Consolidated Assets $10–50 Billion," has been removed from the *Bank Holding Company Supervision Manual.* Eighteen months after the Economic Growth, Regulatory Relief, and Consumer Protection Act's (EGRRCPA) enactment (May 24, 2018), financial companies with total consolidated assets of less than $250 billion that are not bank holding companies (BHCs) will no longer be subject to the company-run stress testing requirements in section 165(i)(2) of the Dodd-Frank Act. In contrast, on EGRRCPA's date of enactment, BHCs under $100 billion in total consolidated assets were no longer subject to section 165(i)(2). The agencies' regulations implementing company-run stress testing provide that the agencies may extend any deadline relating to company-run stress testing. In order to avoid unnecessary burden for depository institutions and to maintain consistency between BHCs and depository institutions, the agencies are extending the deadlines for all regulatory requirements related to company-run stress testing for depository institutions with average total consolidated assets of less than $100 billion until November 25, 2019 (at which time both statutory exemptions will be in effect). For more information, see the Interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act issued on July 6, 2018.

Section 4070.0

The majority of the content in this section, "Bank Holding Company Rating System," has moved to section 1062.0, "RFI Rating System." In addition to moving the contents to section 1062.0, the information was revised to clarify the applicability of the RFI rating system and to provide current references to regulations and guidance. The elements of the RFI rating system and the ratings' definitions are unchanged. As a result, section 4070.0 was removed from the *Bank Holding Company Supervision Manual.* See section 1062.0 and SR letter 19-4/CA letter 19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion," for more information.

Section 6000.0

This section, the "Alphabetical Subject Index," was removed from the *Bank Holding Company Supervision Manual.* Effective December 31, 2017, the Board no longer offers print versions or subscriptions for the manual, which has rendered the Alphabetical Subject Index obsolete. Manual readers can use the search function within the online version of the manual to find material.

Bank Holding Company Supervision Manual
Supplement 52—September 2017

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the January 2017 supplement.

SUMMARY OF CHANGES

Section 2010.13

Section 2010.13, "Supervision of Subsidiaries (Establishing Accounts for Foreign Governments, Embassies, and Political Figures)," was updated to provide additional guidance, which was conveyed in a 2011 interagency advisory entitled, "Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions." This interagency advisory provides information to financial institutions providing account services to foreign missions in a manner that fulfills the needs of those foreign governments while complying with the provisions of the Bank Secrecy Act. It advises that financial institutions are expected to demonstrate the capacity to conduct appropriate risk assessments and implement the requisite controls and oversight systems to effectively manage the risk identified in these relationships with foreign missions. The 2011 advisory also confirms that it is the financial institution's decision to accept or reject a foreign mission account. See SR letter 11-6, "Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions."

Section 4060.9

Section 4060.9, "Consolidated Capital Planning Processes (Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies)," was updated to clarify that the guidance in the section does not apply to U.S. bank holding companies or intermediate holding companies of foreign banking organizations with $50 billion or more in total consolidated assets. Capital planning guidance for the previously mentioned firms is provided in SR letter 15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms" (section 4063.0.1 of this manual) and SR letter 15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms" (section 4065.0.1 of this manual). In addition, inactive guidance references in this section have been updated.

Section 4069.0

This section, "Dodd-Frank Act Company-Run Stress Testing for Banking Organizations with Total Consolidated Assets of $10–50 Billion," was updated to address changes to the agencies' rules implementing Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) company-run stress testing disclosure requirements since the issuance of SR letter 14-3, "Supervisory Guidance on Dodd-Frank Act Company-Run Stress Testing for Banking Organizations with Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion." For more information on the changes to the Board's stress testing rules, see 80 *Fed. Reg.* 75419 (December 2, 2015).

FILING INSTRUCTIONS

Remove	*Insert*
Title page	revised Title page, updated contact information on the reverse page
2000 Table of Contents, pages 4.1–4.2	2000 Table of Contents, pages 4.1–4.2
2010.13, pages 1–2	2010.13, pages 1–2
4060.9, pages 1–7	4060.9, pages 1–7
4069.0, pages 1–4	4069.0, pages 1–4

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the July 2016 supplement.

SUMMARY OF CHANGES

Section 2126.5

Section 2126.5, "Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds," is a new section that provides applicable banking entities with information on the procedures for submitting a request for an extended transition period for a hedge fund or private equity fund that qualifies as an illiquid fund pursuant to section 13 of the Bank Holding Company Act of 1956 (BHC Act), also known as the Volcker rule. Under the statute, a banking entity must apply to the Board for an extended transition period for an illiquid fund regardless of the banking entity's primary financial regulatory agency. The term "banking entity" is defined by statute to include, with limited exceptions: (i) any insured depository institution (IDI) (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (ii) any company that controls an IDI (including a bank holding company (BHC), savings and loan holding company (SLHC), and any other company that controls an insured depository institution but that is not a BHC or SLHC, such as the parent company of an industrial loan company); (iii) any company that is treated as a BHC for purposes of section 8(a) of the International Banking Act of 1978 (for example, any foreign bank operating a branch or agency in the United States); and (iv) any affiliate or subsidiary of any of the foregoing (for example, a broker–dealer subsidiary of a BHC). (Refer to SR-16-18.)

Section 3140.0

This section, "Section 4(c)(8) of the BHC Act (Leasing Personal or Real Property)," has been revised to include a brief summary of a June 10, 2016, Board order (FRB Order no. 2016-07) that approved a notice by a foreign bank holding company and its foreign wholly owned subsidiary bank to engage in permissible nonbanking activities under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y. The nonbanking activities include railcar leasing and the provision of certain railcar fleet management services pursuant to sections 225.28(b)(3) and 225.21(a)(2) of Regulation Y. The corresponding table of Laws, Regulations, Interpretations, and Orders has been amended to include the order.

FILING INSTRUCTIONS

Remove	*Insert*
1010.0 Table of Contents, pages 5–6, pages 6.1–6.2	1010.0 Table of Contents, pages 5–6, pages 6.1–6.2
2000 Table of Contents, pages 17–18, pages 18.1–18.2	2000 Table of Contents, pages 17–18, pages 18.1–18.2
	2126.5, pages 1–3
3000 Table of Contents, pages 7–8	3000 Table of Contents, pages 7–8
3140.0, pages 1–4, 4.1 pages 11–12	3140.0, pages 1–4, 4.1 pages 11–12

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Banking Supervision and Regulation has issued since the publication of the January 2016 supplement.

SUMMARY OF CHANGES

Section 1050.2

Section 1050.2, "Guidance for the Consolidated Supervision of Regional Bank Holding Companies," is revised (beginning at subsection 1050.2.5) to include guidance for regional banking organizations based on SR-16-4, "Relying on the Work of the Regulators of Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $50 Billion." The letter was issued by the Federal Reserve to explain its expectations for its examiners' reliance on the work of the regulators of insured depository institution subsidiaries of these holding companies. The letter presents a tailored supervisory approach for regional banking organizations, which are defined as companies with total consolidated assets of between $10 billion and $50 billion.

Section 4066.0

Section 4066.0, "Consolidated (Funding and Liquidity Risk Management)," is amended at subsection 4066.0.2 to include "Appendix B - Interagency Guidance on Funds Transfer Pricing Related to Funding and Contingent Liquidity Risks," issued March 1, 2016. The guidance was issued to address weaknesses observed in some large financial institutions' funds transfer pricing practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk. (Refer to SR-16-03 and to the March 1, 2016, attachment to the interagency guidance, "Illustrative Funds Transfer Pricing Methodologies.")

Section 4070.1

Section 4070.1, "Rating...Risk Management Processes and Internal Controls of BHCs..." is partially superseded as the result of the issuance of SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion." With the issuance of SR-16-11, SR-95-51 (section 4070.1) is applicable only to bank holding companies and state member banks having $50 billion or more in total assets.

Section 4071.0

Section 4071.0, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion," is a new section that reaffirms the Federal Reserve's long-standing supervisory approach that emphasizes the importance of prudent risk management. This section's guidance and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less Than $50 Billion," outlines core risk categories and risk-management principles. This supervisory guidance reflects updates to, and partially supersedes, SR-95-51, "Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies." The guidance in SR-16-11 provides clarifications on, and distinguishes supervisory expectations for, the roles and responsibilities of the board of directors and senior management. The risk-management expectations within this guidance are applicable to all supervised institutions with total consolidated assets of less than $50 billion, including bank holding companies, state member banks, savings and loan holding companies, and foreign banking organizations with total combined U.S. assets of less than $50 billion. The guidance also applies to insurance and commercial savings and loan holding companies with total consolidated assets of less than $50 billion.

Substantive changes that are included in SR-16-11 (when compared to SR-95-51) are:

1. Certain major risk categories are modified.
   a. Compliance risk is a separate core risk;
   b. Reputation risk is not considered a core risk
   c. Risk definitions that are revised:
      i. Operational risk is the risk resulting from inadequate or failed internal processes, people, and systems or from external events.
      ii. Market risk includes commodity prices
      iii. Legal risk includes legal sanctions

2. The responsibilities of the board of directors versus senior management are separated across all risk-management components.
   a. Senior management is responsible for risk identification.
   b. Senior management is responsible for the establishment and maintenance of effective information systems.
   c. Both the board of directors and senior management are responsible for an effective system of internal controls.

3. Additional risk-management concepts are included:
   a. Information systems should consist of a consolidated and integrated view of risks.
   b. The board of directors should approve significant policies to establish risk tolerances for the institution's activities.

Section 5000.0

Section 5000.0, "BHC Inspection Program (General)," is revised at subsection 5000.0.4.3.05 to provide additional guidance on the supervisory approach to be used for holding companies with total consolidated assets of $10 billion or less. The guidance pertains to relying on the work of insured depository institution (IDI) regulators for community banking organizations. Examiners are to rely substantially on the findings of the IDI regulator in evaluating the overall condition of the holding company. Reserve Bank reviews are to evaluate the condition, performance, and prospects of a subsidiary IDI based on the conclusion of the IDI regulator and are not to duplicate the IDI regulator's work. (Refer to SR-16-4.)

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Bank Holding Company Supervision Manual
Supplement 49—January 2016

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Banking Supervision and Regulation has issued since the publication of the July 2015 supplement.

SUMMARY OF CHANGES

Section 2060.1

Section 2060.1, "Audit (Management Information Systems)," is revised (beginning at subsection 2060.1.8) to include an Overview and Appendix A—"Interagency Advisory on External Audits of Internationally Active U. S. Financial Institutions." The federal banking agencies[1] (the agencies) issued the advisory to communicate their support for the principles and expectations that are set forth in Parts 1 and 2, respectively, of the Basle Committee on Banking Supervision (the BCBS) March 2014 guidance on "External audits of banks."

The agencies acknowledge that the existing standards and practices in the United States are broadly consistent with the BCBS external audit guidance. Because of the legal and regulatory framework in the United Sates, certain differences exist between the standards and practices followed in the United States and the principles and expectations in the BCBS external audit guidance. These differences are addressed in this advisory, which also describes the agencies' supervisory expectations for U. S. financial institutions within the scope of the advisory for incorporating the principles and expectations in the BCBS external audit guidance into their practices. The advisory also outlines examiner responsibilities related to these supervisory expectations.

The BCBS external audit guidance is intended for "internationally active banks," which, the agencies defined in the advisory (Refer to SR-16-2 and its attachment.)

Section 2093.0

Section 2093.0, "Control and Ownership (Shareholder Protection Arrangements)" is a new section that discusses Federal Reserve supervisory concerns and issues regarding the establishment of arrangements by some bank and savings and loan holding companies (collectively, "holding companies") to protect the financial investments made by shareholders (collectively, "shareholder protection arrangements"). There has been an increase in interest by some holding companies to benefit certain shareholders, enhance short-term investor returns, and/or provide a distinct disincentive for investors to acquire or increase ownership in a holding company's common stock and other capital instruments. Such shareholder protection arrangements raise concerns because they could have negative implications on a holding company's capital or financial position, limit a holding company's financial flexibility and capital raising capacity, or otherwise impair a holding company's ability to raise additional capital in the future. These arrangements impede the ability of a holding company to serve as a source of strength to its insured depository institutions subsidiaries and are considered unsafe and unsound. A holding company, regardless of its asset size, should be aware that the Federal Reserve may object to a shareholder protection arrangement based on the facts and circumstances and the features of the particular arrangement. Examples of shareholder protection arrangements that have raised supervisory issues are discussed. (Refer to SR-15-15.)

Section 4061.0

Section 4061.0, "Consolidated Capital (Capital Planning)," is revised for amendments to Regulation Y, 12 C.F.R. 225.8 "Capital Planning." The rule was amended to limit the ability of a bank holding company with $50 billion or more in total consolidated assets to make capital distributions under the rule if the bank holding company's net capital issuances are less than the amount indicated in its capital plan. The tier 1 common capital ratio requirement was removed, and certain mandatory capital action assumptions were modified. (Refer to 79 *Fed. Reg.* 64040 (October 27, 2014) and 80 *Fed. Reg.* 75424 (December 2, 2015)).

1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Section 4060.7

Section 4060.7, Consolidated Capital (Assessing Capital Adequacy and Risk at Large Banking Organizations and Others with Complex Risk Profiles) is deleted. The section was derived from SR-99-18, superseded by SR-15-18 and SR-15-19, both issued on December 18, 2015.

Section 4063.0

Section 4063.0, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms," is a new section consisting of Federal Reserve guidance that was issued to explain its expectations for capital planning at Large Institution Supervision Coordinating Committee (LISCC) firms and large and complex bank holding companies and intermediate holding companies of foreign banking organizations. This guidance is consistent with the broad supervisory expectations set forth in SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions." It sets forth the Federal Reserve's core capital planning expectations for LISCC and large and complex firms. Several appendices are included that detail supervisory expectations on a firm's capital planning processes. The new guidance largely consolidates the Federal Reserve's existing capital planning guidance.

The expectations for LISCC Firms and Large and Complex Firms are higher than the expectations for Large and Noncomplex Firms. Within the group of firms subject to this guidance, the Federal Reserve has significantly heightened expectations for the LISCC Firms. This guidance sets forth only minimum expectations, and LISCC Firms are consistently expected to exceed those minimum standards and have the most sophisticated, comprehensive, and robust capital planning practices for all of their portfolios and activities. Refer to SR-15-18 and its attachment.

Section 4065.0

Section 4065.0, "Federal Reserve Supervisory Assessment of Capital Planning And Positions for Large and Noncomplex Firms," The Federal Reserve's guidance explains its supervisory expectations for capital planning at large and noncomplex bank holding companies and intermediate holding companies of foreign banking organizations, consistent with the broad supervisory expectations set forth in SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions." This guidance applies to U.S. bank holding companies and intermediate holding companies of foreign banking organizations that have total consolidated assets of at least $50 billion but less than $250 billion, have consolidated total on-balance sheet foreign exposure of less than $10 billion, and are not otherwise subject to the Federal Reserve's LISIC framework (referred to as a "Large and Noncomplex Firm"). Refer to SR-15-19 and its attachment.

Section 4080.0

Section 4080.0, "Federal Reserve System Bank Holding Company Surveillance Program," is revised to discuss the Federal Reserve's revision of its safety-and-soundness surveillance program (the Surveillance Program) for top-tier bank holding companies and savings and loan holding companies (HCs). The revised program includes a new early warning model for HCs, the *"Holding Company Statistical Assessment of Bank Risk"* or "HC-SABR" model. It deploys risk identification algorithms ("Outlier Metrics") and other surveillance products to process financial and economic data and generate forward-looking, actionable intelligence on HCs that will provide examiners and other supervisory staff with early signals by which to monitor risk-taking. Results are used to assess exposures, outlooks, and possible compliance shortcomings, with the goal of calibrating supervisory resources to risk. The Surveillance Program's objectives, structure, and maintenance are discussed along with additional information on the metrics, procedures, and write-up requirements used to monitor HCs. The program also distributes surveillance results across the Federal Reserve's supervision function. (Refer to SR-15-16 and its attachment.)

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Bank Holding Company Supervision Manual
Supplement 48—July 2015

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Banking Supervision and Regulation has issued since the publication of the January 2015 supplement.

SUMMARY OF CHANGES

Section 2010.2

Section 2010.2, “Supervision of Subsidiaries (Loan Administration and Lending Standards),” is revised (subsection 2010.2.4.1.9) to remove a footnote reference to SR letter 02-16, “Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations,” which is superseded by SR letter 15-6, “Interagency Frequently Asked Questions (FAQs) on the Regulatory Capital Rule.”

Section 2090.2

Section 2090.2, “Control and Ownership (BHC Formations),” has been revised to include the Board’s April 9, 2015, approval of its Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (effective May 15, 2015). This policy statement expands the applicability of the former policy statement to include savings and loan holding companies (SLHCs). The policy applies to those bank holding companies (BHCs) and certain SLHCs that have consolidated assets of less than $1 billion. Previously, the policy only applied to BHCs having consolidated assets of less than $500 million.

Section 2128.03

Section 2128.03, “Credit-Supported and Asset-Backed Commercial Paper (Risk Management and Internal Controls) is revised (subsection 2128.03.3.3) to delete a footnote reference to SR letter 05-13 and its attachment, “Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Program Liquidity Facilities and the Resulting Risk-Based Capital Treatment,” which is superseded by SR letter 15-6 “Interagency Frequently Asked Questions on the Regulatory Capital Rule.”

Section 2500.0

This section, “Supervision of Savings and Loan Holding Companies” was revised to include a reference to SR letter 14-9, “Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program,” which provides a listing of supervisory guidance documents (SR letters) that were issued prior to July 21, 2011. The Federal Reserve has determined that these SR letters are applicable to savings and loan holding companies.

Section 3070.3

This section, “Section 4(c)(8) of the BHC Act (Non-Traditional Mortgages–Associated Risks),” is revised to delete a footnote reference to SR letter 02-16, “Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations,” and its attachment, which is superseded by SR letter 15-6 “Interagency Frequently Asked Questions on the Regulatory Capital Rule.” Refer to subsection 3070.3.2.5. “Secondary Market Activity.”

Section 3111.0

This section, “Section 4(c)(8) of the BHC Act (Acquisition of Savings Associations)” includes (subsection 3111.0.3) reference corrections to listed Board orders that authorized the acquisition of savings associations.

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PURPOSE AND THE ROLE OF GUIDANCE

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

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

This manual is designed to provide guidance to examination and supervision personnel. *It should not be considered a legal reference document.* Questions concerning the applicability of and compliance with federal laws and regulations should be referred to appropriate legal counsel.

USE OF THE MANUAL

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

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

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

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

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

TYPES OF HOLDING COMPANIES

Bank Holding Companies (Including Financial Holding Companies)

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

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

Savings and Loan Holding Companies

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

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

1020.0.1 INTRODUCTION

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

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

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

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

2. 12 U.S.C. § 1467a(*l*).

3. Ch. 240, 70 Stat. 133.

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

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

1020.0.3 KEY STATUTES, REGULATIONS, AND GUIDANCE THAT APPLY TO SLHCS

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

1020.0.3.1 Regulation LL

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

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

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

5. 12 U.S.C. § 5414(b).

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

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

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

Safe and Sound Operations

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

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

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

1020.0.3.2 Regulation MM

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

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

1020.0.3.3 Regulation Q

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

7. 12 C.F.R. 238.170.
8. 12 C.F.R. 238.10.
9. Public Law 115–174, 132 Stat. 1296 (2018). SLHCs significantly engaged in insurance activities are generally exempt from most of these requirements.
10. For more information, see this manual's section 2010.0, entitled "Supervision of Subsidiaries," specifically subsection 2010.0.1, entitled "Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks."
11. 12 C.F.R. 238.8(a)(1).

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

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

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

1020.0.3.4 Applicable Guidance to SLHCs

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

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

1020.0.4 GENERAL SUPERVISORY APPROACH IN ASSESSING SLHCS

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

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

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

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

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

In the supervision of BHCs and SLHCs, Federal Reserve examiners rely on the work of the regulators of insured depository institution (IDI) subsidiaries. The principle of relying on the work of the IDI regulators is a well-established tenet of Federal Reserve supervisory policy and is required by statute.[14] BHC and SLHC supervision focuses on the Federal Reserve's assessment of the consolidated organization based on a review of parent and nonbank activities, together with an assessment of the organization's IDI subsidiaries. When assigning Federal Reserve supervisory ratings to BHCs and SLHCs where the Federal Reserve is not the IDI regulator, the Federal Reserve will rely, to the fullest extent possible, on the assessment of the IDI as reflected in the examination work performed by the IDI regulator(s). For more information, see SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion."

1020.0.4.1 Supervisory Portfolios and Types of SLHCs

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

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

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

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

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

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

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

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

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

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

1020.0.4.2 Assignment of Supervisory Ratings

CORE Rating System

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

Indicative RFI Ratings

In 2011, the Board began transitioning SLHCs to the Board's "RFI/C(D)" rating system (commonly referred to as "RFI"), applicable to BHCs. The Federal Reserve decided to issue "indicative RFI ratings" to SLHCs until such time that a rating system was formally adopted for these companies.[17] Indicative ratings were issued to SLHCs as a way of providing feedback to SLHCs regarding their performance relative to supervisory expectations. Further, indicative ratings described how the SLHC would be rated under the RFI rating system if applied to the company. Similar to traditional inspections, the findings accompanying the indicative rating included detailed descriptions of deficiencies that need to be addressed by management and/or the board of directors.

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

Assignment of RFI Ratings

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

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

17. For more information on the RFI rating system, see SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion," and this manual's section 1062.0, "RFI Rating System."
18. See 83 Fed. Reg. 56,081 (November 7, 2018).

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

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

Large Financial Institutions Rating System

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

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

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

Regulation LL restricts SLHCs from commencing certain activities without the Federal Reserve's prior approval unless the company received a composite rating of 1 or 2 at its most recent examination.[20] After the issuance of the LFI ratings system, the Federal Reserve amended regulatory provisions so that they will apply to entities that receive numerical composite ratings, as well as to entities that do not receive numerical composite ratings (including firms subject to the LFI rating system). To be considered satisfactory, an SLHC under the LFI ratings system would have to be rated "Broadly Meets Expectations" or "Conditionally Meets Expectations" for each component of the LFI rating system. An SLHC rated "Deficient-1" or lower for any component would not be considered satisfactory. This standard applies to any provision contained in the Federal Reserve's regulations, which requires or refers to a firm having a satisfactory composite rating.

Supervisory Framework and Rating System for Insurance Organizations

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

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

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

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

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

ally Meets Expectations, Deficient-1, and Deficient-2) to each of the three rating components (Capital Management, Liquidity Management, and Governance & Controls) used to assess supervised insurance organizations.[22]
- *Incorporating the work of other supervisors*: Similar to the approach taken by the Federal Reserve in its consolidated supervision of other firms, the oversight of supervised insurance organizations relies, to the fullest extent possible, on work performed by other relevant supervisors.

1020.0.5 SPECIFIC ISSUES RELATED TO THE SUPERVISION OF SLHCS

1020.0.5.1 Qualified Thrift Lender and the Qualified Thrift Lender Test

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

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

1020.0.5.2 Covered Savings Associations

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

Applicability Considerations

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

1. existed on December 31, 2017, and
2. had $20 billion or less in total assets as reported on its December 31, 2017, Call Report.[30]

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

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22. To be considered "well managed," a firm must receive a rating of "Conditionally Meets Expectations" or better in each of the three rating components. Each rating is defined specifically for supervised insurance organizations with particular emphasis on the obligation that firms serve as a source of financial and managerial strength for their depository institution(s).
23. 12 U.S.C. 1467a(m).
24. 12 U.S.C. 1467a(l).
25. 12 U.S.C. 1467a(m)(1).
26. Public Law 115–174, 132 Stat. 1310; 12 U.S.C. 1464a.
27. 12 U.S.C. § 1464a(c); 12 C.F.R. 101.4(a)(1).
28. See 84 Fed. Reg. 23,991 (May 24, 2019).
29. 12 U.S.C. § 1464a(d); 12 C.F.R. 101.4(a)(2).
30. 12 U.S.C. § 1464a(1); 12 C.F.R. 101.3(a)(1).
31. See *Frequently Asked Questions: Implementation of Covered Savings Association Final Rule*, Office of the Comptroller of the Currency, OCC 2019-31 (July 2019), at 5 ("OCC FAQs").

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

Federal Reserve Legal Interpretations of CSAs and Holding Companies over CSAs

The Federal Reserve Act does not address the treatment of CSAs for purposes of compliance with the affiliate transaction rules in sections 23A and 23B of the Federal Reserve Act (as implemented by the Board's Regulation W, 12 C.F.R. part 223) or membership in the Federal Reserve System (12 C.F.R. part 208). On April 1, 2021, the Federal Reserve published legal interpretations regarding the treatment of CSAs, clarifying that a CSA is subject to the same requirements regarding membership in the Federal Reserve System and the same prohibitions on affiliate transactions, under sections 23A and 23B of the Federal Reserve Act, as a national bank.[34]

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

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

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

WHAT'S NEW IN THIS REVISED SECTION

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

1040.0.1 BHC INSPECTIONS

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

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

1040.0.1.1 Authority for Bank Holding Company Inspections

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

1040.0.2 FOCUS AND SCOPE OF BHC INSPECTIONS

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

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

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

1. See 12 U.S.C. 1844.
2. Supervisory staff includes individuals that are on and/or off site.

1040.0.3 EXAMINATIONS OF FUNCTIONALLY REGULATED SUBSIDIARIES

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

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

1040.0.3.1 Use of Examination Reports and Information

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

1040.0.3.2 Coordination with Other Regulators

The Board is to

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

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

1040.0.4 SUPERVISION OF A NONBANK FINANCIAL COMPANY

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

1045.0.1 OVERVIEW AND RELIANCE ON THE INSURED DEPOSITORY INSTITUTION REGULATOR

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

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

The Reserve Bank evaluates the condition, performance, and prospects of the subsidiary IDI based on the conclusions of the IDI regulator and makes best efforts not to duplicate the work of other prudential regulators. Refer to SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion."

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

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

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

1045.0.2 DEFINITION OF COMPLEX HOLDING COMPANIES

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

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

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

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

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

1045.0.3 SUPERVISION AND SURVEILLANCE APPROACH

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

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

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

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

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

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

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

2. See SR-19-4/CA-19-3, "Supervisory Rating Systems for Holding Companies with Consolidated Assets Less Than $100 billion," and section 1062.0 of this manual.

1045.0.4.1 Complex Holding Companies

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

1045.0.4.2 Noncomplex Holding Companies

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

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

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

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

1045.0.5.1 Complex Holding Companies

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

- Any on-site review should be targeted at those areas where additional information or analysis is needed to assign a complete supervisory rating.

1045.0.5.2 Noncomplex Holding Companies

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

1045.0.6 INSPECTION REPORT CONTENT FOR CBO HOLDING COMPANIES

1045.0.6.1 Inspection Report Content for Small Noncomplex Holding Companies

As noted above, the supervisory cycle for noncomplex holding companies with less than $3 billion in total consolidated assets (“small noncomplex holding companies”) generally is determined by the examination frequency of the lead IDI subsidiary. Small noncomplex holding companies are assigned a risk-management rating and a composite rating from the RFI/C(D) rating system. Furthermore, Federal Reserve examiners rely on the primary regulator’s work on the subsidiary IDI.[3] At small noncomplex holding companies, Federal Reserve examination staff focus their review at the parent holding company and any nonbanking activities.

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

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

All reports will contain the following information:

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

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

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

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

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

- *Overall Conclusion:* A discussion about the overall conclusion of the offsite review is included in the inspection report for holding companies rated "3" or worse. The contents of this heading will depend on the specific circumstances, such as multiple depository institution subsidiaries or a material nonbank subsidiary. This section may also be used for 1- or 2-rated companies if the examiner needs to convey a specific message to management.
- *Source of Strength:* The report may include language that a BHC or a SLHC is expected to act as a source of managerial and financial strength to its subsidiary depository institutions.[4] The report will inform holding company management and the board of directors to take steps to conserve assets and other resources for the benefit of the depository institution and keep the Reserve Bank informed of such measures.
- *Matters Requiring Attention:* This language is included in the report when examination staff cite a Matter Requiring Immediate Attention (MRIA) or Matter Requiring Attention (MRA). The definitions of MRIAs and MRAs, or references to the guidance defining MRIAs and MRAs, should be included as a footnote in the report.[5] The report should also provide a reference to the Statement Clarifying the Role of Supervisory Guidance.[6]
- *Enforcement Action:* This heading is included in the report if the holding company is under an enforcement action, will be placed under an enforcement action, or is communicating the termination of an enforcement action. Several factors dictate the contents of this heading language, such as
  - action status (initiate, continue, or terminate);
  - type of action (informal actions vs. formal actions);
  - whether the informal action is enclosed in the inspection report or will be communicated in a separate cover; and
  - whether the holding company is in noncompliance with the financial holding company requirements of section 4(*l*) of the Bank Holding Company Act and is therefore subject to the provision of section 4(m).
- *Troubled Condition:* If the holding company is determined to be in troubled condition, the report will communicate this information to the holding company. The report will also indicate whether the holding company is no longer considered to be in troubled condition. Furthermore, the section will also include references to relevant regulations and guidance, including
  - 12 CFR 225.71 (Regulation Y)
  - 12 CFR 238.72 (Regulation LL)
  - SR-19-12, "Statement Regarding Insurance Policies for Directors and Officers"
  - SR-03-6, "Guidance Regarding Restrictions on Institutions in Troubled Condition"
  - SR-02-17, "Guidance Regarding Indemnification Agreements and Payments"

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

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

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

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

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

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

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

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

Section 1001.1, “Community Bank Supervision Process,” of the *Commercial Bank Examination Manual* describes the use of a letter-format examination report in lieu of the standard, longer-form report for communicating the findings of safety-and-soundness examinations and inspections of community banking organizations that result in composite supervisory ratings of “4” or “5.” The purpose of using the letter format for these poorly rated institutions is to enable Reserve Bank examination staff to focus their reports on key findings and improve the communication of supervisory expectations to companies in need of significant improvement. Furthermore, these institutions are examined with increased frequency, and the letter format hastens the communication of supervisory expectations to the institution.[7]

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

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

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

1045.0.7 COMPLETION STANDARD FOR EXAMINATION AND INSPECTION REPORTS

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

7. See also SR-19-5, “Communication Expectations for Community Bank Examinations and Inspections.”

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

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

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

Further, to ensure that findings are communicated to a supervised institution in a timely manner, Reserve Banks should ensure that the duration between the start of an examination/inspection to the completion and delivery of an examination/inspection report does not exceed 90 days.[10] In cases when reports are subject to statutory requirements for other state or federal agency review, such as by the Consumer Financial Protection Bureau (CFPB),[11] Reserve Banks may exceed these guidelines at the discretion of senior management. However, deviations from these guidelines are expected to be rare. At the discretion of senior Reserve Bank management, additional exemptions from this 90-day guideline may be considered for examinations that are conducted simultaneously on multiple affiliated banks or examinations of larger complex CBOs that require additional time on-site to review specialized or complex business lines.

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

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

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

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

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

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

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

WHAT'S NEW IN THIS REVISED SECTION

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

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

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

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

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

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

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

1. See Attachment C to SR-08-9/CA-08-12 or this section's appendix for the definitions of "core clearing and settlement organizations," "critical financial markets," and "key financial markets."

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

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

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

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

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

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

Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant primary supervisors and functional regulators.[4] These relation-

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

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

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

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

Similarly, the Federal Reserve seeks to assist relevant primary supervisors and functional regulators in performing their supervisory responsibilities with respect to regulated subsidiaries by sharing pertinent information that relates to these regulated subsidiaries consistent with each agency's supervisory responsibilities and applicable law. Examples include shared information relating to the financial condition, risk-management policies, and operations of a banking organization that may have a material impact on regulated subsidiaries, as well as information concerning transactions or relationships between regulated subsidiaries and their affiliates.

1050.0.2 KEY OBJECTIVES FOR, AND APPROACHES TO, CONSOLIDATED SUPERVISION

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

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

5. See SR-00-13.

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

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

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

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

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

1050.0.2.1 Key Supervisory Objectives

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

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

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

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

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

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

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

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

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

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

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

1050.0.2.1.3 Interagency Coordination

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

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

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

1050.0.2.2 Risk-Focused Approach to Consolidated Supervision

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

The Federal Reserve also focuses special supervisory attention on the risk-management systems and internal controls used by core clearing and settlement organizations or organizations that have a significant presence in key financial markets. In light of the potential for problems in these areas to transmit an adverse impact across the banking and financial system, these activities pose special legal, reputational, and other risks to the banking organization and its depository institution subsidiaries. The Federal Reserve has unique expertise and perspective in these areas based on its broader central bank responsibilities and functions.

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

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

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

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

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

1050.0.2.3 Supervisory Portfolios

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

BHC Portfolios:

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

FBO Portfolios:

- large complex foreign banking organizations (LCBO FBOs)
- multi-office foreign banking organizations (multi-office FBOs)
- single-office foreign banking organizations (single-office FBOs)

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

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

1050.0.3 SUPERVISORY GUIDANCE

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

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

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

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

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

1050.0.3.1 Overview of Significant Federal Reserve Supervisory Activities

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

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

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

1. key corporate governance functions, including internal audit;
2. risk management and internal control functions for primary risks of the consolidated organization (or combined U.S. operations for FBOs), and supporting MIS;
3. where applicable, core clearing and settlement activities and related risk management and internal controls of firms that are large-value payment system operators and market utilities;
4. for LCBOs, activities in critical or key financial markets in which the organization plays a significant role, as well as related risk management and internal controls;
5. where applicable, areas of emerging interest with potential financial market consequences;
6. consolidated financial strength (in the case of FBOs, the financial strength of combined U.S. operations);
7. risk management and financial condition of significant nonbank subsidiaries; and
8. parent company and nonbank funding and liquidity (in the case of FBOs, funding and liquidity of U.S. operations).

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

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

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

- internal audit infrastructure;

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

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

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

In conducting the activities described in the guidance, the Federal Reserve will rely to the fullest extent possible on the information and assessments of relevant primary supervisors and functional regulators, and will work with such supervisors and regulators to align each agency's assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of consolidated BHC or combined U.S. FBO operations, as applicable. In addition, because of the specific statutory limitations that apply with respect to functionally regulated subsidiaries of a BHC or FBO, the Federal Reserve will continue to adhere to the procedures and limits described in SR-00-13 (see sections 3900.0 and 1040.0) in conducting any examination of, or requesting a specialized report from, a functionally regulated subsidiary of a BHC or FBO.[16] Under these provisions, for example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it reasonably determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.

1050.0.3.2 Application of Supervisory Guidance

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

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

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

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

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

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

1050.0.4 APPENDIX—DEFINITIONS OF KEY TERMS FOR CONSOLIDATED SUPERVISION

1050.0.4.1 Supervisory Objectives

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

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

1050.0.4.2 Supervisory Activities

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

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

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

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

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

1050.0.4.3 Foreign Banking Organization Supervision

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

Comprehensive, consolidated supervision: An FBO is supervised or regulated in such a manner that its home-country supervisor receives sufficient information on the worldwide operations of the FBO (including the relationship of the bank to any affiliate) to assess the FBO's overall financial condition and compliance with law and regulation. The Foreign Bank Supervision Enhancement Act of 1991 introduced the requirement that the Federal Reserve approve the establishment of all *U.S. banking offices* of FBOs, and in that connection, take into account whether the FBO is subject to comprehensive, consolidated supervision by its home-country supervisor.

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

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

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

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

Traded through: Transacted or arranged by the personnel of the institution in question (in an agent role), but booked at a different related legal entity. For supervisory purposes, the U.S. operations of FBOs include activities that are *booked in* or traded through U.S. operations.

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

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

1050.0.4.4 Other Terms

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

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

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

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

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

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

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

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

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

Key corporate governance functions: Primary firmwide governance mechanisms relied upon by the board of directors and senior management. This includes the board and its committees, senior management and its executive committees, internal audit, and other functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining the consolidated organization as well as a firm's business resiliency and crisis management capabilities.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

WHAT'S NEW IN THIS REVISED SECTION

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

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

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

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

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

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

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

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

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

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

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

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

1050.1.1.2—Functionally Regulated Subsidiaries

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

1050.1.2 UNDERSTANDING THE ORGANIZATION

For each large complex BHC, the Federal Reserve will develop an understanding of the legal, operating, and corporate governance structure of the organization and its primary strategies, business lines, and risk-management and internal control functions.[6] This understanding will inform the development of a risk assessment and supervisory plan for the BHC. Typically, the information necessary to gain this understanding may be obtained from the organization's management, public reports, regulatory reports, surveillance screens, third-party sources (e.g., credit rating agency and market analyst reports), and other relevant primary supervisors or functional regulators. Key elements that should be identified and understood include the following:

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

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

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

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

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

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

1050.1.3 ASSESSING THE LARGE COMPLEX BHC ON A CONSOLIDATED BASIS

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

1050.1.3.1 Risk Management

1050.1.3.1.1 Key Corporate Governance Functions

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

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

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

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

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

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

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

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

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

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

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

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

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

9. Active participation by the Federal Reserve in an exami-

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

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

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

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

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

The Federal Reserve will understand and assess risk-management and control functions for primary risks to the consolidated organization (primary firmwide risk-management and control functions), and associated MIS, for each large complex BHC. This will include risk-management and control functions for primary credit, legal and compliance,[10] liquidity, market, operational, and reputational risks for the consolidated organization. The Federal Reserve also will understand and assess other risk-management and control functions that, based on the specific characteristics and activities of the individual BHC, relate to primary risks to the organization as a whole.

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

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

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

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

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

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

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

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

Supervisory Activities: The Federal Reserve will use continuous monitoring activities to understand and assess each primary firmwide risk-management or control function. This process begins with the overarching design and architecture of each primary firmwide risk-management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in section 1050.1.3.1.3 below). Activities will verify the sufficiency of fundamental aspects of internal controls in relation to the holding company's current risk profile and in comparison with supervisory expectations and evolving sound practices and assess the capability of these primary functions (whether centralized or decentralized) to remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

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

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

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

1050.1.3.1.3 Risk Management of Material Portfolios and Business Lines

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

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

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

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

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

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

Many activities of large complex BHCs span legal entities that are subject to oversight by multiple supervisors or regulators or that are outside the oversight of other supervisors or regulators. If this is the case, or if the primary supervisor or functional regulator does not conduct or coordinate the necessary continuous monitoring or examination activities in a reasonable period of time, the Federal Reserve will initiate and lead these activities in coordination with other relevant primary supervisors and functional regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.1.4 Risk Management of Nonmaterial Business Lines

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

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

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

1050.1.3.1.5 Core Clearing and Settlement Activities (Where Applicable)

Objectives: The Federal Reserve will understand and assess the adequacy of risk-management and internal controls—including credit risk-management practices—related to core clearing and settlement organizations.[12] In light of the potential for problems in these areas to transmit an adverse impact across the banking and financial system, and given the Federal Reserve's unique expertise and perspective with respect to these activities, the Federal Reserve focuses special supervisory attention on the risk-management and internal control practices and the public disclosures made by an organization with respect to these activities.

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

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

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

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

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

1050.1.3.1.6 Significant Presence in Critical Financial Markets (Where Applicable)

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

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

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

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

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

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

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

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

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

1050.1.3.1.7 Risk Management of Activities in Key Financial Markets

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

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

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

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

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

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

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

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

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

Supervisory Activities: During each supervisory planning cycle, and more frequently as required, continuous monitoring opportunities will be identified that utilize information gained through LCBO supervision to further the Federal Reserve's understanding of risks and activities that could adversely affect LCBOs or the stability of domestic or global financial markets. Activities will include meetings with chief risk officers, chief financial officers, and other LCBO senior management, as well as collaboration with other domestic and foreign supervisors and regulators and foreign central banks.

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

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

1050.1.3.2 Financial Condition

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

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

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

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

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

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

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

When assessing the adequacy of a BHC's liquidity levels and funds management practices, areas of focus include[18]

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

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

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

17. Footnote reserved.

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

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

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

1050.1.3.3 Impact

1050.1.3.3.1 Risk Management and Financial Condition of Significant Nonbank Subsidiaries

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

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

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

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

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

3. evaluate the degree to which nonbank entity risks may present a threat to the safety and soundness of subsidiary depository institutions, including through transmission of legal, compliance, or reputational risks;
4. identify and assess any intercompany relationships, dependencies, or exposures—or aggregate firmwide concentrations—with the potential to threaten the condition of a depository institution affiliate; and
5. evaluate the effectiveness of the policies, procedures, and systems that the holding company and its nonbank subsidiaries use to ensure compliance with applicable laws and regulations, including consumer protection laws.[20]

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

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

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

1050.1.3.3.2 Parent Company and Nonbank Funding and Liquidity

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

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

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

Areas of focus will include an assessment of

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

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

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

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

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

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

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

22. This policy statement is available on the Board's public website at www.federalreserve.gov/paymentsystems/psr.

1050.1.4 INTERAGENCY COORDINATION

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

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

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

Supervisory Activities. The Federal Reserve will continue to work with the relevant primary supervisors and functional regulators of a large complex BHC's subsidiaries to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the BHC on a consolidated basis. The Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant primary supervisors or functional regulators when appropriate and permitted by applicable laws and regulations.[24]

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

- supervisory protocols, agreements, and MOUs with primary supervisors and functional regulators that allow the coordination of supervisory activities and that permit the ongoing exchange of information, including confidential information on a confidential basis;
- bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- periodic and as-needed contacts with primary supervisors and functional regulators to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities;
- the use of information technology platforms, such as the Banking Organization National Desktop (BOND),[25] 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.

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

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

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

1050.1.4.1.1 Coordination of Examination Activities at a Supervised BHC Subsidiary

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

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

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

1050.1.4.2 Cooperation and Information Sharing With Host-Country Foreign Supervisors

Objectives: Many large complex BHCs have considerable international banking and other operations that are licensed and supervised by foreign host-country authorities. As home-country supervisor for domestic BHCs, the Federal Reserve is responsible for the comprehensive, consolidated supervision of these global organizations, while each host country is responsible for supervision of the legal entities (including foreign subsidiaries of U.S. BHCs) in its jurisdiction.

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

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

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

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

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

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

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

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

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

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

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

1050.1.4.3 Indications of Weakness or Risk Related to Subsidiary Depository Institutions

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

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

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

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

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

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

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

Supervisory Activities:

- *Depository institution subsidiary*. In instances when a depository institution subsidiary's condition or management is rated less than satisfactory, or when the depository institution subsidiary otherwise faces financial stress or material risks, the Federal Reserve's primary supervisory objectives as consolidated supervisor are to ensure that the parent company (1) provides appropriate support to the depository institution and (2) does not take action that could harm the depository institution. The Federal Reserve will work closely with the primary supervisor to understand whether the BHC or a nonbank affiliate has contributed to the depository institution's weakened condition, to understand the impact of the depository institution on the BHC's condition, and to determine if the holding company is providing appropriate support to the depository institution. The Federal Reserve will coordinate its activities with those of the primary supervisor to the extent appropriate.
- *Nonbank subsidiary*. When any nonbank subsidiary faces financial stress or material risks, the Federal Reserve will seek to ensure that its condition and activities do not jeopardize the safety and soundness of the BHC or its depository institution subsidiaries, as discussed above in sections 1050.1.3.3.1, "Risk Management and Financial Condition of Significant Nonbank Subsidiaries" and 1050.1.3.3.2, "Parent Company and Nonbank Funding and Liquidity." The Federal Reserve also will take appropriate steps to ensure that any actions taken by the parent company to assist a nonbank subsidiary do not impair the BHC's continuing ability to serve as a source of strength to its depository institution subsidiaries. The Federal Reserve will coordinate its activities with those of any relevant functional regulator to the extent appropriate.

1050.1.4.5 Edge and Agreement Corporations

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

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

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

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

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

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

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

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

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

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

1050.2.1 ACTIVITIES OF THE FEDERAL RESERVE AND OTHER SUPERVISORS AND REGULATORS

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

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

A range of continuous monitoring activities is utilized, along with testing activities (examination activities),[3] to develop and maintain an understanding and assessment of the condition of a regional HC. For organizations within this portfolio, continuous monitoring activities typically take the form of meetings with the HC's management, analysis of a firm's management information system (MIS) reports and regulatory reports, review of surveillance screens, and discussions and coordination with other relevant primary supervisors and functional regulators, including review of their work. Federal Reserve staff determine the scope and frequency of supervisory monitoring activities based on a firm's risk profile. For many regional HCs that are in sound condition, examiners perform monitoring activities on a periodic or quarterly basis, supplemented by more frequent or intensive activities as necessary.

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

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

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

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

The nature and scope of independent Federal Reserve supervisory work required to develop and maintain an understanding and assessment of a regional HC depend largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. Many regional HCs conduct the majority of their business operations through a single bank subsidiary, increasing the likelihood that a single primary supervisor has a complete view of, and ability to address, major aspects of the organization's business activities and related risks, risk management, and controls. In these instances, the Federal Reserve typically will be able to use the information and assessments developed by this primary supervisor of the bank subsidiary to develop an understanding and assessment of the condition of the regional HC and its consolidated activities. However, for a regional HC with more extensive or complex nonbank activities, the Federal Reserve will perform a more extensive assessment of the firm's risk-management systems and financial condition of nonbank subsidiaries.

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

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

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

1050.2.1.2 Functionally Regulated Subsidiaries

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

1050.2.2 UNDERSTANDING THE ORGANIZATION

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

To understand the organizations, examiners generally review the following:

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

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

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

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

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

1050.2.3 ASSESSING THE REGIONAL HC ON A CONSOLIDATED BASIS

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

1050.2.3.1 Risk Management

1050.2.3.1.1 Key Corporate Governance Functions

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

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

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

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

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

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

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

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

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

Supervisory Activities: For each regional HC, the Federal Reserve will review and assess the adequacy of oversight provided by the board and senior management, as well as the adequacy of internal audit and associated MIS. The Federal Reserve also will review and assess other key corporate governance functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining consolidated holding company operations, as well as the organization's business resiliency and crisis management capabilities.[7]

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

  The results of continuous monitoring activities, as documented in supervisory products that reflect the Federal Reserve's overview and risk assessment of the organization, may identify certain corporate governance functions that will require more intensive supervisory focus due to (1) significant changes in corporate strategy, activities, organizational structure, oversight mechanisms, or key personnel; (2) potential concerns regarding the adequacy of a specific governance function; or (3) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another primary supervisor or functional regulator.
- *Internal audit*. Continuous monitoring activities will be used to understand and assess key elements of internal audit governance for the consolidated organization, including (1) the adequacy (and, where applicable, independence[9]) of the audit committee; (2) the independence, professional competence, and the quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk-assessment process; and (4) the adequacy of audit programs and workpaper standards. On at least an annual basis, the results of these supervisory activities

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

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

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

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

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

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

  If the area of concern is not within the oversight of another primary supervisor or functional regulator, or if the supervisor or regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.
- *Additional required audit testing activities*. In all instances, the Federal Reserve will conduct testing activities as part of its audit infrastructure review (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that the internal audit program is appropriately designed and achieving its objectives.[10]

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

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

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

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

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

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

10. For nontraditional HCs, the Federal Reserve will routinely conduct testing activities on at least a three-year cycle in instances where the HC's relevant functional regulator has not developed—or, because of the organization's legal, operating, and regulatory structure, is not able to develop—a comprehensive understanding and assessment of the internal audit infrastructure.

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

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

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

Supervisory Activities: The Federal Reserve will use continuous monitoring activities to review and assess each primary firmwide risk-management and control function. This process begins with the overarching design and architecture of each primary firmwide risk-management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in subsection 1050.2.3.1.3). Federal Reserve staff will verify the sufficiency of fundamental aspects of internal controls in relation to the holding company's current risk profile. In particular, supervisory activities focus on assessing the adequacy of a firm's primary control functions and whether a firm's control functions (centralized or decentralized) remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

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

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

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

1050.2.3.1.3 Risk Management of Material Portfolios and Business Lines

Objectives: For each regional HC, there are selected portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as residential mortgage or commercial real estate lending) that are primary drivers of risk or revenue, or that otherwise materially contribute to either understanding inherent risk within the consolidated organization or assessing controls for a broader corporate function (such as consolidated credit-risk management).

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

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

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

A regional HC's activities may span legal entities that are subject to oversight by multiple supervisors or regulators or that are outside the oversight of other supervisors or regulators. In these cases, or if the primary supervisor or functional regulator does not conduct or coordinate the necessary continuous monitoring or examination activities in a reasonable period of time, the Federal Reserve will initiate and lead these activities in coordination with other relevant primary supervisors and functional regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described in subsection 1050.2.1.2.

1050.2.3.1.4 Risk Management of Nonmaterial Business Lines

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

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

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

1050.2.3.2 Financial Condition

Objectives: The Federal Reserve's evaluation of a regional HC's consolidated financial condition focuses on the ability of the organization's resources to support the level of risk associated with its activities. Assessments are developed for each "CAEL" subcomponent: Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).[12] In developing this evaluation, the Federal Reserve's primary focus is on reviewing and assessing:

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

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

When assessing the adequacy of a HC's liquidity levels and funds-management practices, examiners focus on[14]

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

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

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

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

12. See SR-19-4/CA-19-3 for more information about the CAEL subcomponents.

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

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

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

1050.2.3.3 Impact

1050.2.3.3.1 Risk Management and Financial Condition of Significant Nonbank Subsidiaries

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

Due to these interrelationships, financial, legal, compliance, or reputational risks in one part of a HC can affect other parts of the organization. Even absent these interactions, the parent or nonbank subsidiaries of an organization may present financial, legal, compliance, or reputational risk to the consolidated entity, and thus to its depository institution subsidiaries. As the consolidated supervisor, the Federal Reserve is responsible for reviewing and assessing the risks that the parent holding company and its nonbank subsidiaries may pose to the holding company or its depository institution subsidiaries. The primary objectives of Federal Reserve supervision of the nonbank subsidiaries of a holding company are to:

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

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

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

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

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

Federal Reserve staff may use periodic testing to supplement continuous monitoring to (1) ensure that key risk-management and internal control practices conform to internal policies and/or are designed to ensure compliance with the law, and (2) understand and assess operations presenting a moderate or greater likelihood of significant negative impact to a subsidiary depository institution or the consolidated organization. Areas of potential negative impact include financial or operational risks that pose a potential threat to the safety and soundness of a depository institution subsidiary, or to the holding company's ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. Testing will focus on controls for identifying, monitoring, and controlling such risks. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described in subsection 1050.2.1.2.

1050.2.3.3.2 Parent Company and Nonbank Funding and Liquidity

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

Areas of focus will include an assessment of:

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

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

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

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

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

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

For regional HCs where parent company or nonbank subsidiary third-party debt obligations are deemed to be material in relation to equity or may otherwise have a potentially negative impact on the HC's ability to serve as a source of strength for its depository institution subsidiaries, the Federal Reserve will undertake testing activities on at least a three-year cycle, assessing the individual elements of risk management for parent company and nonbank funding and liquidity: board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and related internal controls. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described in subsection 1050.2.1.2.

1050.2.4 INTERAGENCY COORDINATION

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

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

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

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

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

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

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

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

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

1050.2.4.1.1 Coordination of Examination Activities at a Supervised HC Subsidiary

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

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

If, following these activities, the Federal Reserve's information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant primary supervisor or functional regulator in the manner discussed in subsection 1050.2.3.[20]

1050.2.4.2 Cooperation and Information Sharing With Host-Country Foreign Supervisors

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

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

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

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

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

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

Additionally, the Federal Reserve and other U.S. supervisors have at times faced challenges in accessing information on a bank's or HC's foreign operations or in carrying out examinations of cross-border or foreign activities. These circumstances are to be taken into account when developing a supervisory strategy for a regional HC with cross-border or foreign operations.

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

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

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

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

1050.2.4.3 Indications of Weakness or Risk Related to Subsidiary Depository Institutions

Objectives: For areas beyond those specifically addressed in subsection 1050.2.3, there may be circumstances where the Federal Reserve has indications of material weakness or risk in a depository institution subsidiary of a HC that is supervised by another primary supervisor, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of that supervisor. Because a primary objective of consolidated supervision is to protect the HC's depository institution subsidiaries, the Federal Reserve will follow up with the appropriate primary supervisor in these circumstances to help ensure that, to the extent that a material weakness or risk exists, these weaknesses are addressed appropriately by the HC and its depository institution subsidiaries.

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

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

1050.2.4.4 Condition or Management of HC Subsidiary is Less than Satisfactory

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

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

Supervisory Activities:

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

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

1050.2.4.5 Edge and Agreement Corporations

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

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

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

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

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

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

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

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

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

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

1050.2.4.6 Nontraditional Holding Companies

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

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

Supervisory Activities: The Federal Reserve will primarily utilize continuous monitoring activities to maintain its assessments of risk management and financial condition for nontraditional HCs, relying on the assessments and information developed by the primary functional regulator to the fullest extent possible.

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

1050.2.5 RELYING ON THE WORK OF OTHER REGULATORS

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

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

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

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

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

supervisory goals for a holding company with total consolidated assets of less than $100 billion.[24]

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

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

The following guidance explains the Federal Reserve's supervisory expectations for relying on the work of the IDI regulators in the supervision of regional holding companies.[26] Refer to SR-16-4.

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

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

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

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

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

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

- use all information made available from the IDI regulators to reach conclusions regarding the consolidated holding company's overall condition and to assign appropriate Federal Reserve supervisory ratings.

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

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

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

- the IDI examination reports are not current;[28]
- the composite rating for the holding company or any of its IDI subsidiaries is less than satisfactory; or
- the holding company has deteriorating financial or risk trends that are not reflected in the most current IDI regulators' examination reports.

5. If Federal Reserve staff do not have an adequate basis for relying on the IDI regulators' supervisory findings, the Federal Reserve will work to resolve information gaps with the IDI regulators.[29]

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

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

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

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

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

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

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

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

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

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

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

1050.2.6.1 Overview

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

1050.2.6.2 Scope

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

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

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

1050.2.6.3 Summary of Inspection Conclusions

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

31. For more information, see SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion."

1050.2.6.4 Ratings

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

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

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

Rating 3 (Fair). Holding companies in this group exhibit a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, these companies are vulnerable and require more than normal supervisory attention and financial surveillance. However, the risk management and financial capacity of the company, including the potential negative impact of the nondepository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

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

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

1050.2.6.5 Violations of Law*

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

1050.2.6.6 Matters Requiring Attention*

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

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

Table 1. Holding Company Ratings

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

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

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

33. See 12 CFR 262, Appendix A, "Statement Clarifying the Role of Supervisory Guidance."

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

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

Board and Senior Management Oversight *[Assign a Rating 1 to 5]*

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

Policies, Procedures, and Limits
[Assign a Rating 1 to 5]
Examiners should describe their assessment of the holding company's policies, procedures, and limits given the risks inherent in the organization's activities and stated goals and objectives.

Risk Monitoring and Management Information Systems
[Assign a Rating 1 to 5]
Examiners are to evaluate the adequacy of risk measurement and monitoring, management reports, information systems including the assumptions, data, and procedures used to measure risk and the consistency of these tools with the complexity of the organization's activities.

Internal Controls
[Assign a Rating 1 to 5]
Examiners are to assess the adequacy of internal controls and audit, including the accuracy of financial reporting and disclosure, the strength and influence of audit, the independence of control areas from management, and the consistency of audit scopes relative to the organization's complexity.

1050.2.6.8 Financial Condition *[Assign a Rating 1 to 5]*

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

Capital
[Assign a Rating 1 to 5]
Examiners should describe the adequacy of the organization's consolidated capital position from a regulatory capital perspective. (See for example, 12 CFR part 217 and 12 CFR part 225.) The evaluation of capital adequacy will consider the risk inherent in an organization's activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the parent company and subsidiaries' debt. Also discuss the capital planning process, and capital management objectives viewed in accordance with applicable statutes and regulations.[34]

Asset Quality
[Assign a Rating 1 to 5]
Examiners should assess the quality of the organization's consolidated assets. The evaluation will include, as appropriate, both on-balance sheet and off-balance sheet exposures, and the level of classified and nonperforming assets. Forward-looking indicators of asset quality, such as the adequacy of underwriting standards, the level of concentration risk, the adequacy of credit administration policies and procedures, and the adequacy of management information systems for credit risk may also form the Federal Reserve's view of asset quality. Also assess the adequacy of the allowance at the parent company level if applicable.

Earnings
[Assign a Rating 1 to 5]
In assessing the quality and sustainability of consolidated earnings, examiners should consider the level, trend, and sources of earnings, as well as the ability of earnings to augment capital as necessary, to provide ongoing support for a bank holding company's activities. In addition, examiners should assess material nonrecurring income and expense items, and adjust the return on average assets accordingly.

Liquidity
[Assign a Rating 1 to 5]
Examiners should describe the consolidated organization's ability to attract and maintain the sources of funds necessary to support its opera-

34. For more background information, see SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies."

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

1050.2.6.9 Impact
[Assign a Rating 1 to 5]

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

Parent Company Financial Analysis

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

Intercompany Transactions

Examiners should comment on:

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

1050.2.6.10 Depository Institution
[Assign a Rating 1 to 5]

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

1050.2.6.11 Other Matters*

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

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

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

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

1050.2.6.12 Closing Comments

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

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

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

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

1050.2.6.13 Signature of Directors

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

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

1050.2.7 COMBINED ROLL-UP REPORT FOR REGIONAL BANKING ORGANIZATIONS

1050.2.7.1 Applicability, Purpose, and Outline of the Report

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

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

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

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

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

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

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

41. See SR-19-6, "Federal Financial Institutions Examination Council Policy Statement on the Principles for Completing the Report of Examination."

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

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

I. Directorate Responsibility (see 1050.2.7.2)
II. Scope (see 1050.2.7.3)
III. Overall Risk Profile, Conclusions, and Key Supervisory Themes (see 1050.2.7.4)
  a. Overall Risk Profile*
  b. Overall Conclusions
  c. Holding Company Rating
  d. Bank Rating
  e. Key Supervisory Themes*
IV. Summary of Ratings (see 1050.2.7.5)
V. Apparent Violations of Law* (see 1050.2.7.6)
VI. Supervisory Issues* (see 1050.2.7.7)
  a. Matters Requiring Immediate Attention (MRIAs)*
  b. Matters Requiring Attention (MRAs)*
  c. Status of Prior MRIAs/MRAs*
VII. Compliance with Enforcement Action(s)* (see 1050.2.7.8)
VIII. Consolidated Management and Risk Management (see 1050.2.7.9)
IX. Consolidated Financial Condition (see 1050.2.7.10)
X. Impact and Depository Institution(s) (see 1050.2.7.11)
  a. Impact
  b. Depository Institution(s)
XI. Information Technology Assessment* (see 1050.2.7.12)
XII. Fiduciary Activities Assessment* (see 1050.2.7.13)
XIII. Consumer Compliance Assessment (see 1050.2.7.14)
XIV. Additional Supervisory Assessments (see 1050.2.7.15)
  a. Bank Secrecy Act/Anti-Money Laundering Compliance Program
  b. Audit Program*
  c. Other Matters*
XV. Signature of Directors (see 1050.2.7.16)

1050.2.7.2 Directorate Responsibility

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

42. See also SR-20-28/CA-20-14, "Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System."

1050.2.7.3 Scope

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

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

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

1050.2.7.4 Overall Risk Profile, Conclusions, and Key Supervisory Themes

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

*Overall Risk Profile**

If the bank and the BHC are both rated a composite "1" or "2," this subheading is optional. This subheading is required if the bank and/or the BHC are rated a composite "3," "4," or "5." In either case, this subheading is very concise, typically one paragraph in length. In terms of content, this subheading describes the organization's overall risk profile within the context of the analysis that is described in the Overall Conclusions subheading below. This section should focus on the key activities that influence the risk profile and could include a discussion of specific risk stripes.[43] However, this subheading should *not* include a risk matrix, nor should this subheading repeat information on the organization's risk profile that is included in the sections on "Consolidated Management and Risk Management," and "Consolidated Financial Condition."

Overall Conclusions

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

Holding Company Rating

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

Bank Rating

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

43. See SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion."

*Key Supervisory Themes**

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

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

1050.2.7.5 Summary of Ratings

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

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

*1050.2.7.6 Apparent Violations of Law**

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

1050.2.7.7 Supervisory Issues*

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

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

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

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

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

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

1050.2.7.8 Compliance with Enforcement Action*

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

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

1050.2.7.9 Consolidated Management and Risk Management

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

Management Rating
[Assign a Rating 1 to 5]

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

Risk Management Rating
[Assign a Rating 1 to 5]

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

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

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

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

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

1050.2.7.10 Consolidated Financial Condition

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

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

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

In situations where the Financial Condition Rating or any of the financial ratings are rated "3" or worse, examiners may describe the weaknesses or deficiencies in the introductory comment before providing a more comprehensive discussion and assessment as listed below.

- Consolidated Capital – *[Assign a Rating 1 to 5*]
- Consolidated Asset Quality – *[Assign a Rating 1 to 5*] (also see table 2)
- Consolidated Earnings – *[Assign a Rating 1 to 5*]
- Consolidated Liquidity – *[Assign a Rating 1 to 5*]
- Sensitivity to Market Risk – *[Assign a Rating 1 to 5*]

46. For more information, see subsection 1050.2.6.8 "Financial Condition" in this section and section 1002.1 of the *Commercial Bank Examination Manual*.

1050.2.7.11 Impact and Depository Institutions

This required section is divided into the following two subsections:

Impact [Assign a Rating 1 to 5]

The Impact, or I component, is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). In supporting the Impact component rating, examiners should describe general activities and profiles of the parent company and nonbank entities. Examiners should evaluate both the risk management practices and financial condition of the non-depository entities and assess the potential negative impact non-depository institution(s) and/or the parent company could directly or indirectly have upon the risk management or financial condition of subsidiary depository institution(s) now or in the future. The Impact assessment generally covers (1) Parent Company Financial Analysis; (2) Intercompany Transactions; and (3) Nonbank Subsidiaries. For more information on assessing this component rating, see 1050.2.6.9, "Impact."

The depth of analysis will depend on the complexity of the organization, as well as any issues that were identified during the supervisory event. For BHCs rated "1" or "2," the examiners should generally provide one paragraph of supporting comments in this subsection for each of the three key areas noted in the preceding paragraph.

Depository Institutions [Assign a Rating 1 to 5]

In most cases, the Depository Institution rating reflects the SMB subsidiary's composite CAMELS rating. In a multi-depository institution holding company, this rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institution(s), weighted by both asset size and

Table 2. Summary of Items Subject to Adverse Classification

Organization	Substandard	Doubtful	Loss	Total
Parent				
Bank Subsidiaries				
Nonbank Subsidiaries				
Totals at Current Event [*Date*]				
Totals at Previous Event [*Date*]				
Totals at Previous Event [*Date*]				

the relative importance of each depository institution within the holding company structure. For more information on the assessment of the Depository Institution rating, see section 1062.0, "RFI Rating System" in this manual. In general, the comments in this subsection are brief as risk management and financial matters applicable to the subsidiary SMB are described in previous sections of the Combined Roll-Up Report.

1050.2.7.12 Information Technology Assessment* *[Assign Composite Rating and Component Ratings 1 to 5]*

The Information Technology Assessment section is optional. The section is mandatory, however, if an information technology assessment was completed during the roll-up event and a rating was assigned.[47] In these instances, examiners should communicate the ratings that were assigned as well as the supporting rationale for the ratings. Information technology conclusions should only be reflected in the Consolidated Financial Condition or Consolidated Management and Risk Management sections of the report, when they are significant contributing factors to the overall financial condition or the management or risk management rating components. In addition, significant supervisory concerns should be reflected in the Supervisory Issues section.

If examiners communicated to the institution the conclusions of an information technology assessment or examination in a separate report or supervisory letter, the Combined Roll-Up Report should contain a concise paragraph of the report conclusions from that assessment under the "Additional Supervisory Assessments" section (see 1050.2.7.15).

1050.2.7.13 Fiduciary Activities Assessment* *[Assign Composite Rating and Component Ratings 1 to 5]*

The Fiduciary Activities Assessment section is optional. The section is mandatory, however, if a fiduciary activities assessment was completed during the roll-up event and a trust or transfer-agent rating was assigned.[48] In these instances, examiners should communicate the ratings that were assigned as well as the supporting rationale for the ratings. Fiduciary activities conclusions should only be reflected in the Consolidated Financial Condition or Consolidated Management and Risk Management sections of the report when they are significant contributing factors to the overall financial condition or the management or risk management rating components. Significant supervisory concerns should be reflected in the Supervisory Issues section.

If examiners communicated to the institution the conclusions of a trust or transfer agent examination in a separate report or supervisory letter, the Combined Roll-Up Report should contain a concise paragraph of the report conclusions from that assessment under the "Additional Supervisory Assessments" section (see 1050.2.7.15).

1050.2.7.14 Consumer Compliance Assessment

This section is typically based on supervisory assessments that are completed by Federal Reserve examiners in consumer affairs. When a consumer compliance assessment is conducted during the supervisory cycle, safety-and-

47. See SR-99-8, "Uniform Rating System for Information Technology," and 64 Fed. Reg. 3109 (January 20, 1999) for more information.

48. See SR-98-37, "Uniform Interagency Trust Rating System," and 63 Fed. Reg. 54,704 (October 13, 1998) for more information.

soundness examiners should leverage consumer compliance target examinations, work products and discussions with consumer affairs counterparts, and include a high-level supervisory conclusion. While this section is typically brief, examiners should include additional information, particularly if consumer compliance deficiencies compromise the safety and soundness of the bank or impact the adequacy of risk management. More information about the Federal Reserve's consumer compliance supervision program can be found in the *Consumer Compliance Handbook*.

1050.2.7.15 Additional Supervisory Assessments

The information technology assessment and fiduciary activities assessment should be included in this section if the examination was performed and issued under separate cover during the supervisory cycle. The summary assessments for each area should be a concise paragraph to support the assessments. The assessments of each area should be included in the text. In situations where areas require emphasis, examiners may include information on the deficiencies into the introductory comment, with more detailed comments reserved for discussion under separate subheadings, or in the applicable supplemental report page. Discussion in this section should complement previous comments made in this report without being redundant.

Bank Secrecy Act/Anti Money Laundering Compliance Program

This subsection is mandatory. This subsection should describe the outcome of the BSA and AML compliance assessment from the roll-up supervisory event. If the BSA/AML assessment was completed under separate cover, a concise paragraph should be included in this subsection describing the outcome or conclusions of the assessment. Conclusions should also be reflected in the Consolidated Management and Risk Management section of the report, as appropriate. Significant supervisory concerns should be reflected in the Supervisory Issues section.

*Audit Program**

This subsection is mandatory if an audit assessment was performed during the annual supervisory cycle. If the audit assessment was not performed during the supervisory cycle, examiners should comment on the bank's audit program in the Consolidated Management and Risk Management section.

*Other Matters**

This subsection is optional and should only be included if matters of supervisory importance are not described elsewhere in the report. Examiners should discuss significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the organization is engaged. If issues or concerns are noted, examiners should provide comments on specific areas, such as nontraditional banking activities, affiliate relationships, and significant litigation.

1050.2.7.16 Signature of Directors

This section is mandatory. If the boards of directors for the SMB and the BHC differ, examiners should include a separate signature listing of the board of directors for each entity. This section should indicate that the signature page should be attached to the report and be retained at the institution. The signature of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the applicable (bank or holding company) board delegating the review to such committee.

1050.2.8 TIMING EXPECTATIONS FOR THE COMPLETION OF SAFETY-AND-SOUNDNESS EXAMINATION AND INSPECTION REPORTS

The Federal Reserve has established timing expectations for examination staff in completing safety-and-soundness examination and inspection reports for domestic regional financial institutions and the submission of the reports to the institutions.[49] These expectations apply to examination and inspection reports for domestic institutions supervised by the Federal Reserve having between $10 billion and $100 billion in total

49. For more information, see SR-17-12, "Timing Expectations for the Completion of Safety-and-Soundness Examination and Inspection Reports for Regional Banking Organizations."

consolidated assets, including state member banks, bank holding companies, and their subsidiary Edge Act and agreement corporations, and savings and loan holding companies.

Federal Reserve supervisory staff should complete and send safety-and-soundness examination and inspection reports issued by the Federal Reserve to the institution within the following timeframes:[50]

- 90 calendar days from the start date for all reports issued to noncomplex holding companies;[51] and,
- 100 calendar days from the start date for all reports issued to state member banks, complex holding companies, and their nonbank and Edge Act subsidiaries.

In cases when reports are subject to statutory requirements for review by the Consumer Financial Protection Bureau (CFPB), Reserve Banks may add up to 30 calendar days to the above standards.[52] Reserve Banks may exceed the timing requirements included in this letter at the discretion of Reserve Bank senior management; however, deviations from these standards are expected to be rare, and should be appropriately documented in workpapers. At the discretion of senior Reserve Bank management, additional exemptions from these timeframe guidelines may be considered for Federal Reserve led examinations that are conducted jointly or concurrently with another insured depository institution regulator.

50. Examples of safety-and-soundness examination and inspection reports include, but are not limited to, full scope examination and inspection reports, target letters, roll-up examination and inspection letters, and specialty examination reports.

51. The start date is the date that Reserve Bank examiners and supervisory staff commence the commercial examination and inspection work, either offsite or onsite, excluding pre-exam visitations and examination preparation.

52. See sections 1022, 1024, and 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For more information on the coordination of supervisory activities with the CFPB, see also the "Memorandum of Understanding on Supervisory Coordination" attached to the June 4, 2012 joint press release.

1060.0.1 OVERVIEW AND APPLICABILITY

Each large financial institution (LFI) is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations), including its critical operations and banking offices, remain safe and sound and in compliance with laws and regulations, including those related to consumer protection.[1] On November 21, 2018, the Board adopted a specific rating system for LFIs in order to align with the Federal Reserve's supervisory programs and practices for these firms.[2] The LFI rating system provides a supervisory evaluation of whether a covered firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones.[3]

The LFI rating system applies to:

- bank holding companies with total consolidated assets of $100 billion or more;
- all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of $100 billion or more;[4] and
- U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of $50 billion or more established pursuant to the Federal Reserve's Regulation YY.[5]

The Federal Reserve will assign initial LFI ratings to firms in the LISCC portfolio in early 2019. For all other firms subject to the LFI rating system, the Federal Reserve will assign initial LFI ratings in early 2020.

Federal Reserve supervision staff will continue to use the RFI rating system in assessing bank holding companies with less than $100 billion in consolidated assets. For noncomplex holding companies with less than $3 billion in assets, Reserve Bank supervisory staff will assign only a composite RFI rating and risk-management rating to the firm following an inspection.

The LFI rating system is designed to:

- Fully align with the Federal Reserve's current supervisory programs and practices, which are based upon the LFI supervision framework's core objectives of reducing the probability of LFIs failing or experiencing material distress and reducing the risk to U.S. financial stability;
- Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
- Provide transparency related to the supervisory consequences of a given rating.

1. See SR letter 12-17/CA letter 12-14, "Consolidated Supervisory Framework for Large Financial Institutions." Hereinafter, when "safe and sound" or "safety and soundness" is used in this framework, related expectations apply to the consolidated organization and the firm's critical operations and banking offices. "Critical operations" are a firm's operations, including associated services, functions and support, the failure or discontinuance of which, in the view of the firm or the Federal Reserve, would pose a threat to the financial stability of the United States. "Banking offices" are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.

2. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019). The final rule is effective on February 1, 2019.

3. "Financial strength and resilience" is defined as maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for the continuity of the consolidated organization (including its critical operations and banking offices) through a range of conditions.

"Operational strength and resilience" is defined as maintaining effective governance and controls to provide for the continuity of the consolidated organization (including its critical operations and banking offices) and to promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions.

References to "financial or operational" weaknesses or deficiencies implicate a firm's financial or operational strength and resilience.

4. Savings and loan holding companies (SLHCs) are considered to be engaged in significant commercial activities if they derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)). SLHCs are considered to be engaged in significant insurance underwriting activities if they are either insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies. SLHCs that meet these criteria are excluded from the definition of "covered savings and loan holding company" in section 217.2 of the Board's Regulation Q. See 12 CFR 217.2.

5. Total consolidated assets will be calculated based on the average of the firm's total consolidated assets in the four most recent quarters as reported on the firm's quarterly financial reports filed with the Federal Reserve. A firm will continue to be rated under the LFI rating system until it has less than $95 billion in total consolidated assets, based on the average total consolidated assets as reported on the firm's four most recent quarterly financial reports filed with the Federal Reserve. The Federal Reserve may determine to apply the RFI rating system or another applicable rating system in certain limited circumstances.

The LFI rating system is comprised of three components:

— *Capital Planning and Positions:* an evaluation of (1) the effectiveness of a firm's governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions and events; and (2) the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

— *Liquidity Risk Management and Positions:* an evaluation of (1) the effectiveness of a firm's governance and risk-management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.

— *Governance and Controls:* an evaluation of the effectiveness of a firm's (1) board of directors,[6] (2) management of business lines and independent risk management and controls,[7] and (3) recovery planning (only for domestic firms that are subject to the Board's Large Institution Supervision Coordinating Committee (LISCC) Framework).[8] This rating assesses a firm's effectiveness in aligning strategic business objectives with the firm's risk appetite and risk-management capabilities; maintaining effective and independent risk-management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise planning for the ongoing resiliency of the firm.[9]

1060.0.2 ASSIGNMENT OF THE LFI COMPONENT RATINGS

Each LFI component rating is assigned along a four-level scale:

- *Broadly Meets Expectations:* A firm's practices and capabilities broadly meet supervisory expectations, and the firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions. The firm may be subject to identified supervisory issues requiring corrective action. These issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of conditions.
- *Conditionally Meets Expectations:* Certain, material financial or operational weaknesses in a firm's practices or capabilities may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

  The Federal Reserve does not intend for a firm to be assigned a "Conditionally Meets Expectations" rating for a prolonged period, and will work with the firm to develop an appropriate timeframe to fully resolve the issues leading to the rating assignment and merit upgrade to a "Broadly Meets Expectations" rating.

  A firm is assigned a "Conditionally Meets Expectations" rating-as opposed to a "Deficient" rating-when it has the ability to resolve these issues through measures that do not require a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices. Failure to resolve the issues in a timely manner would most likely result in the firm's downgrade to a "Deficient" rating, since the inability to resolve the issues would indicate that the firm does not

6. References to "board" or "board of directors" in this framework includes the equivalent to a board of directors, as appropriate, as well as committees of the board of directors or the equivalent thereof, as appropriate.

At this time, recovery planning expectations only apply to domestic bank holding companies subject to the Federal Reserve's LISCC supervisory framework. Should the Federal Reserve expand the scope of recovery planning expectations to encompass additional firms, this rating will reflect such expectations for the broader set of firms.

7. The evaluation of the effectiveness of management of business lines would include management of critical operations.

8. There are eight domestic firms in the LISCC portfolio: (1) Bank of America Corporation; (2) Bank of New York Mellon Corporation; (3) Citigroup, Inc.; (4) Goldman Sachs Group, Inc.; (5) JP Morgan Chase & Co.; (6) Morgan Stanley; (7) State Street Corporation; and (8) Wells Fargo & Company. In this guidance, these eight firms may collectively be referred to as "domestic LISCC firms."

9. "Risk appetite" is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm's strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.

possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is recognized that completion and validation of remediation activities for select supervisory issues-such as those involving information technology modifications-may require an extended time horizon. In all instances, appropriate and effective risk-mitigation techniques must be utilized in the interim to maintain safe-and-sound operations under a range of conditions until remediation activities are completed, validated, and fully operational.

- *Deficient-1:* Financial or operational deficiencies in a firm's practices or capabilities put the firm's prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require the firm to make a material change to its business model or financial profile, or its practices or capabilities.

  A firm's failure to resolve the issues in a timely manner that gave rise to a "Conditionally Meets Expectations" rating would most likely result in its downgrade to a "Deficient" rating.

  A firm with a "Deficient-1" rating is required to take timely corrective action to correct financial or operational deficiencies and to restore and maintain its safety and soundness and compliance with laws and regulations, including those related to consumer protection. There is a strong presumption that a firm with a "Deficient-1" rating will be subject to an informal or formal enforcement action, and this rating assignment could be a barrier for a firm seeking Federal Reserve approval to engage in new or expansionary activities.

- *Deficient-2:* Financial or operational deficiencies in a firm's practices or capabilities present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition.

  A firm with a "Deficient-2" rating is required to immediately implement comprehensive corrective measures, and demonstrate the sufficiency of contingency planning in the event of further deterioration. There is a strong presumption that a firm with a "Deficient-2" rating will be subject to a formal enforcement action, and the Federal Reserve would be unlikely to approve any proposal from a firm with this rating to engage in new or expansionary activities.

The Federal Reserve will take into account a number of individual elements of a firm's practices, capabilities, and performance when making each component rating assignment. The weighting of an individual element in assigning a component rating will depend on its impact on the firm's safety, soundness, and resilience as provided for in the LFI rating system definitions. For example, for purposes of the Governance and Controls rating, a limited number of significant deficiencies-or even just one significant deficiency-noted for management of a single material business line could be viewed as sufficiently important to warrant a "Deficient-1" for the Governance and Controls component rating, even if the firm meets supervisory expectations under the Governance and Controls component in all other respects.

Under the LFI rating system, a firm must be rated "Broadly Meets Expectations" or "Conditionally Meets Expectations" for each of the three component ratings (Capital, Liquidity, Governance and Controls) to be considered "well managed" in accordance with various statutes and regulations.[10] A "well managed" firm has sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones.

1060.0.3 LFI RATING COMPONENTS

The LFI rating system is comprised of three component ratings: (1) capital planning and positions, (2) liquidity risk management and positions, and (3) governance and controls.[11]

10. 12 USC 1841 et. seq. and 12 USC 1461 et seq. See, e.g., 12 CFR 225.4(b)(6), 225.14, 225.22(a), 225.23, 225.85, and 225.86; 12 CFR 211.9(b), 211.10(a)(14), and 211.34; and 12 CFR 223.41.

11. There may be instances where deficiencies or supervisory issues may be relevant to the Federal Reserve's assessment of more than one component area. As such, the LFI rating will reflect these deficiencies or issues within multiple rating components when necessary to provide a comprehensive supervisory assessment.

1060.0.3.1 Capital Planning and Positions Component Rating

The Capital Planning and Positions component rating evaluates (1) the effectiveness of a firm's governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

In developing this rating, the Federal Reserve evaluates:

- *Capital Planning:* The extent to which a firm maintains sound capital planning practices through effective governance and oversight; effective risk management and controls; maintenance of updated capital policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into capital planning and projections of capital positions; and
- *Capital Positions:* The extent to which a firm's capital is sufficient to comply with regulatory requirements, and to support its ability to meet its obligations to depositors, creditors, and other counterparties and continue to serve as a financial intermediary through a range of conditions.

1060.0.3.1.1 Definitions for the Capital Planning and Positions Component Rating

Broadly Meets Expectations

A firm's capital planning and positions broadly meet supervisory expectations and support maintenance of safe-and-sound operations. Specifically:

- The firm is capable of producing sound assessments of capital adequacy through a range of conditions; *and*
- The firm's current and projected capital positions comply with regulatory requirements, and support its ability to absorb current and potential losses, to meet obligations, and to continue to serve as a financial intermediary through a range of conditions.

A firm rated "Broadly Meets Expectations" may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet the capital planning and position expectations associated with a "Broadly Meets Expectations" rating will be rated "Conditionally Meets Expectations," "Deficient-1," or "Deficient-2," and subject to potential consequences as outlined below.

Conditionally Meets Expectations

Certain material financial or operational weaknesses in a firm's capital planning or positions may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm's ability to produce sound assessments of capital adequacy through a range of conditions; and/or
- May result in the firm's projected capital positions being insufficient to absorb potential losses, comply with regulatory requirements, and support the firm's ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

The Federal Reserve does not intend for a firm to be rated "Conditionally Meets Expectations" for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm's business model or financial profile, or its governance, risk management, or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the "Conditionally Meets Expectations" rating.

The Federal Reserve will closely monitor the firm's remediation and mitigation activities; in most instances, the firm will either:

1. Resolve the issues in a timely manner and, if no new material supervisory issues arise, be upgraded to a "Broadly Meets Expectations" rating because the firm's capital planning practices and related positions would broadly meet supervisory expectations; or
2. Fail to resolve the issues in a timely manner and be downgraded to a "Deficient-1" rating, because the inability to resolve the issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the "Conditionally Meets Expectations" rating, but new issues are identified that, taken alone, would be consistent with a "Conditionally Meets Expectations" rating. In this event, the firm may continue to be rated "Conditionally Meets Expectations," provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a "Deficient" rating.

A "Conditionally Meets Expectations" rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated "Deficient-1" may be upgraded to "Conditionally Meets Expectations" if the firm's remediation and mitigation activities are sufficiently advanced so that the firm's prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

Deficient-1

Financial or operational deficiencies in a firm's capital planning or positions put the firm's prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its capital planning practices.

Specifically, although the firm's current condition is not considered to be materially threatened:

- Deficiencies in the firm's capital planning processes are not effectively mitigated. These deficiencies limit the firm's ability to effectively assess capital adequacy through a range of conditions; and/or
- The firm's projected capital positions may be insufficient to absorb potential losses and to support its ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

Supervisory issues that place the firm's safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business-such as issues requiring a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices-would generally warrant assignment of a "Deficient-1" rating.

A "Deficient-1" rating may be assigned to a firm regardless of its prior rating. A firm previously rated "Broadly Meets Expectations" may be downgraded to "Deficient-1" when supervisory issues are identified that place the firm's prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated "Conditionally Meets Expectations" may be downgraded to "Deficient-1" when the firm's inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its capital planning and positions consistent with supervisory expectations. There is a strong presumption that a firm rated "Deficient-1" will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated "Deficient-1" for any rating component would not be considered "well managed," which would subject the firm to various consequences. A "Deficient-1" rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (1) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (2) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (3) the proposed activities would not distract the firm from remediating current deficiencies or issues.

Deficient-2

Financial or operational deficiencies in a firm's capital planning or positions present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition.

Specifically, as a result of these deficiencies:

- The firm's capital planning processes are insufficient to effectively assess the firm's capital adequacy through a range of conditions; and/or
- The firm's current or projected capital positions are insufficient to absorb current or potential losses, and to support the firm's ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

To address these deficiencies, the firm is required to immediately (1) implement comprehensive corrective measures sufficient to restore and maintain appropriate capital planning capabilities and adequate capital positions; and (2) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm's financial or operational strength or resiliency. There is a strong presumption that a firm rated "Deficient-2" will be subject to a formal enforcement action by the Federal Reserve.

A firm rated "Deficient-2" for any rating component would not be considered "well managed," which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated "Deficient-2" to engage in new or expansionary activities.

1060.0.3.2 Liquidity Risk Management and Positions Component Rating

The Liquidity Risk Management and Positions component rating evaluates (1) the effectiveness of a firm's governance and risk-management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.

In developing this rating, the Federal Reserve evaluates:

- *Liquidity Risk Management:* The extent to which a firm maintains sound liquidity-risk management practices through effective governance and oversight; effective risk management and controls; maintenance of updated liquidity policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into liquidity planning and projections of liquidity positions; and
- *Liquidity Positions:* The extent to which a firm's liquidity is sufficient to comply with regulatory requirements, and to support its ability to meet current and prospective obligations to depositors, creditors and other counterparties through a range of conditions.

1060.0.3.2.1 Definitions for the Liquidity Risk Management and Positions Component Rating

Broadly Meets Expectations

A firm's liquidity risk management and positions broadly meet supervisory expectations and support maintenance of safe-and-sound operations. Specifically:

- The firm is capable of producing sound assessments of liquidity adequacy through a range of conditions; *and*
- The firm's current and projected liquidity positions comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

A firm rated "Broadly Meets Expectations" may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet the liquidity risk management and position expectations associated with a "Broadly Meets Expectations" rating will be rated "Conditionally Meets Expectations," "Deficient-1," or "Deficient-2," and subject to potential consequences as outlined below.

Conditionally Meets Expectations

Certain material financial or operational weaknesses in a firm's liquidity risk management or positions may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm's ability to produce sound assessments of liquidity adequacy through a range of conditions; and/or
- May result in the firm's projected liquidity positions being insufficient to comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

The Federal Reserve does not intend for a firm to be rated "Conditionally Meets Expectations" for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the "Conditionally Meets Expectations" rating.

The Federal Reserve will closely monitor the firm's remediation and mitigation activities; in most instances, the firm will either:

1. Resolve the issues in a timely manner and, if no new material supervisory issues arise, and be upgraded to a "Broadly Meets Expectations" rating because the firm's liquidity risk-management practices and related positions would broadly meet supervisory expectations; or
2. Fail to resolve the issues in a timely manner and be downgraded to a "Deficient-1" rating, because the firm's inability to resolve those issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the "Conditionally Meets Expectations" rating, but new issues are identified that, taken alone, would be consistent with a "Conditionally Meets Expectations" rating. In this event, the firm may continue to be rated "Conditionally Meets Expectations," provided the new issues do not reflect a pattern of deeper or prolonged liquidity-risk management and positions weaknesses consistent with a "Deficient" rating.

A "Conditionally Meets Expectations" rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated "Deficient-1" may be upgraded to "Conditionally Meets Expectations" if the firm's remediation and mitigation activities are sufficiently advanced so that the firm's prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

Deficient-1

Financial or operational deficiencies in a firm's liquidity risk management or positions put the firm's prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its liquidity risk-management practices.

Specifically, although the firm's current condition is not considered to be materially threatened:

- Deficiencies in the firm's liquidity risk-management processes are not effectively mitigated. These deficiencies limit the firm's ability to effectively assess liquidity adequacy through a range of conditions; and/or
- The firm's projected liquidity positions may be insufficient to support its ability to meet prospective obligations and serve as a financial intermediary through a range of conditions.

Supervisory issues that place the firm's safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business-such as issues requiring a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices-would generally warrant assignment of a "Deficient-1" rating.

A "Deficient-1" rating may be assigned to a firm regardless of its prior rating. A firm previously rated "Broadly Meets Expectations" may be downgraded to "Deficient-1" when supervisory issues are identified that place the firm's prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated "Conditionally Meets Expectations" may be downgraded to "Deficient-1" when the firm's inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its liquidity risk management and positions consistent with supervisory expectations. There is a strong presumption that a firm rated "Deficient-1" will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated "Deficient-1" for any rating component would not be considered "well managed," which would subject the firm to various consequences. A "Deficient-1" rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (1) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (2) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (3) the proposed activities would not distract the firm from remediating current deficiencies or issues.

Deficient-2

Financial or operational deficiencies in a firm's liquidity risk management or positions present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition.

Specifically, as a result of these deficiencies:

- The firm's liquidity risk-management processes are insufficient to effectively assess the firm's liquidity adequacy through a range of conditions; and/or
- The firm's current or projected liquidity positions are insufficient to support the firm's ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

To address these deficiencies, the firm is required to immediately (1) implement comprehensive corrective measures sufficient to restore and maintain appropriate liquidity risk management capabilities and adequate liquidity positions; and (2) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm's financial or operational strength or resiliency. There is a strong presumption that a firm rated "Deficient-2" will be subject to a formal enforcement action by the Federal Reserve.

A firm rated "Deficient-2" for any rating component would not be considered "well managed," which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated "Deficient-2" to engage in new or expansionary activities.

1060.0.3.3 Governance and Controls Component Rating

The Governance and Controls component rating evaluates the effectiveness of a firm's (1) board of directors, (2) management of business lines and independent risk management and controls, and (3) recovery planning (for domestic LISCC firms only). This rating assesses a firm's effectiveness in aligning strategic business objectives with the firm's risk appetite and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.

In developing this rating, the Federal Reserve evaluates:

- *Effectiveness of the Board of Directors:* The extent to which the board exhibits attributes that are consistent with those of effective boards in carrying out its core roles and responsibilities, including: (1) setting a clear, aligned, and consistent direction regarding the firm's strategy and risk appetite; (2) directing senior management regarding the board's information; (3) overseeing and holding senior management accountable, (4) supporting the independence and stature of independent risk management and internal audit; and (5) maintaining a capable board composition and governance structure.

- *Management of Business Lines and Independent Risk Management and Controls*
  The extent to which:
  - Senior management effectively and prudently manages the day-to-day operations of the firm and provides for ongoing resiliency; implements the firm's strategy and risk appetite; maintains an effective risk-management framework and system of internal controls; and promotes prudent risk-taking behaviors and business practices, including compliance with laws and regulations, including those related to consumer protection.
  - Business line management executes business line activities consistent with the firm's strategy and risk appetite; identifies and manages risks; and ensures an effective system of internal controls for its operations.
  - Independent risk management effectively evaluates whether the firm's risk appetite appropriately captures material risks and is consistent with the firm's risk management capacity; establishes and monitors risk limits that are consistent with the firm's risk appetite; identifies and measures the firm's risks; and aggregates, assesses and reports on the firm's risk profile and positions. Additionally, the firm demonstrates that its internal controls are appropriate and tested for effectiveness. Finally, internal audit effectively and independently assesses the firm's risk-management framework and internal control systems, and reports findings to senior management and the firm's audit committee.
- *Recovery Planning (domestic LISCC firms only):* The extent to which recovery planning processes effectively identify options that provide a reasonable chance of a firm being able to remedy financial weakness and restore market confidence without extraordinary official sector support.

1060.0.3.3.1 Definitions for the Governance and Controls Component Rating

Broadly Meets Expectations

A firm's governance and controls broadly meet supervisory expectations and support maintenance of safe-and-sound operations.

Specifically, the firm's practices and capabilities are sufficient to align strategic business objectives with its risk appetite and risk-management capabilities,[12] maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); and otherwise provide for the firm's ongoing financial and operational resiliency through a range of conditions.

A firm rated "Broadly Meets Expectations" may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet supervisory expectations associated with a "Broadly Meets Expectations" rating will be rated "Conditionally Meets Expectations," "Deficient-1," or "Deficient-2," and subject to potential consequences, as outlined below.

Conditionally Meets Expectations

Certain material financial or operational weaknesses in a firm's governance and controls practices may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses may threaten the firm's ability to align strategic business objectives with the firm's risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm's ongoing resiliency through a range of conditions.

The Federal Reserve does not intend for a firm to be rated "Conditionally Meets Expectations" for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the

12. References to risk-management capabilities includes risk management of business lines and independent risk management and control functions, including internal audit.

firm's business model or financial profile, or its governance, risk management or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the "Conditionally Meets Expectations" rating.

The Federal Reserve will closely monitor the firm's remediation and mitigation activities; in most instances, the firm will either:

1. Resolve the issues in a timely manner and, if no new material supervisory issues arise, be upgraded to a "Broadly Meets Expectations" rating because the firm's governance and controls would broadly meet supervisory expectations; or
2. Fail to resolve the issues in a timely manner and be downgraded to a "Deficient-1" rating, because the firm's inability to resolve those issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the "Conditionally Meets Expectations" rating, but new issues are identified that, taken alone, would be consistent with a "Conditionally Meets Expectations" rating. In this event, the firm may continue to be rated "Conditionally Meets Expectations," provided the new issues do not reflect a pattern of deeper or prolonged governance and controls weaknesses consistent with a "Deficient" rating.

A "Conditionally Meets Expectations" rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated "Deficient" may be upgraded to "Conditionally Meets Expectations" if the firm's remediation and mitigation activities are sufficiently advanced so that the firm's prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

Deficient-1

Financial or operational deficiencies in a firm's governance and controls put the firm's prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices.

Specifically, although the firm's current condition is not considered to be materially threatened, these deficiencies limit the firm's ability to align strategic business objectives with its risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm's ongoing resiliency through a range of conditions.

A "Deficient-1" rating may be assigned to a firm regardless of its prior rating. A firm previously rated "Broadly Meets Expectations" may be downgraded to "Deficient-1" when supervisory issues are identified that place the firm's prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated "Conditionally Meets Expectations" may be downgraded to "Deficient-1" when the firm's inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its governance and controls consistent with supervisory expectations. There is a strong presumption that a firm rated "Deficient-1" will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated "Deficient-1" for any rating component would not be considered "well managed," which would subject the firm to various consequences. A "Deficient-1" rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (1) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (2) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (3) the proposed activities would not distract the firm from remediating current deficiencies or issues.

Deficient-2

Financial or operational deficiencies in governance or controls present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition. Specifically, as a result of these deficiencies, the firm is unable to align strategic business objectives with its risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm's ongoing resiliency.

To address these deficiencies, the firm is required to immediately (1) implement comprehensive corrective measures sufficient to restore and maintain appropriate governance and control capabilities; and (2) demonstrate the sufficiency, credibility, and readiness of contingency planning in the event of further deterioration of the firm's financial or operational strength or resiliency. There is a strong presumption that a firm rated "Deficient-2" will be subject to a formal enforcement action by the Federal Reserve.

A firm rated "Deficient-2" for any rating component would not be considered "well managed," which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated "Deficient-2" to engage in new or expansionary activities.

1060.0.4 COMMUNICATION OF RATINGS

In accordance with the Federal Reserve's regulations governing confidential supervisory information, ratings assigned under the LFI rating system will be communicated by the Federal Reserve to the firm, but individual ratings are not disclosed publicly. The Federal Reserve will assign LFI ratings and communicate ratings to large firms on an annual basis and more frequently as warranted. Under the LFI rating system, the Federal Reserve will continue to rely to the fullest extent possible on the information and assessments developed by other relevant supervisors and functional regulators.

INTRODUCTION

This section explains key capital requirements and relevant supervisory guidance that apply to firms that are subject to the large financial institutions (LFI) rating system.[1] The LFI rating system is used to evaluate and communicate the supervisory condition of bank holding companies (BHCs) with total consolidated assets of $100 billion or more; all non-insurance, noncommercial savings and loan holding companies (SLHCs) with total consolidated assets of $100 billion or more; and U.S. intermediate holding companies (IHCs) of foreign banking organizations (FBOs) with combined U.S. assets of $50 billion or more established pursuant to the Federal Reserve's Regulation YY.

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. The following Federal Reserve regulations form the basis of the regulatory framework for assessing capital positions and capital planning:

1. Regulation YY (12 CFR part 252, subparts E and F) and Regulation LL (12 CFR part 238, subparts O and P)
2. Regulation Q (12 CFR part 217), capital adequacy requirements for Board-regulated institutions
3. Regulation Y (12 CFR 225.8) and Regulation LL (12 CFR part 238, subpart S), together known as the capital plan rule

Regulation YY and Regulation LL establish capital stress testing requirements for BHCs and covered SLHCs, respectively, with total consolidated assets of $100 billion or more. Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. The capital plan rule establishes general capital planning requirements for a BHC or covered SLHC with total consolidated assets of $100 billion or more and requires such a firm to develop an annual capital plan that is approved by its board of directors.

1. See SR-19-3/CA 19-2, "Large Financial Institution (LFI) Rating System." See also 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019) for more information. The *Commercial Bank Examination Manual* provides more information on assessing the "capital" rating for commercial banks and thrifts as defined by the Uniform Financial Institutions Rating System. See also SR-96-38.

1060.1.2 ENHANCED PRUDENTIAL STANDARDS: REGULATION YY (12 CFR PART 252)

The financial crisis revealed significant weaknesses in resiliency and risk management in the financial sector, and demonstrated how the failure or distress of large, leveraged, and interconnected financial companies, including FBOs, could pose a threat to U.S. financial stability. To address weaknesses in the banking sector that were evident in the financial crisis, the Board strengthened prudential standards for large U.S. and foreign banking organizations. These enhanced standards included capital planning requirements; supervisory and company-run stress testing; liquidity risk management, stress testing, and buffer requirements; and single counterparty credit limits. The Board's enhanced standards also implemented section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which directed the Board to establish enhanced prudential standards for BHCs and FBOs with total consolidated assets of $50 billion or more.[2]

For FBOs, the Board enhanced standards were based, in part, on the size and complexity of an FBO's activities in the United States. The standards applicable to FBOs with a more limited U.S. presence largely rely on compliance with comparable home country standards applied at the consolidated foreign parent level. In comparison, an FBO with a significant U.S. presence is subject to enhanced prudential standards and supervisory expectations that generally apply to its combined U.S. operations.[3]

The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) amended section 165 of the Dodd-Frank Act by raising the threshold for general application of enhanced prudential standards.[4] More specifically, EGRRCPA increased the $50 billion minimum total consolidated asset threshold to

2. 12 U.S.C. 5365.

3. "Combined U.S. operations" of an FBO means the U.S. branches and agencies of the FBO, if any, and the U.S. subsidiaries of the FBO, if any (such as a U.S. IHC and subsidiaries of such U.S. subsidiaries). The combined U.S. operations of an FBO does not include any section 2(h)(2) company, as defined in section 2(h)(2) of the Bank Holding Company Act (12 U.S.C. 1841(h)(2)). For more information on "combined U.S. operations," see 12 CFR 252.2 and the FR-Y-15 report instructions.

4. Public Law 115–174, 132 Stat. 1296 (2018).

Table 1. Categories of regulatory capital and liquidity requirements in Regulation YY

Category	**U.S. banking organizations and foreign banking organizations**[1]
I	U.S. GSIBs and their depository institution subsidiaries[2]
II	$700 billion or more in total consolidated assets; or $75 billion or more in cross-jurisdictional activity; do not meet the criteria for Category I.[3]
III	$250 billion or more in assets, or firms with $100 billion or more in assets and at least $75 billion in (1) nonbank assets, (2) weighted short-term wholesale funding, or (3) off-balance-sheet exposure, that are not subject to Category I or II standards.
IV	$100 billion or more in total consolidated assets; do not meet the criteria for Category I, II or III.

[1] For **U.S. banking organizations,** the applicable category of regulatory capital and liquidity requirements is measured at the level of the top-tier banking organization level, and applies to any of its depository institution subsidiaries for purposes of capital requirements or to any of its depository institution subsidiaries with $10 billion or more in total consolidated assets for liquidity requirements.

For **FBOs,** the applicable category of regulatory capital and liquidity requirements is measured at the level of the top-tier U.S. IHC level, and applies to any depository institution subsidiary of such holding company for purposes of capital requirements or to any depository institution subsidiary with $10 billion or more in total consolidated assets for liquidity requirements.

[2] Category I standards apply solely to U.S. banking organizations.

[3] Cross jurisdictional activity is equal to the sum of cross jurisdictional claims and cross jurisdictional liabilities, as reported in the FR Y-15, "Systemic Risk Report."

$250 billion for general application of enhanced prudential standards to BHCs. EGRRCPA also provides the Board with discretion to apply standards to BHCs with total consolidated assets of between $100 billion and $250 billion.

In connection with its implementation of EGRRCPA and part of the Board's periodic efforts to improve the transparency, efficiency, and risk-sensitivity of its regulations, the Board revised Regulation YY by establishing categories of prudential standards applicable to BHCs, SLHCs that are not substantially engaged in insurance underwriting or commercial activities (covered SLHCs), and FBOs to align those requirements with a firm's risk profile and to apply consistent standards across similarly situated firms.[5] In particular, the regulation includes risk-based indicators to differentiate firms and tailor the application of enhanced prudential standards based on their (1) size, (2) cross-jurisdictional activity, (3) reliance on short-term wholesale funding, (4) nonbank assets, (5) off-balance-sheet exposure, and (6) whether a firm is identified as a U.S. GSIB under the Board's rules.[6] Each of the risk-based indicators is designed to identify, in a transparent way, firms that pose heightened risk. For example, material reliance on unstable short-term wholesale funding could lead to funding runs that can place stress on a firm and result in dislocations in asset markets should a firm liquidate assets at fire sale prices to recover its funding needs. Table 1 summarizes the scoping criteria for categories of regulatory capital and liquidity requirements in Regulation YY.

1060.1.2.1 Company Run Stress Testing Requirements

Stress testing is a core element of the Board's regulatory framework and supervisory program for large firms. Stress testing enables the Board to assess whether large firms have sufficient capital to absorb potential losses and continue lending under severely adverse conditions. Regulation YY (12 CFR part 252, subpart F) establishes the requirement for certain firms to conduct stress tests. The company-run stress testing

5. Other than risk-committee and related risk-management requirements, the final rule eliminated enhanced regulatory requirements for banking organizations with less than $100 billion in total assets. For FBOs with a limited U.S. presence, the final rule raised the global asset thresholds consistent with the changes made by EGRRCPA and continues to rely on compliance with comparable home-country standards.

6. For FBOs, Regulation YY measures risk-based indicators of the combined U.S. operations or U.S. IHC, as applicable. For U.S. banking organizations, Regulation YY measures risk-based indicators of the total consolidated organization.

Table 2. Applicability of company run stress tests

Type of covered company	Frequency of required stress test
Global systemically important BHC	Annually, by April 5 of each calendar year based on data as of December 31 of the preceding calendar year, unless the time or the as-of date is extended by the Board in writing.
Category II BHC or U.S. IHC	Annually, by April 5 of each calendar year based on data as of December 31 of the preceding calendar year, unless the time or the as-of date is extended by the Board in writing.
Category III BHC or U.S. IHC	Biennially, by April 5 of each calendar year ending in an even number, based on data as of December 31 of the preceding calendar year, unless the time or the as-of date is extended by the Board in writing.
Nonbank financial company supervised by the Board	Periodically, as determined by rule or order.

requirements apply to Category I, Category II, and Category III U.S. BHCs, covered SLHCs, and IHCs. See table 2 for more information on the applicability of the company-run stress tests.

The company run stress testing requirements also apply to insured depository institutions with greater than $250 billion in average total consolidated assets over the prior four quarters (12 CFR part 252, subpart B).

Regulation YY also establishes definitions of stress testing, related terms, as well as methodologies for conducting stress tests, and reporting and disclosure requirements for covered companies.[7] In conducting a stress test under Regulation YY, for each quarter of the planning horizon, a covered company must estimate the following for each scenario required to be used:

1. Losses, pre-provision net revenue, provision for credit losses, and net income
2. The potential impact on the regulatory capital levels and ratios applicable to the covered bank, and any other capital ratios specified by the Board, incorporating the effects of any capital action over the planning horizon and maintenance of an allowance for loan losses or adjusted allowance for credit losses, as appropriate, for credit exposures throughout the planning horizon

The company-run stress testing requirements in Regulation YY also describe the assumptions covered companies must consider regarding its capital actions over the planning horizon. Specifically, it is assumed that the covered company will

1. not pay any dividends on any instruments that qualify as common equity tier 1 capital;
2. make payments on instruments that qualify as additional tier 1 capital or tier 2 capital equal to the stated dividend, interest, or principal due on such instrument;
3. not make a redemption or repurchase of any capital instrument that is eligible for inclusion in the numerator of a regulatory capital ratio; and
4. not make any issuances of common stock or preferred stock.

1060.1.2.1.1 Board and Senior Management Responsibilities

The board of directors or appropriate board committee must review and approve the policies and procedures of the stress testing processes as frequently as economic conditions or the condition of the covered company may warrant. At a minimum, the board of directors must review and approve its stress testing policies and procedures each year a stress test is conducted.[8]

Senior management must establish and maintain a system of controls, oversight, and documentation, including policies and procedures, that are designed to ensure that its stress testing processes are effective in meeting the requirements in Regulation YY. These policies and procedures must, at a minimum, describe the covered company's stress testing practices and methodologies, and processes for validating and updating the company's stress test practices and

7. See 12 CFR 252.56.

8. 12 CFR 252.56(c)(2).

methodologies consistent with applicable laws and regulations.[9]

The board of directors and senior management must receive a summary of the results of any stress test conducted under Regulation YY. After completing the stress tests, the board of directors and senior management must consider the stress test results

- as part of the covered company's capital plan and capital planning process, including when making changes to the covered company's capital structure (including the level and composition of capital);
- when assessing the covered company's exposures, concentrations, and risk positions; and
- in the development or implementation of any plans of the covered company for recovery or resolution.

1060.1.3 REGULATION Q (12 CFR PART 217): CAPITAL POSITIONS

In 2013, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) adopted a rule replacing their general risk-based capital requirements, advanced approaches capital requirements, market risk capital requirements, and leverage capital requirements.[10] The Federal Reserve's capital rule, Regulation Q, addresses weaknesses highlighted during the 2008–09 financial crisis by helping to ensure that the banking system is better able to absorb losses and continue to lend in future periods of economic stress. In addition, Regulation Q implements certain federal laws related to capital requirements and international regulatory capital standards adopted by the Basel Committee on Banking Supervision.

1060.1.3.1 APPLICABILITY

Regulation Q applies on a consolidated basis to every Board-regulated institution (referred to as a "banking organization") that is

- a state member bank;
- a BHC domiciled in the United States that is not subject to 12 CFR part 225, appendix C, or
- a covered SLHC domiciled in the United States.

Regulation Q does not apply to SLHCs substantially engaged in insurance underwriting or commercial activities, or to SLHCs that are insurance underwriting companies.

Smaller Firms that are not Fully Subject to Regulation Q

The Board may, by order, apply any or all of Regulation Q to any BHC, based on an institution's asset size, level of complexity, risk profile, scope of operations, or financial condition. However, there are certain smaller firms that are generally not subject to Regulation Q. As noted above, Regulation Q does not apply to holding companies that are subject to 12 CFR part 225, appendix C, which is the "Small Bank Holding Company and Savings and Loan Holding Company Policy Statement." The Small Bank Holding Company and Savings and Loan Holding Company Policy Statement applies to BHCs with pro forma consolidated assets of less than $3 billion that

1. are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary;
2. do not conduct significant off-balance-sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and
3. do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission.

The Board may, in its discretion, exclude any BHC, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes. With some exceptions, the policy statement applies to SLHCs as if they were BHCs.[11]

In 2019, the agencies adopted a final rule that provides for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of

9. 12 CFR 252.56(c)(1)
10. See 12 CFR part 217 (Regulation Q).

11. See "Control and Ownership (BHC Formations)," in this manual for more information on the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement.

Table 3. Captial Ratio Calculations and Minimum Ratios

Ratio	Calculation	Minimum
Common equity tier 1 capital ratio	$\frac{\text{common equity tier 1 capital}}{\text{standardized total risk-weighted assets}}$	4.5%
Tier 1 capital ratio	$\frac{\text{tier 1 capital}}{\text{standardized total risk-weighted assets}}$	6%
Total capital ratio	$\frac{\text{total capital}}{\text{standardized total risk-weighted assets}}$	8%
Leverage ratio	$\frac{\text{tier 1 capital}}{\text{average total consolidated assets}}$	4%

EGRRCPA.[12] This final rule established the community bank leverage ratio (CBLR) framework, which provides an optional measure of capital adequacy for depository institutions and depository institution holding companies with certain characteristics. A qualifying banking organization that elects to use the CBLR framework and that maintains a leverage ratio of greater than 9 percent will be considered to have satisfied the generally applicable risk-based and leverage capital requirements in the agencies' capital rules.

1060.1.3.2 Minimum Capital Ratios

All banking organizations covered under Regulation Q (12 CFR part 217) are subject to the following minimum regulatory capital requirements: a common equity tier 1 capital ratio of 4.5 percent, a tier 1 capital ratio of 6 percent, a total capital ratio of 8 percent of risk-weighted assets, and a leverage ratio of 4 percent.[13] See table 3 for more information on the calculation of these ratios.

Most banking organizations are expected to operate with capital levels above the minimum ratios. In addition, banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk are expected to maintain capital well above the minimum ratios; in such cases, the Federal Reserve may specify a higher minimum requirement.

In implementing Regulation Q, the Federal Reserve has reserved the authority to require a banking organization to hold more capital if the minimum requirements are not commensurate with the bank's credit, market, operational, or other risks (see 12 CFR 217.1(d)). This is a formal process that requires Federal Reserve approval, and an examiner alone cannot provide this directive.

The *Commercial Bank Examination Manual*'s section entitled, "Assessment of Capital Adequacy" contains more information on the components of capital and risk weighted assets, as defined in Regulation Q.

1060.1.3.3 Supplementary Leverage Ratio

The supplementary leverage ratio measures tier 1 capital relative to total leverage exposure, which includes on-balance-sheet assets (including deposits at central banks) and certain off-balance-sheet exposures.[14]

Advanced approaches banking organizations and Category III banking organizations (both of which are described in greater detail below) are subject to a minimum supplementary leverage ratio of 3 percent. Relative to the tier 1 leverage ratio, the denominator of the supplementary leverage ratio incorporates certain off-balance-

12. See 84 Fed. Reg. 61,797 (November 13, 2019) and 12 CFR 217.12.
13. Tier 1 capital is equal to the sum of common equity tier 1 capital and additional tier 1 capital. Total capital is the sum of common equity tier 1, additional tier 1, and tier 2 capital.
14. 12 CFR 217.10(a)(5) and (c)(4)

sheet exposures such as commitments and derivative exposures. The Federal Reserve applies this to advanced approaches banking organizations regulated by the Board and Category III Board-regulated institutions, because these firms typically hold higher levels of off-balance-sheet exposure that are not captured by the leverage ratio. The supplementary leverage ratio also factors into the prompt corrective action capital ratio framework applicable to these banking organizations at the depository institution level.

In January 2020, the Federal Reserve, together with the OCC and FDIC, issued a final rule to implement EGRRCPA section 402.[15] Under EGRRCPA section 402, the supplementary leverage ratio must not take into account funds of a custodial bank that are deposited with certain central banks, provided that any amount that exceeds the value of deposits of the custodial bank that are linked to fiduciary or custodial and safekeeping accounts must be taken into account when calculating the supplementary leverage ratio as applied to the custodial bank. Custody, safekeeping, and asset servicing activities generally involve holding securities or other assets on behalf of clients, as well as activities such as transaction settlement, income processing, and related record keeping and operational services. To qualify as a custodial banking organization, a depository institution holding company must have a ratio of assets under custody-to-total assets of at least 30:1, calculated as an average over the prior four calendar quarters.

1060.1.3.4 Enhanced Supplementary Leverage Ratio

In 2015, the Federal Reserve implemented an enhanced supplemental leverage ratio requirement for U.S. GSIBs and their depository institution subsidiaries.[16] The enhanced supplementary ratio standards require each U.S. GSIB to maintain a supplementary leverage ratio above 5 percent to avoid limitations on the firm's distributions and certain discretionary bonus payments and also require each of its insured depository institutions to maintain a supplementary leverage ratio of at least 6 percent to be deemed "well capitalized" under the prompt corrective action framework of each agency. Banking organizations that do not meet the enhanced supplementary leverage ratio are subject to restrictions on dividends and discretionary bonus payments, similar to the approach used for purposes of the countercyclical capital buffer (CCyB) described below.

1060.1.3.5 Countercyclical Capital Buffer

The CCyB is a supplemental policy tool that the Federal Reserve can increase during periods of rising vulnerabilities in the financial system and reduce when vulnerabilities recede. It is designed to increase the resilience of advanced approaches banking organizations or Category III Board-regulated institutions when there is an elevated risk of above-normal losses. Increasing the resilience of such organizations will, in turn, improve the resilience of the broader financial system. The Federal Reserve would most likely begin to increase the CCyB above 0 percent to augment minimum capital requirements and other capital buffers when systemic vulnerabilities are meaningfully above normal. By requiring large banking organizations to hold additional capital during a period of excess and removing the requirement to hold additional capital when the vulnerabilities have diminished, the CCyB is expected to moderate fluctuations in the supply of credit over time.

A CCyB, if applicable, would expand the capital conservation buffer by up to 2.5 percent of a banking organization's total risk-weighted assets for advanced approaches banking organizations or Category III Board-regulated institutions. The amount of the CCyB amount is determined by a country's bank supervisor and will differ by jurisdiction. At any point in time, a country's bank supervisor determines the degree of excessive credit growth in its jurisdictions. An advanced approaches Board-regulated institution or a Category III Board-regulated institution must calculate a CCyB amount in accordance with Regulation Q (12 CFR 217.11(b)) for purposes of determining its maximum payout ratio. The payout ratio is set forth in Regulation Q as well as the *Commercial Bank Examination Manual's* section entitled "Dividends."

1060.1.3.6 GSIB Surcharge Requirement

In July 2015, the Board adopted the GSIB surcharge requirements (12 CFR part 217, subpart H) as part of its implementation of sec-

15. 85 Fed. Reg. 4569 (January 27, 2020).
16. 80 Fed. Reg. 49,082 (August 14, 2015).

tion 165 of the Dodd-Frank Act.[17] The GSIB surcharge requirement works to mitigate the potential risk that the material financial distress or failure of a GSIB could pose to U.S. financial stability by increasing the stringency of capital standards for GSIBs as they grow across a group of metrics that serve as proxies for their systemic risk profile. The GSIB surcharge requirements establish a methodology to identify whether a U.S. top-tier BHC is a GSIB and imposes a risk-based capital surcharge on such an institution. The GSIB surcharge requirements takes into consideration the nature, scope, size, scale, concentration, interconnectedness, and mix of activities of each company subject to the rule in its methodology for determining whether the company is a GSIB and the size of the surcharge. These factors are captured in the method 1 and method 2 scores, which use quantitative metrics reported on the FR Y–15 reporting form to measure a firm's systemic footprint. The GSIB surcharge requirements establish the criteria for identifying a GSIB and the methods that those firms must use to calculate a risk-based capital surcharge, which is calibrated to each firm's overall systemic risk and which expands the capital conservation buffer requirement for these firms.

1060.1.3.7 Advanced Approaches

The advanced approaches framework provides a risk-based capital framework that permit certain banking organizations to use an internal risk-measurement approach to calculate capital requirements and advanced measurement approaches in order to calculate regulatory credit and operational-risk capital requirements. An advanced approaches banking organization must calculate its risk-based capital ratios using both the standardized and advanced approaches and meet each minimum requirement with the lower of the two ratios. The advanced approaches are supplemented by the market risk-capital requirement.

The advanced approaches in Regulation Q (12 CFR part 217) apply to Category I and Category II banking organizations. The advanced approaches also apply to a state member bank that is a subsidiary of a global systemically important BHC, a Category II Board-regulated institution; or a subsidiary of a bank, BHC, or SLHC that uses the advanced approaches to calculate its risk-based capital requirements. Advanced approaches banking organizations also include those banking organizations that have elected to use the advanced approaches to calculate their total risk-weighted assets.

17. 80 Fed. Reg. 49,082 (August 14, 2015)

1060.1.3.8 Market Risk Capital Requirement

Banking organizations with significant trading activities are subject to regulatory capital requirements for market risk. The purpose of the market risk capital requirement is to establish risk-based capital requirements for Board-regulated institutions with significant exposure to market risk, provide methods for these Board-regulated institutions to calculate their standardized measure for market risk and, if applicable, advanced measure for market risk, and establish public disclosure requirements. The market risk capital requirement applies to any Board-regulated institution with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or $1 billion or more. On a case-by-case basis, the Federal Reserve may require an institution that does not meet these criteria to comply with the market risk capital requirement if deemed necessary for safety-and-soundness reasons. Table 4 summarizes the applicability of several requirements in Regulation Q.

1060.1.4 REGULATION Y (12 CFR PART 225): CAPITAL PLAN RULE AND STRESS CAPITAL BUFFER

1060.1.4.1 Background and Interconnections with other Capital Rules

The firm's planned capital actions should be consistent with the firm's capital policy, including the amounts of planned dividends and repurchases. A firm's processes for managing and allocating its capital resources are critical to its financial strength and resiliency and to the stability and effective functioning of the U.S. financial system. In 2011, the Board implemented its capital plan rule to require large firms to develop and maintain capital plans supported by robust processes for assessing their capital adequacy.[18]

18. See 12 CFR 225.8; see also Capital Plans, 76 Fed. Reg. 74,631 (December 1, 2011). Amendments to the capital plan rule are found in 79 Fed. Reg. 64,040 (October 27, 2014); 80 Fed. Reg. 75,424 (December 2, 2015); 85 Fed. Reg. 15,576 (March 18, 2020); and 86 Fed. Reg. 7927 (February 3, 2021).

Table 4. Applicability of key requirements of Regulation Q

Requirement in Regulation Q (12 CFR part 217)	Category I	Category II	Category III	Category IV
Supplementary leverage ratio	Yes	Yes	Yes	
Enhanced supplementary leverage ratio	Yes			
Countercyclical capital buffer	Yes	Yes	Yes	
Must recognize elements of accumulated other comprehensive income (AOCI) in regulatory capital	Yes	Yes		
GSIB surcharge requirement	Yes			
Advanced approaches	Yes	Yes		
Market risk capital requirement[1]	Yes	Yes	Depends on the firm's activities	Depends on the firm's activities
Minimum capital standardized capital requirements and leverage ratio (12 CFR 217.10)	Yes	Yes	Yes	Yes

1 Any Board-regulated institution with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or $1 billion or more.

The aim of these requirements is to ensure that large firms have robust, forward-looking capital planning processes that account for their unique risks, and to help ensure that large firms have sufficient capital to continue operations throughout times of economic and financial stress. The capital plan rule works in conjunction with the stress test rules adopted by the Board to implement the stress testing requirements of the Dodd-Frank Act.[19]

In March 2020, the Board adopted the stress capital buffer rule to integrate its capital plan rule and regulatory capital rule through the establishment of a stress capital buffer requirement, creating a single, risk-sensitive framework for large banking organizations.[20] To achieve individually tailored and risk-sensitive capital requirements for firms subject to the capital plan rule, the stress capital buffer rule establishes the size of a firm's stress capital buffer requirement based in part on a supervisory stress test conducted by the Federal Reserve. Through the integration of the capital rule and Comprehensive Capital Analysis and Review (CCAR), the final rule removed redundant elements of the capital and stress testing frameworks, including the CCAR quantitative objection and the assumption that a firm makes all capital actions under stress.

In October 2019, the Board issued a final rule that established a revised framework for applying prudential standards to large firms to align

19. See 12 U.S.C. 5365(i) and 12 CFR part 252.

20. See Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576 (March 18, 2020).

prudential standards more closely to a large firm's risk profile (tailoring rule).[21] The tailoring rule established four categories of prudential standards and applies them based on indicators designed to measure the risk profile of a firm.[22] The scoping criteria for categories of prudential standards in the tailoring rule are described above in table 1. In February 2021, the Board issued a final rule to tailor the requirements in the Board's capital plan rule based on risk. Among other things, the February 2021 final rule modified the capital planning, regulatory reporting, and stress capital buffer requirements for firms subject to Category IV standards under the tailoring rule.[23]

1060.1.4.2 Capital Plan Requirements and Applicability

The capital plan rule applies to top-tier U.S. BHCs and top tier U.S. SLHCs with average total consolidated assets of $100 billion or more, as well as IHCs pursuant to the Board's Regulation YY.[24] The capital plan rule requires such firms to develop and maintain a capital plan that includes an assessment of the sources and uses of capital and reflects forward-looking projections of revenue and losses to monitor and maintain their internal capital adequacy.

At least annually, and prior to the submission of the capital plan to the Federal Reserve, a large firm's board of directors or a designated committee thereof is required to review the capital plan.[25] The board of directors or designated committee must (1) review the robustness of the holding company's process for assessing capital adequacy, (2) ensure that any deficiencies in the firm's process for assessing capital adequacy are appropriately remedied, and (3) approve the firm's capital plan.[26]

21. See Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59,032 (November 1, 2019).

22. The final rule increased the threshold for general application of these standards from $50 billion to $100 billion in total consolidated assets.

23. 86 Fed. Reg. 7927 (February 3, 2021).

24. The capital plan rule also applies to nonbank financial companies supervised by the Board that is made subject to a rule or order of the Board.

25. The capital plans must be submitted by April 5th of a calendar year (or other Federal Reserve Board designated date) for review.

26. As part of this review, the board of directors should consider any remaining uncertainties, limitations, and assumptions associated with the firm's capital adequacy process.

1060.1.4.3 Mandatory Elements of a Capital Plan

A capital plan is defined as a written presentation of a large firm's capital planning strategies and capital adequacy process that includes certain mandatory elements. These mandatory elements are organized into four main components. For more information on the subcomponent elements of these four main components, see Regulation Y and Regulation LL.

1. An assessment of the expected uses and sources of capital over the planning horizon (at least nine quarters, beginning with the quarter preceding the quarter in which the firm submits its capital plan) that reflects the firm's size, complexity, risk profile, and scope of operations, assuming both expected and stressful conditions.
2. A detailed description of the firm's process for assessing capital adequacy, including how the firm will, under expected and stressful conditions,
   - maintain capital commensurate with its risks;
   - maintain capital above the minimum regulatory capital ratios;
   - serve as a source of strength to its subsidiary depository institutions; and
   - maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as a credit intermediary.
3. The firm's capital policy, which is the firm's written assessment of the principles and guidelines used for capital planning, capital issuance, usage and distributions, including internal capital goals, the quantitative or qualitative guidelines for dividend and stock repurchases, the strategies for addressing potential capital shortfalls, and the internal governance procedures around capital policy principles and guidelines; and
4. A discussion of any expected changes to the firm's business plan that are likely to have a material impact on the firm's capital adequacy or liquidity. For example, the capital plan should reflect any expected material effects of new lines of business or activities on the firm's capital adequacy or liquidity, including revenue and losses.

The Board, or the appropriate Reserve Bank with concurrence of the Board, will consider the following factors in reviewing a firm's capital plan:

- the comprehensiveness of the capital plan, including the extent to which the analysis underlying the capital plan captures and addresses potential risks stemming from activities across the firm and the firm's capital policy;
- the reasonableness of the firm's capital plan, the assumptions and analysis underlying the capital plan, and the robustness of its capital adequacy process;
- relevant supervisory information about the firm and its subsidiaries;
- the firm's regulatory and financial reports, as well as supporting data that would allow for an analysis of the firm's loss, revenue, and reserve projections;
- the results of any stress tests conducted by the firm or the Federal Reserve; and
- other information requested or required by the Board or the appropriate Reserve Bank, as well as any other information relevant, or related, to the firm's capital adequacy.

1060.1.4.4 The Capital Plan Rule and Firms Subject to Category IV Standards

All banking organizations, regardless of size and complexity, are expected to have the capacity to analyze the potential impact of adverse outcomes on their financial condition, including on capital.[27] Therefore, risk-management practices should be tailored to the risk and complexity of the individual firm and should include practices to identify and assess its sensitivity to unexpected adverse outcomes before they occur.

In February 2021, the Board issued a final rule that removed the requirement for firms subject to Category IV standards to include certain elements in their capital plans.[28] Firms subject to Category IV standards are not required to calculate estimates of projected revenues, losses, reserves, or pro forma capital levels (effectively a form of stress testing) using scenarios provided by the Board. However, under certain circumstances, based on the macroeconomic outlook or based on the firm's risk profile, financial condition, or corporate structure, the Board may require a firm subject to Category IV standards to submit a capital plan under scenarios provided by the Board. Firms subject to Category IV standards are still required to provide a forward-looking analysis of income and capital levels under expected and stressful conditions in their annual capital plans. These projections are required to be tailored to, and sufficiently capture, the firm's exposures, activities, and idiosyncratic risks in their capital plans. The Federal Reserve conducts an annual assessment of the capital plan of a firm subject to Category IV standards as part of its ongoing supervisory process, and the results of this assessment will continue to be an input into the firm's capital planning and positions component of the LFI rating system.

1060.1.4.5 Stress Capital Buffer

During the 2008–09 financial crisis, some banking organizations continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened. Such capital distributions had a significant negative impact on the overall strength of the banking sector. To encourage better capital conservation and to enhance the resilience of the banking system, Regulation Q limits capital distributions and discretionary bonus payments for banking organizations that do not hold a specified amount of common equity tier 1 capital in addition to the amount of regulatory capital necessary to meet the minimum risk-based capital requirements (capital conservation buffer).

27. For example, smaller BHCs are subject to guidance that clarifies such firms are expected to hold capital commensurate with their overall risk profile. See SR-09-4, Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies (February 24, 2009, revised July 24, 2020). Holding companies with less than $100 billion in total consolidated assets are subject to an overall evaluation and rating of managerial and financial condition and an assessment of future potential risk to subsidiary depository institution(s) as part of the RFI or Modified RFI rating. See SR-19–4/CA-19–3, Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion (February 26, 2019) and SR-13–21, Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less (December 17, 2019, revised March 6, 2019). BHCs with total consolidated assets of $100 billion or greater and certain SLHCs are subject to a supervisory evaluation of whether a covered firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones. See SR-19–3/CA-19-2, "Large Financial Institution (LFI) Rating System" (February 26, 2019).

28. 86 Fed. Reg. 7927 (February 3, 2021).

On March 4, 2020, the Board adopted a final rule establishing a stress capital buffer for BHCs and U.S. IHCs of FBOs that have $100 billion or more in total consolidated assets. The stress capital buffer rule integrates the Federal Reserve's stress test results with its non-stress capital requirements.[29] More specifically, the stress capital buffer rule integrates CCAR with the capital rule. Under the stress capital buffer requirement, the Federal Reserve uses the results of its supervisory stress test to establish the size of a firm's stress capital buffer requirement, which replaces the static 2.5 percent of the risk-weighted assets component of a firm's capital conservation buffer requirement.

The stress capital buffer rule included several changes to the assumptions embedded in the supervisory stress test, notably removing the assumption that firms make all planned common distributions and excluding material business plan changes from the stress capital buffer requirement calculation. Previously, under CCAR, the Board assumed that a firm would continue to make all planned dividends and share repurchases under stress, and therefore required firms to pre-fund nine quarters of planned dividends and share repurchases. Under the stress capital buffer rule, the Board no longer assumes that a firm would continue to make all planned dividends and share repurchases under stress. The stress capital buffer requirement includes four-quarters of planned dividends; therefore, firms are subject to a pre-funding requirement of four quarters of planned dividends. This approach recognizes the capital rule's automatic limitations on capital distributions while continuing to promote forward-looking capital planning and mitigate pro-cyclicality.

A firm's stress capital buffer requirement varies based on a firm's risk. A firm that does not maintain capital ratios above its minimums plus its buffer requirements faces restrictions on its capital distributions and discretionary bonus payments. As explained in Regulation Y, the Board will notify a firm of its stress capital buffer requirement and an explanation of the results of the supervisory stress test by June 30 of the calendar year in which the capital plan was submitted or within 90 calendar days of receiving notice that the Board will recalculate the firm's stress capital buffer requirement pursuant to Regulation Y.[30]

29. 85 Fed. Reg. 15,576 (March 18, 2020).
30. 12 CFR 225.8(h).

1060.1.4.5.1 Calculation and Timing of Stress Capital Buffer Requirements for Firms Subject to Category IV Standards

The tailoring rule made two changes to the stress testing rules for firms subject to Category IV standards. First, the tailoring rule removed the requirement for firms subject to Category IV standards to conduct and publicly disclose the results of company-run stress tests as defined in the Board's stress testing rules. Second, the tailoring rule changed the frequency of the supervisory stress test for firms subject to Category IV standards from annual to biennial.

The Board issued a final rule in February 2021, requiring a firm subject to Category IV standards to update the stress test portion of the stress capital buffer requirement in a manner consistent with the frequency of the supervisory stress test (that is, both would occur every other year).[31] The stress test portion of such a Category IV firm's stress capital buffer requirement is not updated in a year in which it does not participate in the supervisory stress test. A Category IV firm may elect to opt-in to a stress test in a year in which the firm would not generally be subject to the supervisory stress test and to receive an updated stress capital buffer requirement in that year.

1060.1.5 SUPERVISORY ACTIVITIES, GUIDANCE, AND OTHER CONSIDERATIONS IN ASSESSING CAPITAL

1060.1.5.1 Supervisory Stress Test Requirements

Regulation YY requires the Federal Reserve to conduct annual analyses of nonbank financial companies supervised by the Board and BHCs with $100 billion or more in total consolidated assets to evaluate whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. The stress test requirements in Regulation YY establish a framework to conduct supervisory stress tests of large BHCs.

31. 86 Fed. Reg. 7927 (February 3, 2021).

1060.1.5.1.1 Stress Testing Analysis Conducted by the Federal Reserve

For the supervisory stress tests described in Regulation YY, the Board conducts an analysis of each covered company's capital, on a total consolidated basis, taking into account all relevant exposures and activities of that covered company, to evaluate the ability of the covered company to absorb losses in specified economic and financial conditions. The analysis includes an assessment of the projected losses, net income, and pro forma capital levels and regulatory capital ratios and other capital ratios for the covered company and uses analytical techniques that the Board determines are appropriate to identify, measure, and monitor risks a covered company may pose to U.S. financial stability.

The Board conducts stress testing analysis using a minimum of two different scenarios: a baseline scenario and a severely adverse scenario. Prior to completing the supervisory stress test, the Federal Reserve will notify covered companies of the scenarios that the Board will apply in analyzing the institution. Regulation YY provides more information on assumptions used when assessing a company's capital actions over the planning horizon.

Concerning the frequency of these reviews, the Board will conduct annual supervisory stress tests for U.S. GSIBs; Category II BHCs, SLHCs and IHCs; Category III BHCs, SLHCs, and IHCs; and nonbank financial companies supervised by the Board.[32] The Federal Reserve assesses Category IV BHCs, SLHCs and IHCs biennially, occurring in each year ending in an even number.

1060.1.5.1.2 Comprehensive Capital Analysis and Review

At the height of the 2008–09 financial crisis, the Board created the Supervisory Capital Assessment Program (SCAP) as a way to help restore confidence in the largest U.S. banking organizations. SCAP estimated potential losses at those firms assuming that economic and financial conditions worsened. The SCAP evolved into the CCAR supervisory exercise. CCAR reflects a number of important steps forward in the Federal Reserve's approach to the supervision of the largest BHCs. Rather than evaluating capital at a moment in time, CCAR incorporates a forward looking, post-stress evaluation of a BHC's capital adequacy. Further, CCAR involves a simultaneous, horizontal assessment of capital adequacy at the largest U.S. BHCs, thus allowing the process to be informed by the financial condition of, and outlook for, these BHCs individually and as a group.

As part of CCAR, the Federal Reserve evaluates institutions' capital adequacy, internal capital adequacy assessment processes, and their individual plans to make capital distributions, such as dividend payments or stock repurchases.

The Federal Reserve coordinates supervisory stress tests with the CCAR process to reduce duplicative requirements and to minimize regulatory burden.

1060.1.5.2 Key Supervisory Guidance on the Assessment of Capital at Large Financial Institutions

Supervisory guidance outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area. Further, it often provides examples of practices that the agencies generally consider consistent with safety-and-soundness standards and any other applicable laws and regulations.[33] The following supervisory guidance issuances provide insight to industry, as well as supervisory staff, in a transparent way that helps to ensure consistency in the supervisory approach towards assessing capital at large holding companies.[34]

1060.1.5.2.1 Large Financial Institution Rating System

"Large Financial Institution (LFI) Rating System," SR-19-3/CA-19-2, outlines the ratings framework for BHCs and noninsurance, noncommercial SLHCs with total consolidated assets of $100 billion or more, and U.S. IHCs of FBOs established under Regulation YY with total consolidated assets of $50 billion or more. The Capital Planning and Positions rating of the LFI rating system evaluates

32. For more information on the supervisory stress test rule for the SLHCs, see 12 CFR part 238, subpart O.

33. Supervisory guidance does not have the force and effect of law, and the Federal Reserve does not take enforcement actions based on supervisory guidance. See 12 CFR part 262, appendix A.

34. For more information on guidance applicable to large financial holding companies, see the "Large Banking Organizations" topic page on the Board's public website.

1. the effectiveness of a firm's governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions and events; and
2. the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

In developing this rating, the Federal Reserve evaluates

- *Capital planning:* The extent to which a firm maintains sound capital planning practices through effective governance and oversight; effective risk management and controls; maintenance of updated capital policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into capital planning and projections of capital positions; and
- *Capital positions:* The extent to which a firm's capital is sufficient to comply with regulatory requirements, and to support its ability to meet its obligations to depositors, creditors, and other counterparties and continue to serve as a financial intermediary through a range of conditions.

A firm's capital rating under the LFI rating system reflects a broad assessment, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions. In consolidating supervisory findings into a comprehensive assessment of a firm's capital planning and positions, the Federal Reserve takes into account the materiality of a firm's outstanding and newly identified supervisory issues.

A firm's compliance with minimum regulatory capital requirements is considered in assigning the firm's Capital Planning and Positions component rating; however, the Federal Reserve may determine that a firm does not meet expectations regarding its capital position in light of its idiosyncratic activities and risks, even if the firm meets minimum regulatory capital requirements. Any findings from supervisory stress testing or CCAR will represent inputs into the Capital Planning and Positions component rating.

See also the section entitled, "Large Financial Institution Rating System" in section 1060.0 of this manual.

1060.1.5.2.2 Model Risk Management

"Guidance on Model Risk Management," SR-11-7, is an interagency statement that provides guidance for banks on effective model risk management. A "model" refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model consists of three components:

1. an information input component, which delivers assumptions and data to the model
2. a processing component, which transforms inputs into estimates
3. a reporting component, which translates the estimates into useful business information

Models are used for analyzing business strategies, informing business decisions, identifying and measuring risks, valuing exposures, instruments or positions, conducting stress testing, assessing adequacy of capital, managing client assets, measuring compliance with internal limits, maintaining the formal control apparatus of the bank, or meeting financial or regulatory reporting requirements and issuing public disclosures. Rigorous model validation plays a critical role in model risk management; however, sound development, implementation, and use of models are also vital elements. Furthermore, model risk management encompasses governance and control mechanisms such as board and senior management oversight, policies and procedures, controls and compliance, and an appropriate incentive and organizational structure.

1060.1.5.2.3 Supervisory Guidance on Stress Testing

In 2012, the Federal Reserve, OCC, and FDIC issued stress testing guidance for larger banking organizations.[35] The guidance emphasizes the importance of stress testing as an ongoing risk management practice that supports banking organizations' forward-looking assessment of risks and better equips them to address a range of adverse outcomes.

35. See SR-12-7, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 billion in Total Consolidated Assets."

The guidance describes five principles for banking organizations to consider when designing and implementing a stress testing framework:

- *Principle 1:* A banking organization's stress testing framework should include activities and exercises that are tailored to and sufficiently capture the banking organization's exposures, activities, and risks.
- *Principle 2:* An effective stress testing framework employs multiple conceptually sound stress testing activities and approaches.
- *Principle 3:* An effective stress testing framework is forward-looking and flexible.
- *Principle 4:* Stress testing results should be clear, actionable, well supported, and inform decisionmaking.
- *Principle 5:* An organization's stress testing framework should include strong governance and effective internal controls.

The guidance also describes several approaches and applications that banking organizations should consider using, such as scenario analysis, sensitivity analysis, enterprise-wide stress testing, and reverse stress testing. Organizations should also recognize that stress testing approaches will evolve over time and they should update their practices as needed.

1060.1.5.2.4 Dividends Policy Statement

On November 14, 1985, the Federal Reserve Board issued a policy statement on the payment of dividends by state member banks and BHCs. The complete statement is also available in section 2020.5, "Intercompany Transactions (Dividends)," of this manual. Overall, the policy statement states that as a matter of prudent banking it is generally appropriate for a bank or BHC to continue its existing rate of cash dividends on common stock only if

- the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends; and
- the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious considerations to cutting or eliminating its dividends. Such an action will help conserve the organization's capital base and help it weather a period of adverse conditions or distress. It is generally inconsistent with prudent banking practices for a banking organization that is experiencing financial problems or that has inadequate capital to borrow to pay dividends; this would result in increased leverage at the very time the organization needs to reduce its debt or conserve its capital. Similarly, the payment of dividends based solely or largely on gains resulting from unusual or nonrecurring events may be imprudent. Unusual or nonrecurring events may include the sale of assets, the effects of accounting changes, the postponement of large expenses to future periods, or negative provisions to the allowance for loan and lease losses.

1060.1.5.2.5 Supervisory Assessment of Capital Planning and Positions

"Consolidated Supervision Framework for Large Financial Institutions," SR-12-17/CA-12-14, outlines core expectations for sound capital planning for LFIs. This capital planning and positions guidance provides additional details around the Federal Reserve's core capital planning expectations for firms subject to Category I standards and firms subject to Category II or III standards, building on the capital planning requirements included in the capital plan rule and the Board's stress test rules.[36] A firm should maintain a sound capital planning process on an ongoing basis, including in between submissions of its annual capital plan.[37] In addition, this guidance lists broad elements that would be expected of sound capital planning processes. More specifically, to support effective capital planning, and the adequacy of capital positions, each firm should

- maintain strong capital positions that not only comply with regulatory requirements, but also

36. The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve's advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies' supervisory guidance relating to the ICAAP (see 73 Fed. Reg. 44,620 (July 31, 2008)).

37. The term "capital planning process" used in this document, which aligns with terminology in SR-12-17/CA-12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents.

support the firm's ongoing ability to meet its obligations to creditors and other counterparties, as well as continue to serve as a financial intermediary through periods of stress;
- have in place robust internal processes that enable the firm to maintain capital commensurate with its unique risks under normal and stressful conditions, and to provide timely restoration of financial buffers in the event of drawdown;
- maintain processes that enable the identification and measurement of potential risks to asset quality, earnings, cash flows, and other primary determinants of capital positions;
- utilize comprehensive projections of the level and composition of capital resources, supported by rigorous and regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios;
- maintain sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, policies, and controls;
- establish goals for capital positions that are approved by the firm's board of directors and reflect the potential impact of legal or regulatory restrictions on the transfer of capital between legal entities; and
- maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of capital risk measurement and management processes.

In 2021, the Federal Reserve revised SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards," and SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards." While SR-15-18 and SR-15-19 generally apply to the largest BHCs, the principles of the 1985 Policy Statement on the Payment of Dividends are incorporated into these SR letters. Specifically, firms should have comprehensive policies on dividend payments that clearly articulate their objectives and approaches for maintaining a strong capital position and achieving the principles of the policy statement. In addition, the guidance in SR-15-18 and SR-15-19 outlines the Federal Reserve's core capital planning expectations building upon the capital planning requirements in the Federal Reserve's capital plan rule and stress test rules.

More specifically, the guidance outlines capital planning expectations for

- governance,
- risk management,
- internal controls,
- capital policy,
- scenario design, and
- projection methodologies.

Further, the guidance includes several appendixes that detail supervisory expectations on a firm's capital planning processes.

1060.1.5.3 Collaboration with Other Regulators

In the assessment of capital, as well as the other components of the LFI rating system, the Federal Reserve relies on strong, cooperative relationships with other regulators to implement effective consolidated supervision at the holding company-level. The principle of relying on the work of the insured depository institution regulators is a well-established tenet of Federal Reserve supervisory policy and is required by statute.[38]

The Federal Reserve is expected to rely, to the fullest extent possible, on the information and assessments provided by other regulators to support effective supervision. The views of other regulators may validate the conclusions from Federal Reserve-led supervisory events or fill in information gaps. Federal Reserve examination staff should understand and assess the scope of other regulators' work, including the extent to which transaction testing was performed, as well as the severity of the issues identified. By understanding the work of other regulators, Federal Reserve examiners can ascertain the extent another regulator's findings can be leveraged for assigning ratings under the LFI rating system for the holding company.

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

The Federal Reserve issued this guidance (SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards," and its attachment) to explain its supervisory expectations for capital planning at firms subject to category I standards under the Board's tailoring framework.[1] Capital is central to a firm's ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. Therefore, a firm's processes for managing and allocating its capital resources are critical to its financial strength and resilience, as well as the stability and effective functioning of the U.S. financial system. The following guidance provides the Federal Reserve's core capital planning expectations for firms subject to category I standards, building upon the capital planning requirements in the Federal Reserve's capital plan rules and stress test rules.[2]

The guidance outlines capital planning expectations for

- governance
- risk management
- internal controls
- capital policy
- scenario design, and
- projection methodologies.

Further, the guidance includes several appendixes that detail supervisory expectations for a firm's capital planning process. This guidance largely consolidates the Federal Reserve's existing capital planning guidance, including:

- Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice (August 2013)
- Comprehensive Capital Analysis and Review 2015 – Summary Instructions and Guidance (October 2014)
- Instructions for the Capital Assessments and Stress Testing information collection (Reporting Form FR Y-14A)
- SR-11-7, "Supervisory Guidance on Model Risk Management" (Refer to section 2126.0 of this manual)
- SR-12-7, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets"
- SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions"

1060.2.1 GUIDANCE ON SUPERVISORY ASSESSMENT OF CAPITAL PLANNING AND POSITIONS FOR CATEGORY I FIRMS

I. Introduction

This guidance (the attachment to SR-15-18) provides the Federal Reserve's core capital planning expectations for firms subject to category I standards, building upon the capital planning requirements included in the Board's capital plan rules and stress test rules. This guidance outlines capital planning expectations for these firms in the following areas:[3]

- governance
- risk management
- internal controls
- capital policy

1. See 84 Fed. Reg. 59,032 (November 1, 2019) for more information on the Board's tailoring framework. With the issuance of SR-15-18 and SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards," SR-99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," is superseded. In addition, SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," does not apply to firms subject to SR-15-18 and SR-15-19.

2. For the capital plan rules, refer to section 225.8 of Regulation Y (12 CFR 225.8) and section 238.170 of Regulation LL (12 CFR 238.170). Regulation Q (12 CFR part 217) establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Regulation YY (12 CFR part 252) and Regulation LL (12 CFR part 238) establish capital stress testing requirements for bank holding companies, U.S. intermediate holding companies of foreign banking organizations, and covered savings and loan holding companies with total consolidated assets of $100 billion or more.

3. Note that these expectations build upon the capital planning requirements set forth in the Board's capital plan rules and stress test rules (12 CFR 225.8; 12 CFR part 252, subparts E and F). Other relevant rules pertaining to the Board's regulatory regime for capital planning and positions are described in section II, "Regulatory Requirements for Capital Positions and Planning." The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The OMB control numbers for this guidance are OMB No. 7100-0341 and OMB No. 7100-0342.

- incorporation of stressful conditions and events, and
- estimation of the impact on capital positions.

Further, the following appendixes in the guidance provides detailed supervisory expectations on a firm's capital planning process:

A. Use of Models and Other Estimation Approaches
B. Model Overlays
C. Use of Benchmark Models in the Capital Planning Process
D. Sensitivity Analysis and Assumptions Management
E. Role of the Internal Audit Function in the Capital Planning Process
F. Capital Policy
G. Scenario Design
H. Risk-weighted Asset (RWA) Projections
I. Operational Loss Projections

This guidance applies to firms that are subject to category I standards.[4] The Federal Reserve has different expectations for sound capital planning and capital adequacy depending on the size, scope of operations, activities, and systemic importance of a firm. The Federal Reserve has separate guidance set forth in SR-15-19 that clarifies that expectations for firms subject to category I standards are higher than the expectations for firms subject to category II or III standards.

II. Regulatory Requirements for Capital Positions and Planning

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. Certain Federal Reserve regulations form the basis of the regulatory framework for capital positions and capital planning:

1. Regulation Q (12 CFR part 217), Capital Adequacy Requirements for Board-regulated Institutions;
2. Regulation YY (12 CFR part 252, subparts E and F) and subparts O and P of Regulation LL (12 CFR part 238, subparts O and P); and
3. Section 225.8 of Regulation Y (12 CFR 225.8) and subpart S of Regulation LL (12 CFR part 238, subpart S), together, also known as the capital plan rules).

Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Among other things, Regulation YY and Regulation LL establish capital stress testing requirements for bank holding companies and covered savings and loan holding companies, respectively, with total consolidated assets of $100 billion or more. The capital plan rules establish general capital planning requirements for a bank holding company or covered savings and loan holding company with total consolidated assets of $100 billion or more and requires such a firm to develop an annual capital plan that is approved by its board of directors.

This guidance provides the Federal Reserve's core capital planning expectations for firms subject to category I standards, building upon the capital planning requirements in the Federal Reserve's capital plan rules and stress test rules.

III. Capital Planning Expectations

Capital is central to a firm's ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. A firm's capital planning processes are critical to its financial strength and resilience. At firms subject to category I standards, sound capital planning is also critical to the stability and effective functioning of the U.S. financial system.

SR-12-17/CA-12-14 outlines core expectations for sound capital planning for large financial institutions. This capital planning and positions guidance provides additional details around the Federal Reserve's core capital planning expectations for firms subject to category I standards and firms subject to category II or III standards, building on the capital planning requirements included in the capital plan rule and the Board's stress test rules.[5] A firm should

4. This guidance does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board of Governors.

5. The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve's advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies' supervisory guidance relating to the ICAAP (see 73 Fed. Reg. 44,620 (July 31, 2008)).

maintain a sound capital planning process on an ongoing basis, including between submissions of its annual capital plan.[6]

A. Governance

The Federal Reserve expects a firm to have sound governance over its capital planning process. In general, senior management should establish the capital planning process and the board of directors should review and periodically approve that process.

1. Board of Directors

A firm's board of directors is ultimately responsible and accountable for the firm's capital-related decisions and for capital planning. The firm's capital planning should be consistent with the strategy and risk appetite set by the board and with the firm's risk levels, including how risks at the firm may emerge and evolve under stress. The board must annually review and approve the firm's capital plan.[7]

The board should direct senior management to provide a briefing on their assessment of the firm's capital adequacy at least quarterly, and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The briefing should describe whether current capital levels and planned capital distributions remain appropriate and consistent with capital goals (see Section III.D, "Capital Policy"). In their briefing, senior management should also highlight for the board any problem areas related to capital planning identified by senior management, internal audit, or supervisors.

The board should hold senior management accountable for providing sufficient information on the firm's material risks and exposures to inform board decisions on capital adequacy and actions, including capital distributions. Information provided to the board should be clear, accurate, and timely. The board should direct senior management to provide this information at least quarterly and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The information presented to the board should include consideration of a number of factors, such as

- macro-economic conditions and relevant market events;
- current capital levels relative to budgets and forecasts;
- post-stress capital goals and targeted real time capital levels (see section III.D, "Capital Policy");
- enterprise-wide and line-of-business performance;
- expectations from stakeholders (including shareholders, regulators, investors, lenders, counterparties, and rating agencies);
- potential sources of stress to the firm's operating performance; and
- risks that may emerge only under stressful conditions.

After receiving the information, the board should be in a position to understand the major drivers of the firm's projections under a range of conditions, including baseline and stress scenarios.

The board should direct senior management to provide information about the firm's estimation approaches, model overlays, and assessments of model performance (see Appendix A, "Use of Models and Other Estimation Approaches," Appendix B, "Model Overlays," and Appendix C, "Use of Benchmark Models in the Capital Planning Process"). The board should also receive information about uncertainties around projections of capital needs or limitations within the firm's capital planning process to understand the impact of these weaknesses on the process. This information should include key assumptions and the analysis of sensitivity of a firm's projections to changes in the assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management"). The board should incorporate uncertainties in projections and limitations in the firm's capital planning process into its decisions on capital adequacy and capital actions. It should also review and approve mitigating steps to address capital planning process weaknesses.

The board should direct senior management to establish sound controls for the entire capital planning process. The board should approve policies related to capital planning, and review them annually. The board should also approve capital planning activities and strategies. The board of directors should maintain an accurate record of its meetings pertaining to the firm's capital planning process.

6. The term "capital planning process" used herein, which aligns with terminology in SR-12-17/CA-12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents.
7. 12 CFR 225.8(e)(1)(iii).

2. Senior Management

Senior management should direct staff to implement board-approved capital policies, capital planning activities, and strategies in an effective manner. Senior management should make informed recommendations to the board regarding the firm's capital planning and capital adequacy, including post-stress capital goals and capital distribution decisions. Senior management's proposed capital goals and capital distributions should have analytical support and take into account the expectations of important stakeholders, including shareholders, rating agencies, counterparties, depositors, creditors, and supervisors.

Senior management should design and oversee the implementation of the firm's capital planning process; identify and assess material risks and use appropriate firm-specific scenarios in the firm's stress test; monitor and assess capital planning practices to identify limitations and uncertainties and develop remediation plans; understand key assumptions used throughout a firm's capital planning process and assess the sensitivity of the firm's projections to those assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management"); and review the capital planning process at least quarterly.

Senior management should establish a process for independent review of the firm's capital planning process, including the elements outlined in this guidance. The independent review process should be designed to identify the weaknesses and limitations of the capital planning process and the potential impact of those weaknesses on the process. Senior management should also develop remediation plans for any identified weaknesses affecting the reliability of capital planning results. Both the specific identified weaknesses and the remediation plans should be reported to the board of directors in a timely manner.

B. Risk Management

A firm should have a risk management infrastructure that appropriately identifies, measures, and assesses material risks and provides a strong foundation for capital planning.[8] This risk management infrastructure should be supported by comprehensive policies and procedures, clear and well-established roles and responsibilities, and strong and independent internal controls. In addition, the risk management infrastructure should be built upon sound information technology and management information systems. The Federal Reserve's supervisory assessment of the sufficiency of a firm's capital planning process will depend in large part on the effectiveness of the firm's risk management infrastructure and the strength of its process to identify unique risks under normal and stressful conditions, as well as on the strength of its overall governance and internal control processes.

8. 12 CFR 225.8(e)(2).

1. Risk Identification and Assessment Process

A firm's risk identification process should include a comprehensive assessment of risks stemming from its unique business activities and associated exposures. The assessment should include on-balance sheet assets and liabilities, off-balance sheet exposures, vulnerability of the firm's earnings, and other major firm-specific determinants of capital adequacy under normal and stressed conditions. This assessment should also capture those risks that only materialize or become apparent under stressful conditions.

The specifics of the risk identification process will differ across firms given differences in organizational structure, business activities, and size and complexity of operations. However, the risk identification process at all firms subject to this guidance should be dynamic, inclusive, and comprehensive, and drive the firm's capital adequacy analysis. A firm should

- evaluate material risks across the enterprise to ensure comprehensive risk capture on an ongoing basis;
- establish a formal risk identification process and evaluate material risks at least quarterly;
- actively monitor its material risks; and
- use identified material risks to inform key aspects of the firm's capital planning, including the development of stress scenarios, the assessment of the adequacy of post-stress capital levels, and the appropriateness of potential capital actions in light of the firm's capital objectives.

A firm should be able to demonstrate how material risks are accounted for in its capital planning process. For risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and distributions. The firm should also be able to identify risks that may be difficult to quantify and explain how these risks are addressed in the capital planning process. The firm should appropriately segment risks beyond generic categories such as credit risk, market risk, and operational risk.

The Federal Reserve expects a firm to seek input from multiple stakeholders across the organization (for example, senior management, finance and risk professionals, front office and line-of-business leadership) in identifying its material risks. In addition, a firm should update its risk assessment at least quarterly to reflect changes in exposures, business activities, and its broader operating environment.

2. Risk Measurement and Risk Materiality

A firm should have a sound risk measurement process that informs senior management about the size and risk characteristics of exposures and business activities under both normal and stressful operating conditions. A firm is generally expected to use quantitative approaches supported by expert judgment, as appropriate, for risk-measurement.

Identified weaknesses, limitations, biases, and assumptions in the firm's risk measurement processes should be assessed for their potential impact on the integrity of a firm's capital planning process (see Appendix D, "Sensitivity Analysis and Assumptions Management"). A firm should have a process in place for determining materiality in the context of material risk identification and capital planning. This process should include a sound analysis of relevant quantitative and qualitative considerations, including, but not limited to, the firm's risk profile, size, and complexity, and their effects on the firm's projected regulatory capital ratios in stressed scenarios.[9]

A firm should identify how and where its material risks are accounted for within the capital planning process. The firm should be able to specify material risks that are captured in its scenario design, the approaches used to estimate the impact on capital, and the risk drivers associated with each material risk.

As part of its risk measurement processes, a firm should identify and measure risk that is inherent to its business practices and closely assess the reliability of assumptions about risk reduction resulting from risk transfer or risk mitigation techniques (see Appendix D, "Sensitivity Analysis and Assumptions Management"). Specifically, the firm should critically assess the enforceability and effectiveness of any guarantees, netting, and collateral agreements. Assumptions about accessibility and valuation of collateral exposures should also be closely reviewed for reliability given the likelihood that asset values will change rapidly in a stressed market.

C. Internal Controls

A firm should have a sound internal control framework that helps ensure that all aspects of the capital planning process are functioning as designed and result in sound assessments of the firm's capital needs. The framework should include

- an independent internal audit function;
- independent review and validation practices; and
- integrated management information systems, effective reporting, and change control processes.

A firm's internal control framework should support its entire capital planning process, including: the sufficiency of and adherence to policies and procedures; risk identification, measurement, and management practices and systems used to produce input data; and the models, management overlays, and other methods used to generate inputs to post-stress capital estimates. Any part of the capital planning process that relies on manual procedures should receive heightened attention. The internal control framework should also assess the aggregation and reporting process used to produce reports to senior management and to the board of directors and the process used to support capital adequacy recommendations to the board.

In addition, the control framework should include an evaluation of the firm's process for integrating the separate components of the capital planning process at the enterprise-wide level.

9. For simplicity, the terms "quantitative" and "qualitative" are used to describe two different types of approaches, with the recognition that all quantitative estimation approaches involve some qualitative/judgmental aspects, and qualitative estimation approaches produce quantitative output.

1. Comprehensive Policies, Procedures, and Documentation for Capital Planning

A firm should have policies and procedures that support consistent and repeatable capital planning processes.[10] Policies and procedures should describe the capital planning process in a manner that informs internal and external stakeholders of the firm's expectations for internal practices, documentation, and business line controls. The firm's documentation should be sufficient to provide relevant information to those making decisions about capital actions. The documentation should also allow parties unfamiliar with a process or model to understand generally how it operates, as well as its main limitations, key assumptions, and uncertainties.

Policies and procedures should also clearly identify roles and responsibilities of staff involved in capital planning and provide accountability for those responsible for the capital planning process. A firm should also have an established process for policy exceptions. Such exceptions should be approved by the appropriate level of management based upon the gravity of the exception. Policies and procedures should reflect the firm's current practices, and be reviewed and updated as appropriate, but at least annually. A firm should maintain evidence that management and staff are adhering to policies and procedures in practice.

A firm's documentation should cover key aspects of its capital planning process, including its risk-identification, measurement and management practices and infrastructure; methods to estimate inputs to post-stress capital ratios; the process used to aggregate estimates and project capital needs; the process for making capital decisions; and governance and internal control practices. A firm's capital planning documentation should include detailed information to enable independent review of key assumptions, stress testing outputs, and capital action recommendations.

2. Model Validation and Independent Review of Estimation Approaches

Models used in the capital planning process should be reviewed for suitability for their intended uses. A firm should give particular consideration to the validity of models used for calculating post-stress capital positions. In particular, models designed for ongoing business activities may be inappropriate for estimating losses, revenue, and expenses under stressed conditions. If a firm identifies weaknesses or uncertainties in a model, the firm should make adjustments to model output if the findings would otherwise result in the material understatement of capital needs (see Appendix B, "Model Overlays"). If the deficiencies are critical, the firm should restrict the use of the model, apply overlays, or avoid using the model entirely.

A firm should independently validate or otherwise conduct effective challenge of models used in internal capital planning, consistent with supervisory guidance on model risk management.[11] The model review and validation process should include an evaluation of conceptual soundness of models and ongoing monitoring of the model performance. The firm's validation staff should have the necessary technical competencies, sufficient stature within the organization, and appropriate independence from model developers and business areas to provide a critical and unbiased evaluation of the estimation approaches.

A firm should maintain an inventory of all estimation approaches used in the capital planning process, including models used to produce projections or estimates used by the models that generate final loss, revenue, expense, and capital projections.[12] Material models should receive greater attention (see Appendix C, "Use of Benchmark Models in the Capital Planning Process").[13] The intensity and frequency of validation work should be a function of the importance of those models in generating estimates of post-stress capital.

Not all models can be fully validated prior to use in capital planning. However, a firm should conduct a conceptual soundness review of all models prior to their use in capital planning. If such a conceptual soundness review is not possible, the absence of that review should be made transparent to users of model output and the

10. See Instructions for the Capital Planning and Stress Testing Information Collection (Reporting Form FR Y-14A), Appendix A (Supporting Documentation).

11. See SR-11-7. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

12. The definition of a model covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

13. Materiality of the model is a function of both the importance of the business or portfolio assessed and the impact of the model on the firm's overall results.

firm should determine whether the use of compensating controls (such as conservative adjustments) are warranted.

Further, a firm should treat output from models for which there are model risk management shortcomings with caution. In addition, a firm should have compensating controls for known model uncertainties and apply well supported conservative adjustments to model results, as appropriate.

A firm should ensure that benchmark or challenger models that contribute to post-stress capital estimates or are otherwise used explicitly in the capital planning process are identified and subject to validation (see Appendix C, "Use of Benchmark Models in the Capital Planning Process").

3. *Management Information Systems and Change Control Processes*

A firm should have internal controls that ensure the integrity of reported results and that make certain the firm is identifying, documenting, reviewing, and tracking all material changes to the capital planning process and its components. The firm should ensure that such controls exist at all levels of the capital planning process. Specific controls should ensure

- sufficiently sound management information systems to support the firm's capital planning process;
- comprehensive reconciliation and data integrity processes for key reports;
- the accurate and complete presentation of capital planning process results, including a description of adjustments made to compensate for identified weaknesses; and
- that information provided to senior management and the board is accurate and timely.

Many of the processes used to assess capital adequacy, including models, data, and management information systems, are tightly integrated and interdependent. As a result, a firm should ensure consistent change control oversight across the entire firm, in line with existing supervisory guidance.[14] A firm should establish and maintain a policy describing minimum internal control standards for managing change in capital planning process policies and procedures, model development, information technology, and data. Control standards for these areas should address risk, testing, authorization and approval, timing of implementation, post-installation verification, and recovery, as applicable.

4. *Internal Audit Function*

Internal audit should play a key role in evaluating capital planning and the elements described in this guidance to ensure that the entire process is functioning in accordance with supervisory expectations and the firm's policies and procedures. Internal audit should review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, internal audit should ensure appropriate independent review and challenge is occurring at all key levels within the capital planning process.

As discussed further in Appendix E, "Role of the Internal Audit Function in the Capital Planning Process," internal audit staff should have the appropriate competence and influence to identify and escalate key issues. All deficiencies, limitations, weaknesses and uncertainties identified by the internal audit function that relate to the firm's capital planning process should be reported to senior management, and material deficiencies should be reported to the board of directors (or the audit committee of the board) in a timely manner.[15]

D. Capital Policy

A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions.[16] This includes internal post-stress capital goals (as discussed in more detail below and in Appendix F, "Estimating Impact on Capital Positions") and real-time targeted capital levels; guidelines for dividend payments and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance responsibilities and procedures for the capital policy. The capital policy must be approved by the firm's board of directors or a designated committee of the board.[17]

The capital policy should be reevaluated at least annually and revised as necessary to ad-

14. Federal Financial Institutions Examination Council, "IT Examination Handbook—Operations Booklet."

15. For additional information on supervisory expectations for internal audit, see SR-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

16. 12 CFR 225.8(d)(7).

17. 12 CFR 225.8(e)(1)(iii).

dress changes to the firm's business strategy, risk appetite, organizational structure, governance structure, post-stress capital goals, real-time targeted capital levels, regulatory environment, and other factors potentially affecting the firm's capital adequacy.

A capital policy should describe the firm's capital adequacy decision-making process, including the decision-making process for common stock dividend payments or stock repurchases.[18] The policy should incorporate actionable protocols, including governance and escalation, in the event a post-stress capital goal, real-time targeted capital level, or other early warning metric is breached. The policy should also include elements such as

- roles and responsibilities of key parties, including those responsible for producing analytical materials, reviewing the analysis, and making capital distribution recommendations and decisions;
- factors and key metrics that influence the size, timing, and form of capital actions, and the analytical materials used in making capital action decisions; and
- the frequency with which capital adequacy will be evaluated and the analysis that will be considered in the determination of capital adequacy, including the specific circumstances that activate the contingency plan.

1. Post-Stress Capital Goals

A firm should establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders. Post-stress capital goals should be calibrated based on the firm's own internal analysis, independent of regulatory capital requirements, of the minimum level of post-stress capital the firm has deemed necessary to remain a going concern over the planning horizon. A firm should also determine targets for real-time capital ratios and capital levels that ensure that capital ratios and levels would not fall below the firm's internal post-stress capital goals (including regulatory minimums) under stressful conditions at any point over the planning horizon. For more details, see Appendix F, "Capital Policy."

18. Consistent with the Board's November 14, 1985, Policy Statement on the Payment of Cash Dividends, the principles of which are incorporated into this guidance, firms should have comprehensive policies on dividend payments that clearly articulate the firm's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. See *Bank Holding Company Supervision Manual,* section 2020.5.1.1, Intercompany Transactions (Dividends).

E. Incorporating Stressful Conditions and Events

As part of its capital planning process, a firm should incorporate appropriately stressful conditions and events that could adversely affect the firm's capital adequacy into its capital planning. As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm's activities and associated risks, including those related to the company's capital adequacy and financial condition.[19] More generally, as part of its ongoing capital adequacy assessment, a firm should use multiple scenarios to assess a broad range of risks, stressful, conditions, or events that could impact the firm's capital adequacy.

1. Scenario design

A firm should develop complete firm-specific scenarios that focus on the specific vulnerabilities of the firm's risk profile and operations. The scenario design process should be directly linked to the firm's risk identification process and associated risk assessment. For those aspects of risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and distributions.

In developing its scenarios, the firm should recognize that multiple stressful conditions or events can occur simultaneously or in rapid succession. The firm should also consider the cumulative effects of stressful conditions, including possible interactions among the conditions and second-order or "knock-on" effects.

When identifying and developing the specific set of stressful conditions to capture in its stress scenarios, the firm should engage a broad range of internal stakeholders, such as risk experts, business managers, and senior management, to ensure the process comprehensively takes into account the full range of vulnerabilities specific to the firm.

19. 12 CFR 225.8(e)(2).

2. Scenario narrative

A firm's stress scenario should be supported by a detailed narrative describing how the scenario addresses the firm's particular material risks and vulnerabilities, and how the paths of the scenario variables relate to each other. The narrative should describe the key attributes of the scenario, including any stress events in the scenario, such as counterparty defaults, large operational risk related events, and ratings downgrades. For more details, see Appendix G, "Scenario Design."

F. Estimating Impact on Capital Positions

A firm should employ estimation approaches that allow it to project the impact on capital positions of various types of stressful conditions and events. The firm's stress testing practices should capture the potential increase in losses or decrease in pre-provision net revenue (PPNR) that could result from the firm's risks, exposures, and activities under stressful scenarios. A firm should estimate losses, revenues, expenses, and capital using a sound method that relates macroeconomic and other risk drivers to its estimates. The firm should be able to identify the manner in which key variables, factors, and events in a scenario affect losses, revenue, expenses, and capital over the planning horizon. Projections of losses and PPNR should be done at a level of granularity that allows for the appropriate differentiation of risk drivers, while balancing practical constraints such as data limitations (see Appendix A, "Use of Models and Other Estimation Approaches" and Appendix D, "Sensitivity Analysis and Assumptions Management").

The balance sheet projection process should establish and incorporate the relationships among revenue, expense, and on- and off-balance sheet exposures under stressful conditions, including new originations, purchases, sales, maturities, prepayments, defaults, and other borrower and depositor behavior considerations. A firm should also ensure that changes in its asset mix and resulting RWAs are consistent with PPNR and loss estimates. A firm should be able to identify key risk drivers, variables or factors in the scenarios that generate increased losses, reduced revenues, and changes to the balance sheet and RWAs over the planning horizon (see Appendix H, "Risk-weighted Asset (RWA) Projections").

1. Loss estimation

A firm should estimate losses using a sound method that relates macroeconomic and other risk drivers to losses. A firm should empirically demonstrate that a strong relationship exists between the variables used in loss estimation and prior losses. When using supervisory scenarios, a firm should project additional scenario variables beyond those included in the supervisory scenarios if the additional variables would be more directly linked to particular portfolios or exposures. A firm should include a variety of loss types in its stress tests based on the firm's exposures and activities. Loss types should include retail and wholesale credit risk losses, credit and fair value losses on securities, market and default risk on trading and counterparty exposures, and operational-risk losses.

a. Credit risk losses on loans and securities

A firm should develop sound methods to estimate credit losses under stress that take into account the type and size of portfolios, risk characteristics, and data availability. A firm should understand the key characteristics of its loss estimation approach. In addition, a firm's reserves for each quarter of the planning horizon, including the last quarter, should be sufficient to cover estimated loan losses consistent with generally accepted accounting standards. A firm should account for the timing of loss recognition in setting the appropriate level of reserves at the end of each quarter of the planning horizon.

A firm should test credit-sensitive securities for potential other-than-temporary impairment (OTTI) regardless of current impairment status. The threshold for determining OTTI for structured products should be based on cash-flow analysis and credit analysis of underlying obligors.

b. Fair-value losses on loans and securities

As applicable, a firm should project changes in the fair value of loans and available-for-sale securities (and impaired held-to-maturity securities). The projections should be based on relevant risk drivers, such as changes in credit spreads and interest rates. The firm should ensure that the risk drivers appropriately capture underlying risk characteristics of the loan or security, including duration and the credit risk of the underlying collateral or issuer.

c. Market and default risks on trading and counterparty exposures

A firm should project how the stress affects mark-to-market values and the default risk of its trading and counterparty exposures. A firm should capture all of its trading positions and counterparty exposures, identify all relevant risk factors, and employ sound revaluation methods. As part of its scenario analysis, as described in greater detail in section III.E of this guidance "Incorporating Stressful Conditions," a firm should use scenarios that severely stress the firm's mark-to-market positions and account for the firm's idiosyncratic risks.

d. Operational-risk losses

A firm should maintain a sound process for estimating operational risk losses in its capital planning process. Operational losses can rise from various sources, including inadequate or failed internal processes, people, and systems, or from external events (see Appendix I, "Operational Loss Projections").

A firm should have a structured, transparent, and repeatable framework in place to develop credible loss projections under stress that takes into account the differences in loss characteristics of different types of operational loss events. The approaches used to project operational losses should be well supported and include scenario analysis.

2. *PPNR*

In projecting PPNR, a firm should take into account not only its current positions, but also how its activities, business strategy, and revenue drivers may evolve over time under the varying circumstances and operating environments. The firm should ensure that the various PPNR components, including net interest income, non-interest income and non-interest expense, and other key items projected by the firm such as balance sheet positions, RWA, and losses, are projected in a manner that is internally consistent.

The ability to effectively project net interest income is dependent upon the firm's ability to identify and aggregate current positions and their attributes; project future changes in accruing balances due to a variety of factors; and appropriately translate the impact of these factors and relevant interest rates into net interest income based on assumed conditions. Accordingly, a firm's current portfolio of interest-bearing assets and liabilities should serve as the foundation for its forward-looking estimates of net interest income. Beginning positions, positions added during the planning horizon, and the expected behavior of those positions are critical determinants of net interest income. A firm should have the ability to capture these dynamic relationships under its stress scenarios, and should ensure all related assumptions are well supported (see Appendix D, "Sensitivity Analysis and Assumptions Management").

Non-interest income is derived from a diverse set of sources, including fees, certain realized gains and losses, and mark-to-market income. Non-interest income generally is more susceptible to rapid changes than net interest income, especially if certain market measures move sharply. A firm's projections should incorporate material factors that could affect the generation of non-interest income under stress, including the firm's business strategy, the competitive landscape, and changing regulations.

Non-interest expenses include both expenses that are likely to vary with certain stressful conditions and those that are not. Projections of expenses that are closely linked to revenues or balances should vary with projected changes in revenue or balance sheet levels. Non-interest expense should be projected using either quantitative estimation methods or well-supported judgment, depending on the underlying drivers of the expense item.

3. *Aggregating Estimation Results*

A firm should have well-documented processes for projecting the size and composition of on- and off-balance sheet positions and RWAs over the planning horizon that feed in to the wider capital planning process (see Appendix H, "Risk-weighted Asset (RWA) Projections").

A firm should have a consistently executed process for aggregating enterprise-wide stress test projections of losses, revenues, and expenses, including estimating on- and off-balance sheet exposures, and RWAs, and for calculating post-stress capital positions and ratios. The aggregation system should be able to bring together data and information across business lines, portfolios, and risk types and should include the data systems and sources, data reconciliation points, data quality checks, and appropriate internal control points to ensure accurate and consistent projection of financial data within enterprise-wide scenario analysis. Internal processes for aggregating projections from all relevant systems and regulatory templates should be identified and documented. In addition, the beginning points for projections and scenario variables should align with the end of the historical reference period.

Appendix A: Use of Models and Other Estimation Approaches

Projections of losses and PPNR under various scenarios are key components of enterprise-wide stress testing and capital planning. The firm should ensure that its projection approaches, including any specific processes or methodologies employed, are well supported, transparent, and repeatable over time.

A firm should generally use models or other quantitative methods, supported by expert judgment as appropriate, as the basis for generating projections. In limited instances, such as in cases of new products or businesses, or where insufficient data are available to support modeled approaches, qualitative approaches may be appropriate in lieu of quantitative methods to generate projections for those specific areas.

A firm should adhere to supervisory guidance on model risk management (SR-11-7) when using models, and should have sound internal controls around both quantitative and qualitative approaches.

1. Quantitative Approaches

Firms use a range of quantitative approaches for capital planning. The type and level of sophistication of any quantitative approach should be appropriate for the type and materiality of the portfolio or activity for which it is used and the granularity and length of available data. The firm should also ensure that the quantitative approach selected generates credible estimates that are consistent with assumed scenario conditions.

A firm should separately estimate losses and PPNR for portfolios or business lines that are either sensitive to different risk drivers or sensitive to risk drivers in a markedly different way, particularly during periods of stress. For instance, losses on commercial and industrial loans and commercial real estate (CRE) loans are, in part, driven by different risk factors, with the path of property values having a pronounced effect on CRE loan losses, but not necessarily on other commercial loans. Similarly, although falling property values affect both income-producing CRE loans and construction loans, the effect often differs materially due to structural differences between the two portfolios. Such differences can become more pronounced during periods of stress.

A firm should have a well-supported variable selection process that is based on economic intuition, in addition to statistical significance where applicable. The firm should provide a clear rationale for the macroeconomic variables or other risk drivers chosen for all quantitative approaches, including why certain variables or risk drivers were not selected.

A firm should estimate losses and PPNR at a sufficiently disaggregated level within a given portfolio or business line to capture observed variations in risk characteristics (for example, credit score or loan-to-value ratio ranges for loan portfolios) and performance across sub-portfolios or segments under changing conditions and environments. Loss and PPNR estimates should also be sufficiently granular to capture changing exposure levels over the planning horizon. However, in assessing the appropriate level of granularity of segments, a firm should factor in issues such as the availability of data or the costs and benefits of model complexity. For example, when projecting losses for a more diverse portfolio with a range of borrower risk characteristics and observed historical performance, firms should segment the portfolio more finely based on key risk attributes unless the segments lack sufficient data observations to produce reliable model estimates.

a. Use of Data

A firm should use internal data to estimate losses and PPNR as part of its enterprise-wide stress testing and capital planning practices.[20] However, it may be appropriate for a firm to use external data if internal data limitations exist as

20. Firms are required to collect and report a substantial amount of risk information to the Federal Reserve on FR Y-14 schedules. These data may help to support the firms' enterprise-wide stress test. See Capital Assessments and Stress Testing information collection, Reporting Forms FR Y-14A, Q, and M.

a result of systems limitations, acquisitions, or new products, or other factors that may cause internal data to be less relevant for developing stressed estimates. If a firm uses external data to estimate its losses or PPNR, the firm should ensure that the external data reasonably approximate underlying risk characteristics of the firm's portfolios or business lines. Further, the firm should make adjustments to estimation methods or outputs, as appropriate, to account for identified differences in risk characteristics and performance reflected in internal and external data. In addition, firms should relate their projections under stress scenarios to the characteristics of their assets and activities described in their internal data.

A firm should generally include all available data in its analysis, unless the firm no longer engages in a line of business or its activities have changed such that the firm is no longer exposed to a particular risk. The firm should not selectively exclude data based on the changing nature of the ongoing business or activity without strong empirical support. For example, excluding certain loans only on the basis that they were underwritten to standards that no longer apply or on the basis that the loans were acquired by the firm is not sound practice.

b. Use of Vendor Models[21]

A firm should have processes to confirm that any vendor or other third-party models it uses are sound, appropriate for the given task, and implemented properly. A firm should clearly outline limitations and uncertainties associated with vendor models.

Vendor model management includes having an appropriate vendor selection process, assigning staff to oversee and maintain the vendor relationships, and ensuring that there is sufficient documentation of vendor models. A firm should also confirm that vendor models have been sufficiently tested and that data used by the vendor are appropriate for use at the firm. The firm should also establish key measures for evaluating vendor model performance and tracking those measures whenever those vendor models are used, as well as assess vendor models (including to incorporate any relevant updates or changes). Vendor models should be subject to validation processes similar to those employed for models developed internally.

2. *Assessing Model Performance*

A firm should use measures to assess model performance that are appropriate for the type of model being used. The firm should outline how each performance measure is evaluated and used. A firm should also assess the sensitivity of material model estimates to key assumptions and use benchmarking to assess reliability of model estimates (see Appendix C, "Use of Benchmark Models in the Capital Planning Process" and Appendix D, "Sensitivity Analysis and Assumptions Management").

A firm should employ multiple performance measures and tests, as generally no single measure or test is sufficient to assess model performance. This is particularly the case when the models are used to project outcomes in stressful circumstances. For example, assessing model performance through out-of-sample and out-of-time back testing may be challenging due to the short length of observed data series or the paucity of realized stressed outcomes against which to measure the model performance. When using multiple approaches, the firm should have a consistent framework for evaluating the results of different approaches and supporting rationale for why it chose the methods and estimates ultimately used.

A firm should provide supporting information about models to users of the model output, including descriptions of known measurement problems, simplifying assumptions, model limitations, or other ways in which the model exhibits weaknesses in capturing the relationships being modeled. Providing such qualitative information is critical when certain quantitative criteria or tests measuring model performance are lacking.

3. *Qualitative Approaches*

A qualitative approach to project losses and PPNR may be appropriate in limited cases where severe data or other limitations preclude the development of reliable quantitative approaches. The firm should document why such an approach is reliable for generating projections and is justified based on business need.

When using a qualitative approach, the firm should substantiate assumptions and estimates using analysis of current and past risk drivers and performance, internal risk identification, forward-looking risk assessments, external analy-

21. See SR-13-19/CA 13-21, "Guidance on Managing Outsourcing Risk." (Refer to this manual's section 2124.3)

sis or other available information. The firm should conduct an initial and ongoing assessment of the performance and viability of the qualitative approach. The processes used in qualitative projection approaches should be transparent and repeatable. The firm should also clearly document qualitative approaches and key assumptions used.

Qualitative approaches should be subject to independent review, although the review may differ from the review of quantitative approaches or models. The level of independent review should be commensurate with the

- materiality of the portfolio or business line for which the qualitative approach is used;
- impact of the approach's output on the overall capital results; and
- complexity of the approach.

Firm staff conducting the independent review of the qualitative approaches should *not* be involved in developing, implementing or using the approach. However, this staff can be different than the staff that conducts validation of quantitative approaches or models.

Appendix B: Model Overlays

A firm may need to rely on overrides or adjustments to model output (model overlay) to compensate for model, data, or other known limitations.[22] If well-supported, use of a model overlay can represent a sound practice.

A model overlay may be appropriate to address cases of identified weaknesses or limitations in the firm's models that cannot be otherwise addressed, or for select portfolios that have unique risks that are not well captured by the model used for those exposures and activities.[23] In contrast, a model overlay that functions as a general "catch all" buffer on top of targeted capital levels to account for model weaknesses generally would not represent sound practice.[24]

A firm should also avoid extensive reliance on model overlays throughout its capital planning process, particularly for material portfolios or where an overlay would have a large effect on projections. Further, a firm should reduce its reliance on overlays by addressing the underlying model issue over time. Firms should evaluate the reasons for overlays and track and analyze overlay performance.

As part of its overall documentation of methodologies used in stress testing, a firm should document its use of model overlays. Firms must be able to identify the main factors necessitating the use of an overlay as well as how the selected overlay addresses those factors. Key assumptions related to the overlay should be clearly outlined and consistent with assumed scenario conditions.

1. *Process for Applying Overlays*

A firm should establish a consistent firm-wide process for applying model overlays and for controls around model overlays. The process can vary by model type and portfolio, but should contain some key elements, as described below. This process should be outlined in the firm's policies and procedures and include a specific exception process for the use of overlays that do not follow the firm's standards. As part of model development, implementation and use, overlays should be well documented, supported and communicated to senior management. Model overlays should be applied in an appropriate, systematic, and transparent manner. Model results should also be reported to senior management with and without overlay adjustments.

Model overlays (including those based solely on expert or management judgment) should be subject to validation or some other type of effective challenge.[25] Consistent with the materiality principle in SR-11-7, the intensity of model risk management for overlays should be a function of the materiality of the model and overlay. Effective challenge should occur before the model overlay is formally applied, not on an ex-post basis.

22. For the purposes of this appendix, the term "overlays" will be used to cover overrides, overlays, or other adjustments applied to model output. Firms should follow expectations set forth in SR-11-7, relating to overlays.

23. Expectations for the use of judgment within model development is discussed in Appendix A, "Use of Models and Other Estimation Approaches."

24. Firms may choose to apply overall capital buffers as an additional conservative measure, beyond overlays applied at the model level. Overall capital buffers should be subject to the same governance processes applicable to model overlays, as described in section 2 of this appendix. However, supervisors emphasize that having such a buffer should not in any way replace sound model risk management practices for overlays at the individual model level or address the need for the overlay at the individual model level.

25. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

Validation or other type of effective challenge of model overlays may differ from quantitative model validation. Staff responsible for effective challenge should *not* also be setting the overlay itself or providing significant input to the level or type of overlay. For example, a committee that develops an overlay should not also be responsible for the effective challenge of the overlay. In addition, staff engaging in the effective challenge of model overlays should meet supervisory expectations relating to incentives, competence, and influence (as outlined in SR-11-7). Staff conducting effective challenge should confirm that model overlays are sufficiently conservative to compensate for model limitations and associated uncertainties in model estimates. Sensitivity analysis should be used to help quantify the overlay.

2. *Governance of Overlays*

Overlays and adjustments used by a firm should be reviewed and approved at a level within the organization commensurate with the materiality of that overlay or adjustment to overall pro forma results. In general, the purpose and impact of overlays should be communicated to senior management in a manner that facilitates an understanding of the issues by the firm's senior management. Material overlays to the model—either in isolation or in combination—should receive a heightened level of support and scrutiny, up to and including review by the firm's board of directors (or a designated committee), in instances where the impact on pro forma results is material.

Senior management should periodically receive a high-level description of the use of model overlays. This description should include the number of models having overlays, whether more material models have overlays, whether overlays on the whole result in more or less conservative projections, and the range of the effect of overlays on the model output (especially for those cases where the overlays produce less conservative outcomes).

Senior management should be able to independently assess the reasonableness of using an overlay to capture a particular risk or compensate for a known limitation. Extensive use of overlays should trigger discussion as to whether new or improved modeling approaches are needed to reduce overlay dependency. Signs that the underlying model needs revision or redevelopment include a high rate of overrides or overrides that consistently affect model performance.

Appendix C: Use of Benchmark Models in the Capital Planning Process

As noted in Appendix A, "Use of Models and Other Estimation Approaches," a firm should use a variety of methods, including benchmarking, to assess model performance and gain comfort with model estimates. A firm should use benchmark or challenger models to assess the performance of its primary models for all material portfolios or to supplement, where appropriate, the primary models.[26] Such models should be used in conjunction with other aspects of benchmarking, such as comparing model results to actual market data, internal firm data, data from similar firms or portfolios, or judgmental estimates by business line experts. A firm should also use benchmark models during validation as an additional check on the primary model and its results.

Use of benchmark models is particularly important when primary models have exhibited significant deficiencies or are still under development. For instance, a firm's primary model may use a preferred methodology, but lack a rich data set to support modeled estimates. In these cases, the firm should use benchmark models based on different data and modeling approaches to provide additional checks on primary model estimates. To the extent that a benchmark model highlights that a primary model has flaws (e.g., the model is producing output that is vastly different from experience during prior periods of stress), a firm should analyze whether it would be appropriate to adjust the model specification, apply model overlays, or develop different estimation approaches.

Benchmark models that are developed and run independently of primary models can be used to more effectively calibrate the firm's final estimates. For example, a firm can use benchmark model outputs to substantiate model overlays, given differences in risk capture between primary and benchmark models. This type of "triangulation" is especially suitable for those areas of modeling that present considerable uncertainty.

Benchmark models used to arrive at the firm's final estimates should be subject to model risk

26. Note that the terms "benchmark model" and "challenger model" are used interchangeably for purposes of this appendix to mean a model to support or give additional perspective to a primary model.

management. The intensity and frequency of validation or other type of effective challenge of benchmark models of a firm should correspond to the importance of those models in generating estimates. For example, if the output of a benchmark model is averaged with primary model results to develop final estimates, or if the benchmark model is used to develop overlays or overrides for the primary model, that model should be subject to more intensive validation.

Benchmark models that are used only during the validation process and do not contribute directly to the firm's estimates do not need to be validated. However, a firm should assess the rigor of all benchmark models and benchmark data used to ensure they provide reasonable comparisons.

Appendix D: Sensitivity Analysis and Assumptions Management

A firm should understand the sensitivity of its stress testing estimates used in capital planning to the various inputs and assumptions. In addition, sensitivity analysis should be used to test the robustness of quantitative approaches and models and enhance reporting to the firm's senior management, board of directors, and supervisors. A firm should ensure that it identifies, documents, and manages the use of all key assumptions used in capital planning.

1. Sensitivity Analysis

Understanding and documenting a range of potential outcomes provides insight into the inherent uncertainty and imprecision around pro forma results. A firm should assess the sensitivity of its estimates of capital ratios, losses, revenues, and RWAs to key assumptions and uncertainty across the entire firm's projections under stress. Through this assessment, a firm should calculate a range of potential estimates based on changes to assumptions and inputs. Examples of assumptions that generally should be subject to sensitivity analysis include projected market share, size of the market, cost and flow of deposits, utilization rate of credit lines, discount rates, or level and composition of trading assets and RWA.

A firm should also evaluate the sensitivity of models to key assumptions to evaluate model performance, assess the appropriateness of assumptions, and understand uncertainty associated with model output.

Sensitivity analysis for capital planning models should be applied in a manner consistent with the expectations outlined in the Federal Reserve's supervisory guidance on model risk management (refer to SR-11-7). Sensitivity analysis should be conducted during model development and during model validation to provide information about how models respond to changes in key inputs and assumptions, and how those models perform in stressful conditions. In addition, sensitivity analysis should be applied to understand the range of possible results from vendor-provided models and vendor-provided scenario forecasts that have opaque or proprietary elements. Sensitivity analysis should be used to provide information to help users of model output interpret results, but does not have to result in changes to models or model outputs. Changes made based on sensitivity analysis should be clearly documented and justified.

A firm should ensure that the key sensitivities are presented to senior management and the board in advance of decision-making around the firm's capital plan and capital actions. Sensitivity analysis should also be used to inform senior management, and, as appropriate, the board of directors about the potential uncertainty associated with models employed of the firm's projections under stress.

2. Assumptions Management

A firm should clearly document assumptions when estimating losses, PPNR, and balance sheet, and RWA components. Documentation should include the rationale and empirical support for assumptions and specifically address how those assumptions are consistent with and appropriate under the firm's scenario conditions.

A firm's rationale for assumptions used in capital planning should be consistent with the different effects of scenario conditions, shifts in portfolio mix, and growth or decline in balances projected over the planning horizon. For example, the firm should scrutinize and support any assumptions about sizeable loan growth during a severe economic downturn.

A firm should generally use conservative assumptions, particularly in areas of high uncertainty. The firm should provide greater support for assumptions that appear optimistic or otherwise appear to benefit the firm (such as loss reduction or revenue enhancement). A firm should not assume that senior management will be able to realize favorable strategic actions that cannot be reasonably assured in stress scenarios given the high level of uncertainty around market conditions. Further, a firm should not assume that it would have the perfect foresight that would allow it, for example, to make significant expense reductions in the first quarter of the forecast horizon in anticipation of the forthcoming economic deterioration described in the scenario.

A firm should not always assume that historical patterns will repeat. For example, a firm should not assume that if it has suffered no or minimal losses in a certain business line or product in the past, such a pattern will continue. In addition, a firm should carefully analyze effects of any structural changes in customer base, product, and financial markets on its projections, as these changes could significantly affect a firm's performance under stress scenarios. Furthermore, the firm should explore the potential effects of changes in assumed interrelationships among variables and the behavior of exposures. The firm should also explicitly justify, document, and appropriately challenge any assumptions about diversification benefits.

A firm should confirm that key assumptions used in vendor or other third-party products are transparent and have sufficient support before using the products in stress testing. The firm should limit use of vendor products whose assumptions are not fully transparent or supported or use those products only in conjunction with another approach or compensating controls (e.g., overlays).

Appendix E: Role of the Internal Audit Function in the Capital Planning Process

A firm's internal audit function should play a key role in evaluating the adequacy of the firm's capital planning process and in assessing whether the risk management and internal control practices supporting that process are comprehensive and effective. A firm should establish an audit program around its capital planning process that is consistent with SR-13-1, "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."

1. Responsibilities of Audit Function

The internal audit function should identify all auditable processes related to capital planning and develop an associated audit plan. The audit function should also perform substantive testing to ascertain the effectiveness of the control framework supporting the firm's capital planning process, communicate identified limitations and deficiencies to senior management, and communicate material limitations and deficiencies to the board of directors (or the audit committee of the board). The audit function should comprehensively cover the firm's capital planning process.

The internal audit function should perform periodic reviews of all aspects of the internal control framework supporting the capital planning process to ensure that all individual components as well as the entire process are functioning in accordance with supervisory expectations and the firm's policies and procedures. The internal audit function should also review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, the internal audit function should ensure appropriate independent review is occurring at various levels within the capital planning process.

A firm's internal audit staff should have the appropriate competence and stature to identify and escalate key issues when necessary. Adequate quantitative expertise is needed to assess the effectiveness of the capital planning processes and procedures. The role of audit staff is to evaluate whether the capital planning process is comprehensive, rigorous, and effective. The internal audit function may also rely on an independent third party external to the firm to complete some of the substantive testing as long as the internal audit function can demonstrate proper independence of the third-party from the area being assessed and provide oversight over the execution and quality of the work.

Other supervisory expectations for the internal audit function relating to the capital adequacy process include

- verifying that acceptable policies are in place and that staff comply with those policies;
- assessing accuracy and completeness of the model inventory;
- evaluating procedures for updating processes and ensuring appropriate change/version controls;
- confirming that staff are meeting documentation standards, including reporting;
- reviewing supporting operational systems and evaluating the reliability of data used in the capital planning process; and
- reviewing the quality of any work conducted by external parties.

2. *Development of Audit Plan*

The internal audit function should have a documented plan describing its strategy to assess the processes and controls supporting the firm's capital planning process. When defining the annual audit universe and audit plan, the internal audit function of a firm should focus on the most significant risks relating to the capital planning process. The firm may leverage existing or regularly scheduled audits to ensure coverage of all the capital planning process components; however, the findings and conclusions of these audits should be incorporated into the overall summary of audit activities and conclusions regarding the firm's capital planning process.

The internal audit function should also establish a process for reviewing and updating, as appropriate, its audit plan annually to account for material changes to the firm's capital planning process, internal control systems, infrastructure, work processes, business lines, or changes to relevant laws and regulations. The firm should also ensure that the periodic assessment of the capital planning process is supported by a reliable and current assessment of the individual components.

3. *Briefings to Senior Management and Board*

On an annual basis, the internal audit function should report to senior management and the board of directors on the capital planning process to inform recommendations and decisions on the firm's capital plan. The report should provide an opinion of the capital planning process, a statement of the effectiveness of the controls and processes employed, a status update on previously identified issues and remediation plans, and any open issues or uncertainties related to the firm's capital plan. Any key processes that are not comprehensively reviewed and tested, due to timing or significant changes in processes, should be clearly documented and identified as areas with potential heightened risk. In addition, a firm's internal audit function should brief the board of directors (or a designated committee thereof) and senior management at least quarterly on the status of key findings relating to the capital planning process.

The internal audit function should track responses to its findings and report to the board any cases in which senior management is not implementing required changes related to audit findings or is doing so with insufficient intensity. In addition, the internal audit function should report any identified material deficiencies, limitations, or weaknesses related to the firm's capital planning process to the board of directors and senior management in a timely manner.

Appendix F: Capital Policy

A firm's capital policy should describe how the firm manages, monitors, and makes decisions regarding capital planning.[27] The policy should include internal post-stress capital goals and real-time targeted capital levels; guidelines for dividends and stock repurchases; and strategies for addressing potential capital shortfalls.

A firm's capital policy should describe the manner in which consolidated estimates of capital positions are presented to senior management and the board of directors. The capital policy should require staff with responsibility for developing capital estimates to clearly identify and communicate to senior management and board of directors the key assumptions affecting various components that feed into the aggregate estimate of capital positions and ratios. The capital policy should require that aggregated results be directly compared against the firm's stated post-stress capital goals, and that those comparisons are included within the standard reporting to senior management and the board of directors.

1. *Post-Stress Capital Goals*

Post-stress capital goals should provide specific minimum thresholds for the level and composition of capital that the firm intends to maintain during a stress period. Post-stress capital goals should include any capital measures that are relevant to the firm. The firm should be able to demonstrate through its own internal analysis, independently of regulatory capital requirements, that remaining at or above its internal post-stress capital goals will allow the firm to continue to operate. Capital goals should take into consideration the uncertainty inherent in capital planning, as well as the economic and market outlook.

27. A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions. 12 CFR 225.8(d)(7).

The capital policy should describe how senior management and the board concluded that the firm's post-stress capital goals are appropriate, sustainable in different conditions and environments, and consistent with its strategic objectives, business model, and capital plan. In addition, the capital policy should describe the process by which the firm establishes its post-stress capital goals, and include the supporting analysis underpinning the goals chosen by the firm.

A firm should annually review its capital goals, evaluate whether its post-stress capital goals are still appropriate based on changes in operating environment, business mix, or other conditions, and adjust those goals as needed.

A firm should adjust its real-time capital targets (that is the amount of current capital it holds above its post-stress capital goals to ensure it does not fall below those goals under stress) more frequently than it adjusts capital goals, based on changes in the business mix, operating environment, or other current conditions and circumstances.

2. *Dividends and Stock Repurchases*

A firm's capital policy should describe the processes relating to common stock dividend and repurchase decisions, including the processes to determine the timing, form, and amount of all planned distributions. The capital policy should also specify the analysis and metrics that senior management and the board use to make capital distribution decisions. The analysis should include strategic considerations such as new business initiatives, potential acquisitions, and the other relevant factors.

The capital policy should identify the types of calculations and analysis that support a firm's proposed capital actions and determine the amount of capital available for distribution at any given time. For example, a firm should develop and use payout ratio limits in the decision making process. While payout ratio limits or targets should not be the single determining factor, the capital policy should describe how payout ratio limits or targets are considered, including how they are consistent with firm's strategic goals, how they were derived, and what analysis was used to determine the appropriate amount of capital to distribute in a given period. Further, a firm should include in its capital policy threshold levels for payout ratios that trigger management action. Such action should include escalation to the board and potential suspension of capital distributions. Escalation protocols should be clear, credible, and actionable in the event of an actual or projected target is breached.

3. *Contingency Plans for Capital Shortfalls*

A firm's capital policy should include specific capital contingency actions the firm would take to remedy any current or prospective deficiencies in its capital position. The firm's capital contingency plan should reflect strategies for identifying and addressing potential capital shortfalls and specify circumstances under which the board of directors and senior management will revisit planned capital actions or otherwise institute contingency measures.[28] A contingency plan should include a set of thresholds for metrics or events that provide early warning signs of capital deterioration and that trigger management action or scrutiny.[29] Additionally, triggers for more severe levels of deterioration should be linked to escalation procedures for more immediate management action and should be consistent with triggers in the firm's recovery plan. Triggers should reflect both point-in-time and forward-looking measures (both baseline and stress).

Capital contingency plans should include options for actions that a firm would consider taking to remedy any current or prospective deficiencies in its capital position, such as reducing or ceasing capital distributions, raising additional capital, reducing risk, or employing other means to preserve existing capital. Contingency options in the firm's capital policy should be consequential, realistic, actionable, and comprehensive.

Capital contingency plans should include a detailed explanation of the circumstances in which the firm would consider implementing these options, including when it would reduce or suspend a dividend or repurchase program or not execute a previously planned capital action.

28. Capital contingency planning should be closely integrated with the broader crisis management framework, including recovery and other contingency planning efforts focused on ensuring sustainability under a broad range of internal or external stresses. See SR-14-1, "Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies," and SR-14-8, "Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies."

29. Capital contingency plans may include triggers for liquidity, earnings, debt and credit default swap spreads, ratings downgrades, stock performance, supervisory actions, general market stress, or other noncapital metrics.

The capital contingency plans should specify the type of information that would be provided to decision makers when the firm's current or projected capital levels have deteriorated, including how management would present options to address the capital position and the long-term viability of the firm. Contingency options should be ranked according to ease of execution and impact and should incorporate an assessment of stakeholder reactions. All options should be evaluated for their feasibility and the reasonableness of underlying assumptions (such as whether a firm would be able to raise capital or draw on capital from another entity during a period of stressful market conditions).

Appendix G: Scenario Design

As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm's risk profile and operations, including those related to the company's capital adequacy and financial condition.[30] The firm's stress scenario should be at least as severe as the Federal Reserve's severely adverse supervisory scenario, measured in terms of its effect on net income and other elements that affect capital.[31]

As noted in the core document, a firm should develop at least one complete firm-specific scenario that focuses on the specific vulnerabilities of the firm's risk profile and operations. The firm's scenario should be carefully tailored to the idiosyncratic risks of the firm, as defined through the firm's internal material risk identification process, and should incorporate circumstances that are particularly stressful to the firm, given the firm's idiosyncratic risks and key vulnerabilities. Such circumstances include those affecting the firm's particular business model, revenue drivers, mix of assets and liabilities, geographic footprint, portfolio characteristics, and specific operational risk vulnerabilities. The firm can incorporate the idiosyncratic stress considerations in macroeconomic and financial market variables or a discrete stress event included in the scenario. A firm-specific scenario would not meet supervisory expectations if it is not tailored to the firm's activities and risks. This is the case even if the severity is generally equivalent to the supervisory stress scenarios or if the post-stress capital ratios are lower than those under the supervisory severely adverse scenario.

The stress scenario should include stressful circumstances and events that could, on a standalone basis or in combination, reduce the firm's capital levels and ratios and potentially impede the firm's ability to operate as a going concern, and cover material risks to which the firm is exposed over the course of an annual planning cycle. A firm's scenario should include factors that capture economy- or market-wide stresses and idiosyncratic risks that can put a strain on the firm. A firm should also take into account conditions and events that have not previously occurred, but that may pose a significant threat to the firm given its exposures, risk profile, and business strategy.

Use of Multiple Scenarios

In addition, a firm should use multiple scenarios as part of its ongoing capital adequacy assessment to assess a broad range of risks, stressful conditions, or events that could impact the firm's capital adequacy. This assessment should inform development of the internal stress scenario(s) used in the firm's plan, the firm's post-stress capital goals, and its current capital targets. The firm's scenarios should collectively address all material risks to which the firm is exposed over the course of an annual planning cycle.

In designing its stress scenarios, a firm should incorporate risks and vulnerabilities that arise from multiple factors, sources and events. Historical data may provide a starting point for scenarios, but a firm should also consider other data sources and challenge conventional assumptions when identifying the stressful conditions and events that could adversely affect the firm's capital adequacy. In certain instances, scenarios that include economic and financial market variables that deviate from historical experience and correlations are appropriate if, for example, previously unobserved vulnerabilities exist in certain sectors of the economy or financial markets. In addition, the firm should not exclude experiences that have occurred outside its own history

30. 12 CFR 225.8(e)(2). In addition, a firm is required to report to the Federal Reserve its projections under a baseline scenario, which captures the firm's view of the likely operating environment over the planning horizon. A firm may use the Board's baseline scenario for its own baseline scenario if the firm can demonstrate that the Board's baseline scenario is appropriate for the firm's own risks, activities, and outlook; however, a firm cannot use the Board's severely adverse scenario for its own stress scenario.

31. For guidance on the severity of the scenarios, a firm should review the Board's "Policy Statement on the Scenario Design Framework for Stress Testing," which sets forth the Board's approach to designing the severely adverse scenario. See 12 CFR part 252, appendix A.

when designing stress scenarios, particularly if the firm has recently expanded its business to include new products, markets, or customers.

The macroeconomic variables used in a given scenario should collectively describe the general operational environment considered in the scenario. A firm should ensure that the scenario includes sufficient macroeconomic variables to support its stress testing estimation methods. While a firm should assess the internal consistency of the scenario, the firm should evaluate whether deviations from historically observed relationships among macroeconomic variables that increase the degree of stress placed on the firm may be appropriate.

Depending on the significance of market risk in a firm's overall risk profile, the firm's stress scenarios should include an adverse movement in financial market variables, such as asset prices, spreads, and rates, and related risk factors that impact a firm's trading exposures. The firm should base market risk factors in the scenario on a thorough evaluation of the specific positions of the firm and the material risks coincident with those positions. A firm should limit use of past periods of financial market stress that do not sufficiently stress the firm's current positions.

Appendix H: Risk-weighted Asset (RWA) Projections

A firm should maintain a sound process for projecting RWAs over the planning horizon. The firm's initial RWA calculations should be consistent with applicable regulatory capital requirements. In addition, the firm's projections of RWAs should be developed in a fashion consistent with the scenario conditions and in accordance with applicable regulatory capital requirements.

1. Initial RWA Calculations

Starting balances for both on- and off-balance sheet exposures and applicable risk weights form the foundation for estimates of post-stress capital ratios. Therefore, firms should verify carefully the accuracy of these starting balances. Moreover, deficiencies in starting RWA calculations are generally compounded in RWA projections over the planning horizon. A firm should ensure that it has sound controls around its RWA calculation and regulatory reporting processes as part of the firm's broader data governance program.

2. RWA Projections

A firm should ensure that RWA projections are consistent with a given scenario and incorporate the impact of projected changes in exposure amounts and risk characteristics of on- and off-balance sheet exposures under the scenario. A firm should demonstrate that assumptions associated with RWA projections are clearly conditioned on a given scenario and are consistent with stated internal and external business strategies. In addition, firms should ensure that projected market risk-weighted assets (market RWAs) are consistent with market factors (e.g., volatility levels, equity index levels, bond spreads) and assumptions around the size and composition of their trading assets.

A firm should document assumptions for projecting RWAs and their relationship to the RWA projections. If the firm's models for projecting RWAs rely upon historical relationships, the firm should provide a description of the historical data used and clearly describe why these relationships are expected to be maintained under a given scenario. Further, a firm should analyze the appropriateness of assumptions regarding the following:

- any aggregation of balance projections by exposure type or characteristic (e.g., balances for exposures that do not distinguish between amounts that are considered past due and those that are current) for purposes of applying corresponding risk weights;
- any use of average or effective risk weights based on the firm's as-of date portfolio composition or historical trend; and
- any exposure types for which RWAs are held constant over the projection horizon.

For purposes of projecting RWAs under the standardized approach, a firm should project balances, risk characteristics, and calculation parameters with appropriate consistency and granularity to facilitate application of appropriate regulatory risk weights for its on- and off-balance sheet exposures.[32] In particular, RWA projections should include information sufficient to assess the impact of potential changes to the following:

32. 12 CFR part 217, subpart D.

- counterparty mix, collateral mix, collateral haircuts, and netting assumptions for derivatives and repo-style transactions;
- default fund assumptions for derivatives that are centrally cleared;
- simplified supervisory formula approach (SSFA) input parameters for securitization exposures;
- organization for Economic Cooperation and Development (OECD) Country Risk Classifications (CRCs) or default status relating to foreign exposures;
- the utilization rate of off-balance sheet lines of credit;
- the mix between unconditionally cancellable and conditionally cancellable off balance sheet exposures;
- the volume of residential mortgage exposures that qualify for 50 percent risk weight, and;
- the volume of past due exposures as defined under Regulation Q.[33]

3. Market Risk-weighted Asset Projections

The methods and processes used to project market RWAs will differ across firms, in part as a function of the combination of model and nonmodel based methods used to determine starting market RWAs. However, as a general matter, market RWAs are expected to be positively correlated to volatility, spreads, or other relevant market factors, holding all things equal. If a firm projects flat or declining market RWAs over the planning horizon under the stress scenarios, the firm should provide support for the reasonableness of these assumptions under stressful market conditions. In addition, the firm should demonstrate that those assumptions are applied consistently across the enterprise-wide stress testing process, including for revenue projections.

If a firm that is not currently subject to the market risk rule projects its trading assets and trading liabilities to grow over the planning horizon, it should assess whether the projected growth would require the firm to calculate market RWA under the regulatory capital rule.[34] The firm should estimate the effect of market RWAs, if applicable, on its projected capital ratios and document the process used to project market RWAs in its capital plan.

4. Independent Review of RWA Reporting and Projections

A firm should implement and document an independent review of RWA regulatory reporting by the firm's internal audit function or another independent control function. The independent review should ensure point-in-time RWA calculation processes appropriately capture all relevant on- and off-balance sheet exposures and are consistent with applicable risk-weighting methodologies to which the firm is subject under Regulation Q. The independent review should be conducted by a party with the necessary expertise to perform such reviews but with independence from the assignment of the risk weights for regulatory reporting purposes. The review should provide reasonable assurance that the initial RWAs are accurate and that the methods used to project RWAs are sound. Documentation of the independent review should clearly describe the scope of the review, outcomes and findings of the review, and any associated remediation efforts. A firm should also ensure that the underlying data processes supporting RWA projections include appropriate controls, reconciliations and attestations, and that data integrity testing is conducted by an independent party.

Appendix I: Operational Loss Projections

A firm faces a wide range of operational risk in conducting its business operations. Operational losses can arise from various sources, including inadequate or failed internal processes, people, and systems, or from external events, and can differ in frequency and severity. For example, some operational loss events, such as credit card fraud, are often more predictable as they occur at high frequency, but generally have low loss severity. The outcome of other events, such as major litigation, are less certain and can result in outsized losses.

1. Risk Identification Process

A firm should maintain a sound process for estimating operational risk losses in its capital planning process, taking into account the differences in loss characteristics of different operational loss event types. A firm's risk identification process should include the evaluation of the type of operational risk loss events to which the

33. 12 CFR 217.32(k).
34. 12 CFR 217.201.

firm is exposed and the sensitivity of those events to internal and external operating environments.

The firm-specific scenario submitted in a firm's capital plan should capture the firm's material operational risks, be designed with the firm's particular vulnerabilities in mind, and include potential firm-specific events such as system failures, or litigation-related losses. The firm should evaluate both the firm's own loss history and the large loss events experienced by industry peers with similar business mix and overall operational risk profiles.

2. Approaches to Operational Loss Estimation

The firm should have transparent and well-supported estimation approaches based on both quantitative analysis and expert judgment, and should not rely on unstable or unintuitive correlations to project operational losses. Scenario analysis should be a core component of the firm's operational loss projection approaches.

Certain operational risks, particularly those most likely to give rise to large losses, often may not have measureable relationships to the overall scenario conditions. In addition, large operational loss events are often idiosyncratic, limiting the relevance of historical data. The firm should also limit dependence on distribution-based approaches that rely on historical data and require significant assumptions when projecting large operational losses. The firm should evaluate a range of outcomes under various scenarios, and make generally conservative assumptions.

The firm should engage business line and senior management to identify operational risk vulnerabilities and assess ways an operational risk event may unfold. The estimation approaches should also be subject to an effective independent review and challenge process.

3. Use of Data

The firm's operational loss projection approaches should make appropriate use of relevant reference data, including both internal and external data, evaluate all measurable linkages to overall scenario conditions, and include all potential sources of material operational risk losses across the firm. A firm's internal loss data should serve as both inputs to the firm's operational loss estimation approaches projections and a benchmark for operational loss estimates in various scenarios. A firm should have sound and comprehensive internal data-collection processes that capture key operational elements. The firm should include all relevant operational loss data, including large operational loss events such as legal settlements and tax and compliance penalties. If a firm's internal data lack sufficient operational loss history or granularity, the firm should use relevant external data to supplement its internal data.

The Federal Reserve has issued guidance (SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards," and its attachment) to explain its supervisory expectations for capital planning at firms subject to category II or III standards, consistent with the broad supervisory expectations set forth in SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions."[1] Capital is central to a firm's ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. Therefore, a firm's processes for managing and allocating its capital resources are critical to its financial strength and resiliency, and also to the stability and effective functioning of the U.S. financial system. The following guidance provides the Federal Reserve's core capital planning expectations for firms subject to category II or III standards, building upon the capital planning requirements in the Federal Reserve's capital plan rules and stress test rules.[2]

Firms subject to category I standards are U.S. holding companies identified as global systemically important bank holding companies. Firms subject to category II standards include banking organizations with $700 billion or more in total consolidated assets; or $75 billion or more in cross-jurisdictional activity; and do not meet the criteria for category I. Firms subject to category III standards include banking organizations with $250 billion or more in total consolidated assets; or banking organizations with $100 billion or more in total consolidated assets and $75 billion or more in weighted short-term wholesale funding, total nonbank assets, or off-balance sheet exposure; and do not meet the criteria for category I or II.

The guidance outlines capital planning expectations for

- governance,
- risk management,
- internal controls,
- capital policy,
- scenario design, and
- projection methodologies.

Further, the guidance includes several appendices that detail supervisory expectations on a firm's capital planning process. This guidance largely consolidates the Federal Reserve's existing capital planning guidance, including:

- Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice (August 2013)
- Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance (October 2014)
- Instructions for the Capital Assessments and Stress Testing information collection (Reporting Form FR Y-14A)
- SR-11-7, "Supervisory Guidance on Model Risk Management" (Refer to section 2126.0 of this manual.)
- SR-12-7, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets"
- SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions."

1060.3.1 GUIDANCE ON SUPERVISORY ASSESSMENT OF CAPITAL PLANNING AND POSITIONS FOR FIRMS SUBJECT TO CATEGORY II OR III STANDARDS

I. Introduction

This guidance (the attachment to SR-15-19) provides the Federal Reserve's core capital planning expectations for firms subject to category II

1. See 84 Fed. Reg. 59,032 (November 1, 2019) for more information on the Board's tailoring rules. The term "capital planning process," as used herein, which aligns with terminology in SR-12-17/ CA-12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents. With the issuance of SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards," and SR-15-19, SR-99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," is superseded. In addition, SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," is superseded with respect to firms subject to SR-15-18 and SR-15-19.

2. For the capital plan rules, refer to section 225.8 of Regulation Y (12 CFR 225.8) and section 238.170 of Regulation LL (12 CFR 238.170). Regulation Q (12 CFR part 217) establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Regulation YY (12 CFR part 252) and Regulation LL (12 CFR part 238) establish capital stress testing requirements for bank holding companies (including U.S. intermediate holding companies of foreign banking organizations) and covered savings and loan holding companies, respectively, with total consolidated assets of $100 billion or more.

or III standards under the Board's tailoring framework, building upon the capital planning requirements included in the Board's capital plan rules and stress test rules. This guidance outlines capital planning expectations for these firms in the following areas:[3]

Governance

- risk management
- internal controls
- capital policy
- incorporation of stressful conditions and events, and
- estimation of the impact on capital positions.

Further, the following appendixes in the guidance provides detailed supervisory expectations on a firm's capital planning process:

A. Use of Models and Other Estimation Approaches
B. Model Overlays
C. Use of Benchmark Models in the Capital Planning Process
D. Sensitivity Analysis and Assumptions Management
E. Role of the Internal Audit Function in the Capital Planning Process
F. Capital Policy
G. Scenario Design
H. Risk-weighted Asset (RWA) Projections
I. Operational Loss Projections

This guidance applies to U.S. bank holding companies and U.S. intermediate holding companies of foreign banking organizations, and covered savings and loan holding companies that are subject to category II or III standards under the Board's tailoring framework.[4] The guidance describes minimum examiner expectations when applying the capital plan rules and stress test rules to such firms.

The Federal Reserve has different expectations for sound capital planning and capital adequacy depending on the size, scope of operations, activities, and systemic importance of a firm. The Federal Reserve has separate guidance set forth in SR-15-18, which clarifies that expectations for firms subject to category I standards are higher than the expectations for firms subject to category II or III standards.

II. Regulatory Requirements for Capital Positions and Planning

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. Certain Federal Reserve regulations form the basis of the regulatory framework for capital positions and capital planning:

(1) Regulation Q (12 CFR part 217), Capital Adequacy Requirements for Board-regulated Institutions;
(2) Subparts E and F of Regulation YY (12 CFR part 252, subparts E and F), and subparts O and P of Regulation LL (12 CFR part 238, subparts O and P); and
(3) Section 225.8 of Regulation Y (12 CFR 225.8) and subpart S of Regulation LL (12 CFR part 238, subpart S), together known as the capital plan rules.

Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Among other things, Regulation YY and Regulation LL establish capital stress testing requirements for bank holding companies and covered savings and loan holding companies, respectively, with total consolidated assets of $100 billion or more. The capital plan rules establish general capital planning requirements for a bank holding company or covered savings and loan holding company with total consolidated assets of $100 billion or more and requires such a firm to develop an annual capital plan that is approved by its board of directors.

This guidance provides the Federal Reserve's core capital planning expectations for firms sub-

3. Note that these expectations build upon the capital planning requirements set forth in the Board's capital plan rules and stress test rules (12 CFR 225.8; 12 CFR part 238, subparts O, P, and S; 12 CFR part 252, subparts E and F). Other relevant rules pertaining to the Board's regulatory regime for capital planning and positions are described in section II, "Regulatory Requirements for Capital Positions and Planning." The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The OMB control numbers for this guidance are OMB No. 7100-0341 and OMB No. 7100-0342.

4. This guidance does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board of Governors. A covered savings and loan holding company is a savings and loan holding company not predominantly engaged in insurance or commercial activities (see 12 CFR 217.2). Firms should refer to this guidance in the development of the capital plans that they will submit by April 5, 2021, and for subsequent years.

ject to this guidance, building upon the capital planning requirements in the Federal Reserve's capital plan rules and stress test rules.

III. Capital Planning Expectations

Capital is central to a firm's ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. A firm's capital planning processes are critical to its financial strength and resiliency.

SR-12-17/CA-12-14 outlines core expectations for sound capital planning for large financial institutions. This capital planning and positions guidance provides additional details around the Federal Reserve's core capital planning expectations for firms subject to category II or III standards, building on the capital planning requirements included in the capital plan rule and the Board's stress test rules.[5] A firm should maintain a sound capital planning process on an ongoing basis, including in between submissions of its annual capital plan.[6]

A. Governance

The Federal Reserve expects a firm to have sound governance over its capital planning process. In general, senior management should establish the capital planning process and the board of directors should review and periodically approve that process.

1. Board of Directors

A firm's board of directors is ultimately responsible and accountable for the firm's capital-related decisions and for capital planning. The firm's capital planning should be consistent with the strategy and risk appetite set by the board and with the firm's risk levels, including how risks at the firm may emerge and evolve under stress. The board must annually review and approve the firm's capital plan.[7]

5. The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve's advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies' supervisory guidance relating to the ICAAP (see 73 Fed. Reg. 44,620 (July 31, 2008)).

6. The term "capital planning process" used in this document, which aligns with terminology in SR-12-17/CA-12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents.

7. 12 CFR 225.8(e)(1)(iii).

The board should direct senior management to provide a briefing on their assessment of the firm's capital adequacy at least quarterly, and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The briefing should describe whether current capital levels and planned capital distributions remain appropriate and consistent with capital goals (see Section III.D, "Capital Policy"). In their briefing, senior management should also highlight for the board any problem areas related to capital planning identified by senior management, internal audit, or supervisors.

The board should hold senior management accountable for providing sufficient information on the firm's material risks and exposures to inform board decisions on capital adequacy and actions, including capital distributions. Information provided to the board should be clear, accurate, and timely. The board should direct senior management to provide this information at least quarterly and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The information presented to the board should include consideration of a number of factors, such as

- macro-economic conditions and relevant market events;
- current capital levels relative to budgets and forecasts;
- post-stress capital goals and targeted real time capital levels (see section III.D, "Capital Policy");
- enterprise-wide and line-of-business performance;
- expectations from stakeholders (including shareholders, regulators, investors, lenders, counterparties, and rating agencies);
- potential sources of stress to the firm's operating performance; and
- risks that may emerge only under stressful conditions.

After receiving the information, the board should be in a position to understand the major drivers of the firm's projections under a range of conditions, including baseline and stress scenarios.

The board should direct senior management to provide information about the firm's estimation approaches, model overlays, and assessments of model performance (see Appendix A, "Use of Models and Other Estimation Approaches" and Appendix B, "Model Overlays").

The board should also receive information about uncertainties around projections of capital needs or limitations within the firm's capital planning process to understand the impact of these weaknesses on the process. This information should include key assumptions and the analysis of sensitivity of a firm's projections to changes in the assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management"). The board should incorporate uncertainties in projections and limitations in the firm's capital planning process into its decisions on capital adequacy and capital actions. It should also review and approve mitigating steps to address capital planning process weaknesses.

The board should direct senior management to establish sound controls for the entire capital planning process. The board should approve policies related to capital planning, and review them annually. The board should also approve capital planning activities and strategies. The board of directors should maintain an accurate record of its meetings pertaining to the firm's capital planning process.

2. *Senior Management*

Senior management should direct staff to implement board-approved capital policies, capital planning activities, and strategies in an effective manner. Senior management should make informed recommendations to the board regarding the firm's capital planning and capital adequacy, including post-stress capital goals and capital distribution decisions. Senior management's proposed capital goals and capital distributions should have analytical support and take into account the expectations of important stakeholders, including shareholders, rating agencies, counterparties, depositors, creditors, and supervisors.

Senior management should design and oversee the implementation of the firm's capital planning process; identify and assess material risks and use appropriate firm-specific scenarios in the firm's stress test; monitor and assess capital planning practices to identify limitations and uncertainties and develop remediation plans; understand key assumptions used throughout a firm's capital planning process and assess the sensitivity of the firm's projections to those assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management"); and review the capital planning process at least semi-annually.

Senior management should establish a process for independent review of the firm's capital planning process, including the elements outlined in this guidance. The independent review process should be designed to identify the weaknesses and limitations of the capital planning process and the potential impact of those weaknesses on the process. Senior management should also develop remediation plans for any identified weaknesses affecting the reliability of capital planning results. Both the specific identified weaknesses and the remediation plans should be reported to the board of directors in a timely manner.

B. Risk Management

A firm should have a risk management infrastructure that appropriately identifies, measures, and assesses material risks and provides a strong foundation for capital planning.[8] This risk management infrastructure should be supported by comprehensive policies and procedures, clear and well-established roles and responsibilities, and strong and independent internal controls. In addition, the risk management infrastructure should be built upon sound information technology and management information systems. The Federal Reserve's supervisory assessment of the sufficiency of a firm's capital planning process will depend in large part on the effectiveness of the firm's risk management infrastructure and the strength of its process to identify unique risks under normal and stressful conditions, as well as on the strength of its overall governance and internal control processes.

1. *Risk Identification and Assessment Process*

A firm's risk identification process should include a comprehensive assessment of risks stemming from its unique business activities and associated exposures. The assessment should include on-balance sheet assets and liabilities, off-balance sheet exposures, vulnerability of the firm's earnings, and other major firm-specific determinants of capital adequacy under normal and stressed conditions. This assessment should also capture those risks that only materialize or become apparent under stressful conditions.

The specifics of the risk identification process will differ across firms given differences in organizational structure, business activities, and size

8. 12 CFR 225.8(e)(2).

and complexity of operations. However, the risk identification process at all firms subject to this guidance should be dynamic, inclusive, and comprehensive, and drive the firm's capital adequacy analysis. A firm should

- evaluate material risks across the enterprise to ensure comprehensive risk capture on an ongoing basis;
- actively monitor its material risks; and
- use identified material risks to inform key aspects of the firm's capital planning, including the development of stress scenarios, the assessment of the adequacy of post-stress capital levels, and the appropriateness of potential capital actions in light of the firm's capital objectives.

A firm should be able to demonstrate how material risks are accounted for in its capital planning process. For risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and distributions.

2. *Risk Measurement and Risk Materiality*

A firm should have a sound risk measurement process that informs senior management about the size and risk characteristics of exposures and business activities under both normal and stressful operating conditions. A firm should employ risk measurement approaches that are appropriate for its size, complexity and risk profile.

Identified weaknesses, limitations, biases, and assumptions in the firm's risk measurement processes should be assessed for their potential impact on the integrity of a firm's capital planning process (see Appendix D, "Sensitivity Analysis and Assumptions Management"). A firm should have a process in place for determining materiality in the context of material risk identification and capital planning. This process should include a sound analysis of relevant quantitative and qualitative considerations, including, but not limited to, the firm's risk profile, size, and complexity, and their effects on the firm's projected regulatory capital ratios in stressed scenarios.[9]

A firm should identify how and where its material risks are accounted for within the capital planning process. The firm should be able to specify material risks that are captured in its scenario design, the approaches used to estimate the impact on capital, and the risk drivers associated with each material risk.

C. Internal Controls

A firm should have a sound internal control framework that helps ensure that all aspects of the capital planning process are functioning as designed and result in sound assessments of the firm's capital needs. The framework should include

- an independent internal audit function;
- independent review and validation practices; and
- integrated management information systems, effective reporting, and change control processes.

A firm's internal control framework should support its entire capital planning process, including the sufficiency of and adherence to policies and procedures; risk identification, measurement, and management practices and systems used to produce input data; and the models, management overlays, and other methods used to generate inputs to post-stress capital estimates. Any part of the capital planning process that relies on manual procedures should receive heightened attention. The internal control framework should also assess the aggregation and reporting process used to produce reports to senior management and to the board of directors and the process used to support capital adequacy recommendations to the board.

1. *Comprehensive Policies, Procedures, and Documentation for Capital Planning*

A firm should have policies and procedures that support consistent and repeatable capital planning processes.[10] Policies and procedures should describe the capital planning process in a manner that informs internal and external stakeholders of the firm's expectations for internal prac-

9. For simplicity, the terms "quantitative" and "qualitative" are used to describe two different types of approaches, with the recognition that all quantitative estimation approaches involve some qualitative/judgmental aspects, and qualitative estimation approaches produce quantitative output.

10. See Instructions for the Capital Planning and Stress Testing Information Collection (Reporting Form FR Y-14A), Appendix A (Supporting Documentation).

tices, documentation, and business line controls. The firm's documentation should be sufficient to provide relevant information to those making decisions about capital actions. The documentation should also allow parties unfamiliar with a process or model to understand generally how it operates, as well as its main limitations, key assumptions, and uncertainties.

Policies and procedures should also clearly identify roles and responsibilities of staff involved in capital planning and provide accountability for those responsible for the capital planning process. A firm should also have an established process for policy exceptions. Such exceptions should be approved by the appropriate level of management based upon the gravity of the exception. Policies and procedures should reflect the firm's current practices, and be reviewed and updated as appropriate, but at least annually.

2. *Model Validation and Independent Review of Estimation Approaches*

Models used in the capital planning process should be reviewed for suitability for their intended uses. A firm should give particular consideration to the validity of models used for calculating post-stress capital positions. In particular, models designed for ongoing business activities may be inappropriate for estimating losses, revenue, and expenses under stressed conditions. If a firm identifies weaknesses or uncertainties in a material model, the firm should make adjustments to model output if the findings would otherwise result in the material understatement of capital needs (see Appendix B, "Model Overlays"). If the deficiencies are critical, the firm should restrict the use of the model, apply overlays, or avoid using the model entirely.

A firm should independently validate or otherwise conduct effective challenge of models used in internal capital planning, consistent with supervisory guidance on model risk management, with priority given to more material models.[11] The model review and validation process should include an evaluation of conceptual soundness of models and ongoing monitoring of the model performance. The firm's validation staff should have the necessary technical competencies, sufficient stature within the organization, and appropriate independence from model developers and business areas to provide a critical and unbiased evaluation of the estimation approaches.

A firm should maintain an inventory of all estimation approaches used in the capital planning process, including models used to produce projections or estimates used by the models that generate final loss, revenue, expense, and capital projections.[12] Material models should receive greater attention.[13] The intensity and frequency of validation work should be a function of the importance of those models in generating estimates of post-stress capital.

Not all models can be fully validated prior to use in capital planning. However, a firm should make efforts to conduct a conceptual soundness review of its material models prior to their use in capital planning. If such a conceptual soundness review is not possible, the absence of that review should be made transparent to users of model output and the firm should determine whether the use of compensating controls (such as conservative adjustments) are warranted.

Further, a firm should treat output from material models for which there are model risk management shortcomings with caution.

3. *Management Information Systems and Change Control Processes*

A firm should have internal controls that ensure the integrity of reported results and that make certain the firm is identifying, documenting, reviewing, and tracking all material changes to the capital planning process and its components. The firm should ensure that such controls exist at all levels of the capital planning process. Specific controls should ensure

- sufficiently sound management information systems to support the firm's capital planning process;
- comprehensive reconciliation and data integrity processes for key reports;
- the accurate and complete presentation of capital planning process results, including a

11. See SR-11-7. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

12. The definition of a model covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

13. Materiality of the model is a function of both the importance of the business or portfolio assessed and the impact of the model on the firm's overall results.

description of adjustments made to compensate for identified weaknesses; and
- that information provided to senior management and the board is accurate and timely.

Many of the processes used to assess capital adequacy, including models, data, and management information systems, are tightly integrated and interdependent. As a result, a firm should ensure consistent change control oversight across the entire firm, in line with existing supervisory guidance.[14] A firm should establish and maintain a policy describing minimum internal control standards for managing change in capital planning process policies and procedures, model development, information technology, and data. Control standards for these areas should address risk, testing, authorization and approval, timing of implementation, and post-installation verification.

4. Internal Audit Function

Internal audit should play a key role in evaluating capital planning and the elements described in this guidance to ensure that the entire process is functioning in accordance with supervisory expectations and the firm's policies and procedures. Internal audit should review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, internal audit should ensure appropriate independent review and challenge is occurring at all key levels within the capital planning process.

As discussed further in Appendix E, "Role of the Internal Audit Function in the Capital Planning Process," internal audit staff should have the appropriate competence and influence to identify and escalate key issues. All deficiencies, limitations, weaknesses and uncertainties identified by the internal audit function that relate to the firm's capital planning process should be reported to senior management, and material deficiencies should be reported to the board of directors (or the audit committee of the board) in a timely manner.[15]

D. Capital Policy

A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions.[16] This includes internal post-stress capital goals (as discussed in more detail below and in Appendix F, "Estimating Impact on Capital Positions") and real-time targeted capital levels; guidelines for dividend payments and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance responsibilities and procedures for the capital policy. The capital policy must be approved by the firm's board of directors or a designated committee of the board.[17]

The capital policy should be reevaluated at least annually and revised as necessary to address changes to the firm's business strategy, risk appetite, organizational structure, governance structure, post-stress capital goals, real-time targeted capital levels, regulatory environment, and other factors potentially affecting the firm's capital adequacy.

A capital policy should describe the firm's capital adequacy decision-making process, including the decision-making process for common stock dividend payments or stock repurchases.[18] The policy should incorporate actionable protocols, including governance and escalation, in the event a post-stress capital goal, real-time targeted capital level, or other early warning metric is breached.

Post-Stress Capital Goals

A firm should establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders. Post-stress capital goals should be calibrated based on the firm's own internal analysis, independent of regulatory capital requirements, of the minimum level of post-stress capital the firm has deemed necessary to remain a going concern over the planning horizon. A firm should also determine targets for real-time capital ratios and

14. Federal Financial Institutions Examination Council, "IT Examination Handbook—Operations Booklet."

15. For additional information on supervisory expectations for internal audit see SR-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

16. 12 CFR 225.8(d)(7).

17. 12 CFR 225.8(e)(1)(iii).

18. Consistent with the Board's November 14, 1985, Policy Statement on the Payment of Cash Dividends, the principles of which are incorporated into this guidance, firms should have comprehensive policies on dividend payments that clearly articulate the firm's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. See *Bank Holding Company Supervision Manual,* section 2020.5.1.1, "Intercompany Transactions (Dividends)."

capital levels that ensure that capital ratios and levels would not fall below the firm's internal post-stress capital goals (including regulatory minimums) under stressful conditions at any point over the planning horizon. For more details, see Appendix F, "Capital Policy."

E. Incorporating Stressful Conditions and Events

As part of its capital planning process, a firm should incorporate appropriately stressful conditions and events that could adversely affect the firm's capital adequacy into its capital planning. As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm's activities and associated risks, including those related to the company's capital adequacy and financial condition.[19]

1. Scenario design

A firm should either develop a complete internal scenario or adjust the Federal Reserve's supervisory scenarios for the specific vulnerabilities of the firm's risk profile and operations, as needed, to appropriately capture the firm's risks (see Appendix G, "Scenario Design").

2. Scenario narrative

A firm's stress scenario should be supported by a brief narrative describing how the scenario addresses the firm's particular material risks and vulnerabilities, and how the paths of the scenario variables relate to each other.

F. Estimating Impact on Capital Positions

A firm should employ estimation approaches that allow it to project the impact on capital positions of various types of stressful conditions and events. The firm's stress testing practices should capture the potential increase in losses or decrease in pre-provision net revenue (PPNR) that could result from the firm's risks, exposures, and activities under stressful scenarios. A firm should estimate losses, revenues, expenses, and capital using a sound method that relates macroeconomic and other risk drivers to its estimates. The firm should be able to identify the manner in which key variables, factors, and events in a scenario affect losses, revenue, expenses, and capital over the planning horizon. The firm may use simple approaches for their non-material portfolios or business lines, such as application of loss or revenue rates during the prior stress periods or other conservative assumptions.

1. Loss estimation

A firm should provide support for the assumed relationship between risk drivers and losses. A firm is expected to estimate losses by type of business activity.

a. Credit risk losses on loans and securities

A firm should develop sound methods to estimate credit losses under stress that take into account the type and size of portfolios, risk characteristics, and data availability. A firm should understand the key characteristics of its loss estimation approach. In addition, a firm's reserves for each quarter of the planning horizon, including the last quarter, should be sufficient to cover estimated loan losses consistent with generally accepted accounting standards.

A firm should test credit-sensitive securities for potential other-than-temporary impairment (OTTI) regardless of current impairment status. The threshold for determining OTTI for structured products should be based on cash-flow analysis and credit analysis of underlying obligors.

b. Operational-risk losses

A firm should maintain a sound process for estimating operational risk losses in its capital planning process. Operational losses can rise from various sources, including inadequate or failed internal processes, people, and systems, or from external events (see Appendix I, "Operational Loss Projections").

2. PPNR

In projecting PPNR, a firm should take into account not only its current positions, but also how its activities, business strategy, and revenue drivers may evolve over time under the varying

19. 12 CFR 225.8(e)(2).

circumstances and operating environments. The firm should ensure that the various PPNR components, including net interest income, non-interest income and non-interest expense, and other key items projected by the firm such as balance sheet positions, RWA, and losses, are projected in a manner that is internally consistent.

The ability to effectively project net interest income is dependent upon the firm's ability to identify and aggregate current positions and their attributes; project future changes in accruing balances due to a variety of factors; and appropriately translate the impact of these factors and relevant interest rates into net interest income based on assumed conditions. Accordingly, a firm's current portfolio of interest-bearing assets and liabilities should serve as the foundation for its forward-looking estimates of net interest income.

Non-interest income is derived from a diverse set of sources, including fees and certain realized gains and losses. Non-interest income generally is more susceptible to rapid changes than net interest income, especially if certain market measures move sharply. A firm's projections should incorporate material factors that could affect the generation of non-interest income under stress, including the firm's business strategy, the competitive landscape, and changing regulations.

Non-interest expenses include both expenses that are likely to vary with certain stressful conditions and those that are not. Projections of expenses that are closely linked to revenues or balances should vary with projected changes in revenue or balance sheet levels.

3. Aggregating Estimation Results

A firm should have well-documented processes for projecting the size and composition of on- and off-balance sheet positions and RWAs over the planning horizon that feed in to the wider capital planning process (see Appendix H, "Risk-weighted Asset (RWA) Projections").

A firm should have a consistently executed process for aggregating enterprise-wide stress test projections of losses, revenues, and expenses, including estimating on- and off-balance sheet exposures, and RWAs, and for calculating post-stress capital positions and ratios. The aggregation system should be able to bring together data and information across business lines, portfolios, and risk types and should include the data systems and sources, data reconciliation points, data quality checks, and appropriate internal control points to ensure accurate and consistent projection of financial data within enterprise-wide scenario analysis. Internal processes for aggregating projections from all relevant systems and regulatory templates should be identified and documented. In addition, the beginning points for projections and scenario variables should align with the end of the historical reference period.

Appendix A: Use of Models and Other Estimation Approaches

Projections of losses and PPNR under various scenarios are key components of enterprise-wide stress testing and capital planning. The firm should ensure that its material projection approaches, including any specific processes or methodologies employed, are well supported, transparent, and repeatable over time.

A firm may use either quantitative methods or qualitative approaches for generating projections. A firm is not expected to employ a sophisticated modeled approach, particularly if the firm can demonstrate that a simpler approach, combined with well-supported expert judgment, produces credible and transparent output. A firm can apply simple assumptions to generate losses or PPNR for its non-material portfolios or business lines.

A firm should adhere to supervisory guidance on model risk management (SR-11-7) when using models, and should have sound internal controls around both quantitative and qualitative approaches.

1. Quantitative Approaches

If a firm decides to employ quantitative approaches, it is not expected to use any specific quantitative estimation method. Any quantitative approach should be appropriate for the type and materiality of the portfolio or activity for which it is used and the granularity and length of available data. The firm should also ensure that the quantitative approach selected generates credible estimates that are consistent with assumed scenario conditions. A firm should separately estimate losses and PPNR for portfolios or business lines that are either sensitive to different risk drivers or sensitive to risk drivers in a markedly different way, particularly during periods of stress.

a. Use of Data

A firm may use either internal or external data to estimate losses and PPNR as part of its enterprise-wide stress testing and capital planning practices.[20] If a firm uses external data to estimate its losses or PPNR, the firm should ensure that the external data reasonably approximate underlying risk characteristics of the firm's portfolios or business lines. Further, the firm should make adjustments to estimation methods or outputs, as appropriate, to account for identified differences in risk characteristics and performance reflected in internal and external data. If internal data are not available, a firm should strive to collect internal data over time to augment its projections.

For material portfolios and business lines, a firm should generally include all available data in its analysis, unless the firm no longer engages in a line of business or its activities have changed such that the firm is no longer exposed to a particular risk. The firm should not selectively exclude data for material portfolios and business lines based on the changing nature of the ongoing business or activity without strong empirical support. For example, excluding certain loans only on the basis that they were underwritten to standards that no longer apply or on the basis that the loans were acquired by the firm is not sound practice.

b. Use of Vendor Models[21]

A firm should have processes to confirm that any vendor or other third-party models it uses are sound, appropriate for the given task, and implemented properly. A firm should clearly outline limitations and uncertainties associated with vendor models.

2. *Assessing Model Performance*

A firm should use measures to assess model performance that are appropriate for the type of model being used. The firm should outline how each performance measure is evaluated and used. A firm should also assess the sensitivity of material model estimates to key assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management").

For models used for material portfolios and business lines, a firm should provide supporting information about the models to users of their output, including descriptions of known measurement problems, simplifying assumptions, model limitations, or other ways in which the model exhibits weaknesses in capturing the relationships being modeled. Providing such qualitative information is critical when certain quantitative criteria or tests measuring model performance are lacking.

3. *Qualitative Approaches*

A firm may use a qualitative approach to project losses and PPNR. When using a qualitative approach for material portfolios and business lines, the firm should substantiate assumptions and estimates using analysis of current and past risk drivers and performance, internal risk identification, forward-looking risk assessments, external analysis or other available information. The firm should conduct an initial and ongoing assessment of the performance and viability of the qualitative approach. The processes used in qualitative projection approaches should be transparent and repeatable. The firm should also clearly document material qualitative approaches and key assumptions used.

Qualitative approaches should be subject to independent review, although the review may differ from the review of quantitative approaches or models. The level of independent review should be commensurate with the

- materiality of the portfolio or business line for which the qualitative approach is used;
- impact of the approach's output on the overall capital results; and
- complexity of the approach.

Firm staff conducting the independent review of the qualitative approaches should *not* be involved in developing, implementing or using the approach. However, this staff can be different than the staff that conducts validation of quantitative approaches or models.

20. Firms are required to collect and report a substantial amount of risk information to the Federal Reserve on FR Y-14 schedules. These data may help to support the firms' enterprise-wide stress test. See Capital Assessments and Stress Testing information collection, Reporting Forms FR Y-14A, Q, and M.

21. See SR-13-19/CA-13-21, "Guidance on Managing Outsourcing Risk."

Appendix B: Model Overlays

A firm may need to rely on overrides or adjustments to model output (model overlay) to compensate for model, data, or other known limitations.[22] If well-supported, use of a model overlay can represent a sound practice.

A model overlay may be appropriate to address cases of identified weaknesses or limitations in the firm's models that cannot be otherwise addressed, or for select portfolios that have unique risks that are not well captured by the model used for those exposures and activities.[23] In contrast, a model overlay that functions as a general "catch all" buffer on top of targeted capital levels to account for model weaknesses generally would not represent sound practice.[24]

As part of its overall documentation of methodologies used in stress testing, a firm should document its use of model overlays.

1. *Process for Applying Overlays*

A firm should establish a consistent firm-wide process for applying model overlays and for controls around model overlays. The process can vary by model type and portfolio, but should contain some key elements, as described below. This process should be outlined in the firm's policies and procedures and include a specific exception process for the use of overlays that do not follow the firm's standards. As part of model development, implementation and use, overlays for material portfolios and business lines should be well documented, supported and communicated to senior management. Model overlays should be applied in an appropriate, systematic, and transparent manner. Model results should also be reported to senior management with and without overlay adjustments.

Model overlays (including those based solely on expert or management judgment) should be subject to validation or some other type of effective challenge.[25] Consistent with the materiality principle in SR-11-7, the intensity of model risk management for overlays should be a function of the materiality of the model and overlay. A firm should make efforts to conduct effective challenge of its material overlays prior to their use in capital planning. If such validation or effective challenge is not possible, those instances should be made transparent to users of the model and overlay.

Validation or other type of effective challenge of model overlays may differ from quantitative model validation. Staff responsible for effective challenge should not also be setting the overlay itself or providing significant input to the level or type of overlay. For example, a committee that develops an overlay should not also be responsible for the effective challenge of the overlay. In addition, staff engaging in the effective challenge of model overlays should meet supervisory expectations relating to incentives, competence, and influence (as outlined in SR-11-7).

2. *Governance of Overlays*

Overlays and adjustments used by a firm should be reviewed and approved at a level within the organization commensurate with the materiality of that overlay or adjustment to overall pro forma results. In general, the purpose and impact of material overlays should be communicated to senior management in a manner that facilitates an understanding of the issues by the firm's senior management. Material overlays to the model—either in isolation or in combination—should receive a heightened level of support and scrutiny, up to and including review by the firm's board of directors (or a designated committee), in instances where the impact on pro forma results is material.

Appendix C: Use of Benchmark Models in the Capital Planning Process

As noted in Appendix A, "Use of Models and Other Estimation Approaches," a firm should use a variety of methods to assess performance of material models and gain comfort with mate-

22. For the purposes of this appendix, the term "overlays" will be used to cover overrides, overlays, or other adjustments applied to model output. Firms should follow expectations set forth in SR-11-7, relating to overlays.

23. Expectations for the use of judgment within model development is discussed in Appendix A, "Use of Models and Other Estimation Approaches."

24. Firms may choose to apply overall capital buffers as an additional conservative measure, beyond overlays applied at the model level. Overall capital buffers should be subject to the same governance processes applicable to model overlays, as described in section 2 of this appendix. However, supervisors emphasize that having such a buffer should not in any way replace sound model risk management practices for overlays at the individual model level or address the need for the overlay at the individual model level.

25. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

rial model estimates. However, a firm is not expected to use benchmark models in its capital planning process.

Appendix D: Sensitivity Analysis and Assumptions Management

A firm should understand the sensitivity of its stress testing estimates used in capital planning to the various inputs and assumptions. In addition, sensitivity analysis should be used to test the robustness of material quantitative approaches and models and enhance reporting to the firm's senior management, board of directors, and supervisors. A firm should ensure that it identifies, documents, and manages the use of all key assumptions used in capital planning.

1. Sensitivity Analysis

Understanding and documenting a range of potential outcomes provides insight into the inherent uncertainty and imprecision around pro forma results. A firm should assess the sensitivity of its estimates of capital ratios, losses, revenues, and RWAs to key assumptions and uncertainty across the entire firm's projections under stress. Through this assessment, a firm should calculate a range of potential estimates based on changes to assumptions and inputs.

A firm should also evaluate the sensitivity of material models to key assumptions to evaluate model performance, assess the appropriateness of assumptions, and understand uncertainty associated with model output.

Sensitivity analysis for capital planning models should be applied in a manner consistent with the expectations outlined in the Federal Reserve's supervisory guidance on model risk management (refer to SR-11-7). Sensitivity analysis should be conducted during model development and during model validation to provide information about how models respond to changes in key inputs and assumptions, and how those models perform in stressful conditions. In addition, sensitivity analysis should be applied to understand the range of possible results from material vendor-provided models and vendor-provided scenario forecasts that have opaque or proprietary elements. Sensitivity analysis should be used to provide information to help users of model output interpret results, but does not have to result in changes to models or model outputs. Changes made based on sensitivity analysis should be clearly documented and justified.

A firm should ensure that the key sensitivities are presented to senior management and the board in advance of decision-making around the firm's capital plan and capital actions. Sensitivity analysis should also be used to inform senior management, and, as appropriate, the board of directors about the potential uncertainty associated with models employed of the firm's projections under stress.

2. Assumptions Management

A firm should clearly document assumptions when estimating losses, PPNR, and balance sheet, and RWA components. Documentation should include the rationale and empirical support for assumptions and specifically address how those assumptions are consistent with and appropriate under the firm's scenario conditions.

A firm's rationale for assumptions used in capital planning should be consistent with the different effects of scenario conditions, shifts in portfolio mix, and growth or decline in balances projected over the planning horizon. For example, the firm should scrutinize and support any assumptions about sizeable loan growth during a severe economic downturn.

A firm should generally use conservative assumptions, particularly in areas of high uncertainty. The firm should provide greater support for assumptions that appear optimistic or otherwise appear to benefit the firm (such as loss reduction or revenue enhancement). A firm should not assume that senior management will be able to realize favorable strategic actions that cannot be reasonably assured in stress scenarios given the high level of uncertainty around market conditions. Further, a firm should not assume that it would have the perfect foresight that would allow it, for example, to make significant expense reductions in the first quarter of the forecast horizon in anticipation of the forthcoming economic deterioration described in the scenario.

A firm should confirm that key assumptions used in material vendor or other third-party products are transparent and have sufficient support before using the products in stress testing. The firm should limit use of material vendor products whose assumptions are not fully transparent or supported or use those products only in conjunction with another approach or compensating controls (e.g., overlays).

Appendix E: Role of the Internal Audit Function in the Capital Planning Process

A firm's internal audit function should play a key role in evaluating the adequacy of the firm's capital planning process and in assessing whether the risk management and internal control practices supporting that process are comprehensive and effective. A firm should establish an audit program around its capital planning process that is consistent with SR-13-1, "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."

1. Responsibilities of Audit Function

The internal audit function should identify all auditable processes related to capital planning and develop an associated audit plan. The audit function should also perform substantive testing to ascertain the effectiveness of the control framework supporting the firm's capital planning process, communicate identified limitations and deficiencies to senior management, and communicate material limitations and deficiencies to the board of directors (or the audit committee of the board). The audit function should comprehensively cover the firm's capital planning process.

The internal audit function should perform periodic reviews of all aspects of the internal control framework supporting the capital planning process to ensure that all individual components as well as the entire process are functioning in accordance with supervisory expectations and the firm's policies and procedures. The internal audit function should also review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, the internal audit function should ensure appropriate independent review is occurring at various levels within the capital planning process.

A firm's internal audit staff should have the appropriate competence and stature to identify and escalate key issues when necessary. The internal audit function may also rely on an independent third party external to the firm to complete some of the substantive testing as long as the internal audit function can demonstrate proper independence of the third-party from the area being assessed and provide oversight over the execution and quality of the work.

2. Development of Audit Plan

The internal audit function should have a documented plan describing its strategy to assess the processes and controls supporting the firm's capital planning process. When defining the annual audit universe and audit plan, the internal audit function of a firm should focus on the most significant risks relating to the capital planning process. The firm may leverage existing or regularly scheduled audits to ensure coverage of all the capital planning process components; however, the findings and conclusions of these audits should be incorporated into the overall summary of audit activities and conclusions regarding the firm's capital planning process.

3. Briefings to Senior Management and Board

On an annual basis, the internal audit function should report to senior management and the board of directors on the capital planning process to inform recommendations and decisions on the firm's capital plan. The report should provide an opinion of the capital planning process, a statement of the effectiveness of the controls and processes employed, a status update on previously identified issues and remediation plans, and any open issues or uncertainties related to the firm's capital plan. Any key processes that are not comprehensively reviewed and tested, due to timing or significant changes in processes, should be clearly documented and identified as areas with potential heightened risk.

The internal audit function should track responses to its material findings and report to the board any cases in which senior management is not implementing required changes related to audit findings or is doing so with insufficient intensity.

Appendix F: Capital Policy

A firm's capital policy should describe how the firm manages, monitors, and makes decisions regarding capital planning.[26] The policy should include internal post-stress capital goals and

26. A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions. 12 CFR 225.8(d)(7).

real-time targeted capital levels; guidelines for dividends and stock repurchases; and strategies for addressing potential capital shortfalls.

A firm's capital policy should describe the manner in which consolidated estimates of capital positions are presented to senior management and the board of directors. The capital policy should require staff with responsibility for developing capital estimates to clearly identify and communicate to senior management and board of directors the key assumptions affecting various components that feed into the aggregate estimate of capital positions and ratios. The capital policy should require that aggregated results be directly compared against the firm's stated post-stress capital goals, and that those comparisons are included within the standard reporting to senior management and the board of directors.

1. *Post-Stress Capital Goals*

Post-stress capital goals should provide specific minimum thresholds for the level and composition of capital that the firm intends to maintain during a stress period. Post-stress capital goals should include any capital measures that are relevant to the firm.

The firm should be able to demonstrate through its own internal analysis, independently of regulatory capital requirements, that remaining at or above its internal post-stress capital goals will allow the firm to continue to operate.

The capital policy should describe how senior management and the board concluded that the firm's post-stress capital goals are appropriate, sustainable in different conditions and environments, and consistent with its strategic objectives, business model, and capital plan. In addition, the capital policy should describe the process by which the firm establishes its post-stress capital goals, and include the supporting analysis underpinning the goals chosen by the firm.

A firm should annually review its capital goals, evaluate whether its post-stress capital goals are still appropriate based on changes in operating environment, business mix, or other conditions, and adjust those goals as needed.

A firm should adjust its real-time capital targets (that is the amount of current capital it holds above its post-stress capital goals to ensure it does not fall below those goals under stress) more frequently than it adjusts capital goals, based on changes in the business mix, operating environment or other current conditions and circumstances.

2. *Dividends and Stock Repurchases*

A firm's capital policy should describe the processes relating to common stock dividend and repurchase decisions, including the processes to determine the timing, form, and amount of all planned distributions. The capital policy should also specify the analysis and metrics that senior management and the board use to make capital distribution decisions. The analysis should include strategic considerations such as new business initiatives, potential acquisitions, and the other relevant factors.

3. *Contingency Plans for Capital Shortfalls*

A firm's capital policy should include specific capital contingency actions the firm would take to remedy any current or prospective deficiencies in its capital position. The firm's capital contingency plan should reflect strategies for identifying and addressing potential capital shortfalls and specify circumstances under which the board of directors and senior management will revisit planned capital actions or otherwise institute contingency measures. A contingency plan should include a set of thresholds for metrics or events that provide early warning signs of capital deterioration and that trigger management action or scrutiny.[27]

Capital contingency plans should include options for actions that a firm would consider taking to remedy any current or prospective deficiencies in its capital position, such as reducing or ceasing capital distributions, raising additional capital, reducing risk, or employing other means to preserve existing capital. Contingency options in the firm's capital policy should be consequential, realistic, actionable, and comprehensive.

Appendix G: Scenario Design

As part of its capital plan, a firm must use at least one scenario that stresses the specific vul-

27. Capital contingency plans may include triggers for liquidity, earnings, debt and credit default swap spreads, ratings downgrades, stock performance, supervisory actions, general market stress, or other noncapital metrics.

nerabilities of the firm's risk profile and operations, including those related to the company's capital adequacy and financial condition.[28] The firm's stress scenario should be at least as severe as the Federal Reserve's severely adverse supervisory scenario, measured in terms of its effect on net income and other elements that affect capital.[29]

As noted in the core document, a firm should create its stress scenario, either by developing a complete internal scenario, or using the Federal Reserve's supervisory scenarios, adjusted for the firm's idiosyncratic risk profile.

The stress scenario should include stressful circumstances and events that could, on a standalone basis or in combination, reduce the firm's capital levels and ratios and potentially impede the firm's ability to operate as a going concern, and cover material risks to which the firm is exposed over the course of an annual planning cycle. A firm's scenario should include factors that capture economy- or market-wide stresses and idiosyncratic risks that can put a strain on the firm. A firm should also take into account conditions and events that have not previously occurred, but that may pose a significant threat to the firm given its exposures, risk profile, and business strategy.

Appendix H: Risk-weighted Asset (RWA) Projections

A firm should maintain a sound process for projecting RWAs over the planning horizon. The firm's initial and projected RWA calculations should be consistent with applicable regulatory capital requirements.

Starting balances for both on- and off-balance sheet exposures and applicable risk weights form the foundation for estimates of post-stress capital ratios. Therefore, firms should verify carefully the accuracy of these starting balances. Moreover, deficiencies in starting RWA calculations are generally compounded in RWA projections over the planning horizon. A firm should ensure that it has sound controls around its RWA calculation and regulatory reporting processes as part of the firm's broader data governance program.

A firm should ensure that RWA projections are consistent with a given scenario and incorporate the impact of projected changes in exposure amounts and risk characteristics of on- and off-balance sheet exposures under the scenario. A firm should demonstrate that assumptions associated with RWA projections are clearly conditioned on a given scenario and are consistent with stated internal and external business strategies. For example, the firm should demonstrate how projected credit RWAs over the planning horizon are related to projected loan growth under the scenario. A firm should provide documented evidence for the appropriateness of key assumptions used to project RWAs.

Appendix I: Operational Loss Projections

A firm faces a wide range of operational risk in conducting its business operations. Operational losses can arise from various sources, including inadequate or failed internal processes, people, and systems, or from external events, and can differ in frequency and severity. For example, some operational loss events, such as credit card fraud, are often more predictable as they occur at high frequency, but generally have low loss severity. The outcome of other events, such as major litigation, are less certain and can result in outsized losses.

1. Risk Identification Process

A firm should maintain a sound process for estimating operational risk losses in its capital planning process, taking into account the differences in loss characteristics of different operational loss event types. A firm's risk identification process should include the evaluation of the type of operational risk loss events to which the firm is exposed and the sensitivity of those events to internal and external operating environments. The firm-specific scenario submitted in a firm's capital plan should capture the firm's material operational risks.

28. 12 CFR 225.8(e)(2). In addition, a firm is required to report to the Federal Reserve its projections under a baseline scenario, which captures the firm's view of the likely operating environment over the planning horizon. A firm may use the Board's baseline scenario for its own baseline scenario if the firm can demonstrate that the Board's baseline scenario is appropriate for the firm's own risks, activities, and outlook; however, a firm cannot use the Board's severely adverse scenario for its own stress scenario.

29. For guidance on the severity of the scenarios, a firm should review the Board's "Policy Statement on the Scenario Design Framework for Stress Testing," which sets forth the Board's approach to designing the severely adverse scenario. See 12 CFR 252, appendix A.

2. Approaches to Operational Loss Estimation

A firm can use a variety of estimation approaches to project operational losses for its enterprise-wide stress testing program, but should not rely on unstable or unintuitive correlations to project operational losses. The firm can use a simple, conservative approach based on historical loss data, such as applying average historical losses, or maximum historical losses, to project operational losses. A firm should also consider the use of scenario analysis to evaluate the effect of material operational risk events, especially those which are less certain or can result in outsized losses.

3. Use of Data

The firm's operational loss projection approaches should make appropriate use of relevant reference data. The firm should supplement its internal data with relevant external data if the internal data lacks sufficient operational loss history or granularity.

1060.20.1 LIQUIDITY

Liquidity is a firm's capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the firm's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the firm. Liquid assets are cash and assets that can be converted to cash quickly if needed to meet financial obligations. Other examples of liquid assets generally include central bank reserves and government bonds. To remain viable, a firm must have enough liquid assets to meet withdrawals by depositors and other near-term obligations.

Liquidity risk is the risk that a firm's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations. A firm's obligations, and the funding sources used to meet them, depend significantly on its business mix, balance-sheet structure, and the cash-flow profiles of its on- and off-balance-sheet obligations.

The purpose of this section is to describe significant guidance issuances and regulations covering liquidity and liquidity risk management. In general, this section focuses on the supervisory assessment of liquidity among firms that are covered by the large financial institution rating system.[1] Below is an outline of the key topics covered in this section:

- SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management"
- Regulation YY, "Enhanced Prudential Standards"
- Regulation WW, "Liquidity Risk Measurement Standards"
  - Liquidity Coverage Ratio
  - Net Stable Funding Ratio
- Liquidity Reporting Requirements
  - FR 2052a Complex Institution Liquidity Monitoring Report
- Supervisory Considerations for Assessing Liquidity
  - SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions"
  - Comprehensive Liquidity Analysis and Review
  - Large Financial Institutions Ratings System (SR-19-3/CA-19-2)
  - CAMELS Ratings (SR-96-38)

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

1060.20.2 INTERAGENCY LIQUIDITY GUIDANCE

The 2008–09 financial crisis demonstrated the importance of effective liquidity risk management to ensure the safety and soundness of firms. Given this experience, supervisors participated in international and national level working groups to assess the lessons learned regarding firms' management of liquidity risk. In September 2008, the Basel Committee on Banking Supervision (BCBS) published "Principles for Sound Liquidity Risk Management and Supervision," which contains 17 principles for managing and supervising liquidity risk.[2]

In 2010, the Federal Reserve and the other supervisors of U.S. depository institutions issued the "Interagency Policy Statement on Funding and Liquidity Risk Management," (2010 policy statement or SR-10-6).[3] The 2010 policy statement sets forth interagency expectations on sound practices for liquidity risk management that are consistent with established Federal Reserve guidance contained in the *Commercial Bank Examination Manual* as well as the "Principles for Sound Liquidity Risk Management and Supervision" published by the BCBS in September 2008.

The 2010 policy statement articulates the process that firms should follow to appropriately identify, measure, monitor, and control their funding and liquidity risks. In particular, the 2010 policy statement re-emphasizes the importance of cash-flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan as primary tools for measuring and managing funding and liquidity risks.

2. Principles for Sound Liquidity Risk Management and Supervision (September 25, 2008).
3. SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," and 75 Fed. Reg. 13656 (March 22, 2010).

1060.20.2.1 Scope of Application of the 2010 Policy Statement

The Federal Reserve expects all supervised firms to manage their liquidity risk using processes and systems that are commensurate with their complexity, risk profile, and scope of operations.

The 2010 policy statement addresses funding and liquidity risk management at insured depository institutions, including state member banks. The basic principles presented in the 2010 policy statement also apply to bank holding companies (BHCs) as well as savings and loan holding companies (SLHCs).[4] BHCs and SLHCs (collectively, holding companies) should manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries.

Holding companies should develop and maintain liquidity management processes and funding programs that are consistent with their complexity, risk profile, and scope of operations. Appropriate liquidity risk management is especially important for holding companies since liquidity difficulties can easily spread to both depository and nondepository subsidiaries. Holding companies should ensure that liquidity is sufficient at all levels of the organization to fully accommodate funding needs in periods of stress.

The general principles presented in the 2010 policy statement also apply to foreign banking organizations (FBOs) operating in the United States. The U.S. operations of FBOs are expected to have appropriate liquidity risk-management processes in place that are consistent with established international standards. Supervisory expectations for the U.S. operations of FBOs are the same as those for comparable domestic organizations. FBO branches and agencies are also expected to implement sound liquidity risk-management processes and practices with full recognition that the liquidity risk-management process depends significantly on the specific business models, governance structures, funding approaches, and liquidity risk profiles of the operations. For example, funding dependencies between a branch and home office, and governance structures without boards of directors, may impact a firm's ability to implement certain risk-management processes, procedures, systems, or controls for certain standalone legal entities. In such cases, appropriate mitigating controls should be in place.

Liquidity risk for the U.S. operations of FBOs should be managed with processes and systems appropriate for the U.S. entities' size, complexity, risk profile, and scope of activities. Regardless of the scope or scale of U.S. operations, the risks undertaken are expected to be managed with 1) effective governance and management oversight as appropriate; 2) adequate policies, procedures, and limits on risk taking; and 3) strong management information systems for measuring, monitoring, reporting, and controlling liquidity risks. While elements of these risk-management processes may be implemented locally or outside of the United States, the Federal Reserve expects to have ready access to the information necessary to maintain an understanding and assessment of these functions.

1060.20.2.2 Key Themes of the 2010 Policy Statement

The following subsections summarize the significant themes of SR-10-6 as well as the 2010 policy statement. To review the 2010 policy statement in its entirety, see the "Interagency Policy Statement on Funding and Liquidity Risk Management," attachment to SR-10-6.

Liquidity Risk-Management Processes

Liquidity risk-management processes and funding programs should take into account the firm's lending, investment, and other activities and should ensure that adequate liquidity is maintained. These processes and programs should fully incorporate real and potential constraints, including legal and regulatory restrictions, on the transfer of funds among subsidiaries and between subsidiaries and the parent holding company. Holding company liquidity should be maintained at levels sufficient to fund holding company and affiliate operations for an extended period of time in a stressed environment when access to normal funding sources are disrupted without having a negative impact on insured depository institution subsidiaries.

Material nonbank subsidiaries, such as broker-dealers, are expected to have liquidity management processes and funding programs that align with the subsidiaries' complexity, risk profile, and scope of operations. A nonbank subsidiary that directly accesses market sources of funding

4. SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

and/or manages specific funding programs should pay particular attention to

- maintaining sufficient liquidity, cash flow, and capital strength to service its debt obligations and cover fixed charges;
- assessing the potential that funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions; and
- ensuring the adequacy of policies and practices addressing the stability of funding and integrity of the firm's liquidity risk profile as evidenced by funding mismatches and the degree of dependence on potentially volatile sources of short-term funding.

Corporate Governance

The Federal Reserve expects the board of directors to provide effective oversight of a firm's liquidity risk and liquidity risk management. The board of directors is ultimately responsible for the liquidity risk assumed by the firm.[5] A firm's senior management is responsible for implementing the policies and risk-management strategies established by the board of directors and are involved in most daily operational decisions.

With regard to a firm's liquidity risk and liquidity risk management, the board of directors or its delegated committee should

- ensure the firm's liquidity risk tolerance is established and communicated in such a manner that all levels of management understand the firm's approach to managing trade-offs between liquidity risk and short-term profits;
- oversee the establishment and approval of liquidity management strategies, policies and procedures, and review them at least annually;
- establish executive-level lines of authority and responsibility for managing the firm's liquidity risk;
- enforce management's duties to identify, measure, monitor, and control liquidity risk; and
- understand and periodically review the firm's contingency funding plan for handling adverse liquidity events and understand the liquidity risk profiles of important subsidiaries and affiliates.

Senior management should

- ensure that board-approved strategies, policies, and procedures for managing liquidity are appropriately executed within the lines of authority and responsibility;
- regularly report to the board of directors on the liquidity risk profile of the firm;
- determine the structure, responsibilities, and controls for managing liquidity risk and for overseeing the liquidity positions of the firm; and
- monitor liquidity risks for each entity across the firm on an ongoing basis.

Strategies, Policies, Procedures, and Risk Tolerances

Firms should have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposures that appropriately reflect the firm's risk tolerances. Firms should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes. Significant business activities should be evaluated for both liquidity risk exposure and profitability.

Effective liquidity risk and risk-management policies and procedures should

- provide for the formulation of plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions;
- address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material;
- articulate a liquidity risk tolerance that is appropriate for the business strategy of the firm;
- employ both quantitative targets and qualitative guidelines for identifying, measuring, and limiting liquidity risk;
- contain provisions for documenting and periodically reviewing assumptions used in liquidity projections; and
- specify the nature and frequency of management reporting.

Liquidity Risk Measurement, Monitoring, and Reporting

- Stress Testing
  Firms should conduct stress tests regularly for

5. See also SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness."

a variety of firm-specific and market-wide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the firm and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the firm's cash flows, liquidity position, profitability, and solvency. Stress tests should also be used to ensure that current exposures are consistent with the firm's established liquidity risk tolerance. The results of stress tests should also play a key role in shaping the firm's contingency planning. More information on liquidity stress testing for large firms is described in the subsection entitled "Regulation YY (12 C.F.R. Part 252)."

- Collateral Position Management
  A firm should be able to calculate all of its collateral positions in a timely manner, including the value of assets currently pledged relative to the amount of security required and unencumbered assets available to be pledged. A firm should monitor available collateral by legal entity, jurisdiction, and currency exposure, and its systems should be able to monitor shifts between intraday and overnight or term collateral usage. A firm should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (i.e., the custodian firm or securities settlement system with which the collateral is held). Firms also should fully understand the potential demand on required and available collateral arising from various types of contractual contingencies during periods of both market-wide and firm-specific stress.

- Management Reporting
  Liquidity risk reports should provide aggregate information with sufficient supporting detail to enable management to assess the sensitivity of the firm to changes in market conditions, its own financial performance, and other important risk factors. The types of reports or information and their timing will vary depending on the firm's complexity and risk profile. For example, reportable items may include cash-flow gaps, cash-flow projections, asset and funding concentrations, key early warning or risk indicators, as well as the use of and availability of government support.

- Liquidity across Currencies, Legal Entities, and Business Lines
  A firm should monitor liquidity risk exposures and funding needs within and across currencies, legal entities, and business lines. A firm should actively monitor and control liquidity risks at the level of individual legal entities, and the consolidated organization, incorporating processes that aggregate data across multiple systems to develop a group-wide view of liquidity risk exposures. Also, a firm should consider operational limitations in the transferability of liquidity, and should maintain sufficient liquidity during economically stressed periods, particularly when there are legal and regulatory restrictions on the transfer of liquidity among regulated entities. A firm's liquidity risk-management plans should describe assumptions regarding the transferability of funds and collateral.

Intraday Liquidity Position Management

Large firms engaged in significant payment, settlement, and clearing activities should actively manage their intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions.

Diversified Funding

A firm should establish a funding strategy that provides effective diversification in the sources and tenor of funding. A firm should consider implementing limits to address counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A firm should periodically assess its ability to access markets and raise new funds. In addition, a firm should identify alternative sources of funding that strengthen its capacity to withstand a variety of severe firm-specific and market-wide liquidity shocks.

Cushion of Liquid Assets

A critical component of a firm's ability to effectively respond to potential liquidity stress is the availability of a cushion of highly liquid assets without legal, regulatory, or operational impediments (i.e., unencumbered) that can be sold or pledged to obtain funds in a range of stress scenarios. Examples of highly liquid assets include U.S. Treasury securities, securities issued by U.S. government-sponsored agencies, and excess reserves at the central bank. The appropriate cushion of highly liquid assets depends on the risk tolerance and risk profile of the firm, as well as estimates of liquidity needs based on a firm's stress testing.

Contingency Funding Plan

A contingency funding plan (CFP) provides a framework for managing unexpected situations or business conditions that may increase liquidity risk. The objective of the CFP is to ensure that the firm's sources of liquidity are sufficient to fund normal operating needs under contingent liquidity events. A CFP also identifies alternative contingent liquidity resources that can be employed under adverse liquidity circumstances. A firm's CFP should be commensurate with its complexity, risk profile, and scope of operations. Effective CFPs generally should

- identify stress events, which include events that may adversely affect the firm's liquidity given its specific balance-sheet structure, business lines, organizational structure, and other characteristics;
- assess the levels of stress severity that can occur during a contingent liquidity event and identify the different stages for each type of event;
- assess funding sources and needs by providing a quantitative projection and evaluation of expected funding needs and funding capacity during the stress event;
- identify potential alternative sources of liquidity and assess the firm's ability to access such contingent funding sources during a liquidity stress event;
- establish liquidity event-management processes, including a crisis management team and administrative structure, as well as action plans for executing various elements of the CFP depending on given levels of stress; and
- establish a framework for monitoring potential liquidity stress events by using early-warning indicators and event triggers.

Internal Controls

Internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide assurance that the firm manages liquidity risk consistent with its board-approved policy. Appropriate internal controls should address relevant elements of the risk-management process, including adherence to policies and procedures, the adequacy of risk identification, risk measurement, reporting, and compliance with applicable rules and regulations. Management should ensure that an independent party regularly reviews and evaluates the various components of the firm's liquidity risk-management process.

1060.20.3 REGULATION YY (12 C.F.R. PART 252)

As discussed in section 1060.1, "Large Financial Institution Rating System: Capital Planning and Positions," the Board adopted enhanced prudential standards to strengthen the resiliency of large banking organizations, including certain FBOs with operations in the United States, and to implement section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[6] These enhanced prudential standards, implemented in the Board's Regulation YY, strengthened the capital and liquidity positions of large banking organizations, and substantially mitigated the risks to safety and soundness and financial stability in the United States. Section 165 of the Dodd-Frank Act directed the Board to establish more string prudential standards for BHCs and FBOs with total consolidated assets of $50 billion or more.[7] In May 2018, Congress enacted the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which amended section 165 of the Dodd-Frank Act to raise the $50 billion minimum total consolidated asset threshold to $250 billion for general application of enhanced prudential standards to BHCs.[8] EGRRCPA also provides the Board with discretion to apply standards to BHCs with total consolidated assets of between $100 billion and $250 billion.

In connection with its implementation of EGRRCPA and as part of the Board's periodic efforts to improve the risk sensitivity of its regulations, the Board revised Regulation YY by establishing categories of prudential standards applicable to BHCs, certain SLHCs, and

6. 12 U.S.C. 5365.
7. 12 U.S.C. 5365.
8. Pub. L. No. 115-174, 132 Stat. 1296 (2018). The term "bank holding company" as used in section 165 of the Dodd-Frank Act includes a foreign bank or company treated as a bank holding company for purposes of the BHC Act, pursuant to section 8(a) of the International Banking Act of 1978. See 12 U.S.C. 3106(a); 12 U.S.C. 5311(a)(1).

FBOs to align those requirements with a firm's risk profile and to apply consistent standards across similarly situated firms.

In particular, Regulation YY establishes risk-based indicators to differentiate firms based on their size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure, and whether a firm is identified as a U.S. global systemically important BHC (U.S. G-SIB). For more information on the firms that are covered by each of the four categories of standards, see section 1060.1 of this manual, "Large Financial Institution Rating System: Capital Planning and Positions" (table 1).

1060.20.3.1 Liquidity Requirements of Regulation YY

The liquidity risk-management requirements in Regulation YY build upon the Board's overall supervisory framework for liquidity adequacy and liquidity risk management.[9] Regulation YY is designed to provide a regulatory framework for ensuring that large BHCs and FBOs establish and maintain robust liquidity risk-management practices, perform internal stress tests for determining the adequacy of their liquidity resources, and maintain a buffer of highly liquid assets in the United States to cover cash-flow needs under stress.

1060.20.3.1.1 Liquidity Risk-Management Requirements

The Board's Regulation YY outlines the liquidity risk-management requirement for large BHCs (12 C.F.R. 252.34) and FBOs (12 C.F.R. 252.156) covered by the rule.[10] This part of the regulation describes governance responsibilities, namely the responsibilities of a firm's board of directors, risk committee, and senior management as well as the need to establish an independent review function. In addition, this section of the regulation describes other liquidity risk-management requirements covering cash-flow projections, contingency funding planning, liquidity risk limits, and liquidity risk monitoring. Many elements of the liquidity risk-management requirements apply to all firms covered by Regulation YY. However, certain elements of the liquidity risk-management requirements do not apply to Category IV firms. This section summarizes Regulation YY's liquidity risk-management requirements. Refer to the regulation for comprehensive information on liquidity risk-management requirements.

Board of Directors (BHC) and U.S. Risk Committee (FBO)

The board of directors of covered BHCs and U.S. risk committee of covered FBOs is responsible for oversight of liquidity risk management and is required to[11]

- approve the firm's liquidity risk tolerance at least annually;[12] and
- receive and review information from senior management at least semiannually to determine whether the firm is operating in accordance with its established liquidity risk tolerance.

In addition, a BHC's board of directors must approve and periodically review the liquidity risk-management strategies, policies, and procedures established by senior management.

Risk Committee

The risk committee of a covered BHC or covered FBO is responsible for understanding the liquidity risks associated with different business lines and products and must be composed of a subset of directors with the appropriate level of risk-management expertise to conduct an in-depth review of the CFP.[13] The risk committee, or a designated subcommittee thereof, is required to review and approve the CFP at least annually and prior to the implementation of material revisions.

Senior Management

Concerning the management of liquidity risk, Regulation YY requires a covered BHC's senior management to

9. For example, supervisory guidance regarding liquidity risk-management practices includes the 2010 policy statement, which is described in subsection 1060.20.2.

10. For large SLHCs, see 12 C.F.R. 238.123.

11. An FBO may maintain its U.S. risk committee at either the global board of directors or at the FBO's U.S. intermediate holding company.

12. The liquidity risk tolerance is the acceptable level of liquidity risk that a firm may assume in connection with its operating strategies.

13. For an FBO, the U.S. risk committee or a designated subcommittee of such committee may be composed of members of the board of directors (or the equivalent thereof) of the FBO or its U.S. intermediate holding company.

- establish and implement strategies, policies, and procedures designed to effectively manage risk;
- oversee the development and implementation of liquidity risk measurement and reporting systems;
- determine whether the firm is operating in accordance with such policies and produces at least quarterly or more often, if conditions change; and
- report to the board of directors or the risk committee regarding the firm's liquidity risk profile and liquidity risk tolerance at least quarterly or more often if conditions change.

Regulation YY requires a covered FBO's U.S. chief risk officer to

- review the strategies, policies, and procedures established by senior management of the U.S. operations for managing liquidity risk;
- review information provided by senior management of the U.S. operations to determine whether the combined U.S. operations are operating in accordance with the established liquidity risk tolerance; and
- report at least semi-annually to the FBO's U.S. risk committee and enterprise-wide risk committee (or the equivalent thereof) on the liquidity risk profile of the FBO's combined U.S. operations and whether it is operating in accordance with the established liquidity risk tolerance.

Senior management of a covered BHC and the U.S. chief risk officer of a covered FBO must

- approve new products and business lines and evaluate liquidity costs, benefits, and risks related to each new business line and product that could have a significant effect on the firm's liquidity risk profile;[14]
- review required cash-flow projections at least quarterly;
- establish the liquidity risk limits specified in the regulation and review the firm's compliance with those limits at least quarterly; and
- review and approve certain aspects of the liquidity stress testing framework and the liquidity buffer at specified intervals.

Independent review function

Covered BHCs (12 C.F.R. 252.34(d)) and FBOs (12 C.F.R. 252.156(c)) are required to establish and maintain a review function, which is independent of management functions that execute funding, to evaluate its liquidity risk management. The independent review function must

- review and evaluate the adequacy and effectiveness of the firm's liquidity risk-management processes, including its liquidity stress test processes and assumptions, regularly, but no less frequently than annually;
- assess whether the firm's liquidity risk-management function complies with applicable laws, regulations, and sound business practices; and
- report material liquidity risk-management issues in writing to the board of directors or the risk committee for corrective action, to the extent permitted by applicable law.

Cash-flow projections

Covered BHCs (12 C.F.R. 252.34(e)) and FBOs (12 C.F.R. 252.156(d)) are required to produce cash-flow projections over, at minimum, short- and long-term time horizons. Firms must update short-term projections daily and longer-term projections at least monthly. Regulation YY requires firms to establish a methodology for making cash-flow projections that result in projections that meet certain criteria. Firms may adapt the cash-flow projection requirements to their particular circumstances, such as if they have significant broker-dealer activities. More frequent cash-flow reports may be appropriate for firms with complex risk profiles or for all firms during times of stress. Similarly, while cash-flow projections over time horizons longer than one year are not required, it may be appropriate for certain firms to produce cash-flow projections for longer time periods, for instance to account for long-term debt maturities, if circumstances warrant.

Contingency funding plan

As part of a robust regulatory framework to promote comprehensive liquidity risk management, covered firms are required to establish and maintain a contingency funding plan (CFP).

14. In addition, a BHC's senior management and FBO's U.S. risk committee must review at least annually significant business lines and products to determine whether the liquidity risk of each line and product is within the firm's liquidity risk tolerance.

As previously discussed, a CFP is a compilation of policies, procedures, and action plans for managing liquidity stress events that, together, provide a plan for responding to a liquidity crisis. The CFP must be commensurate with the firm's capital structure, risk profile, complexity, activities, size, and established liquidity risk tolerance. Regulation YY requires a firm's implementation of its CFP to include quantitative assessments, liquidity event-management processes, monitoring, and testing.

Liquidity risk limits

Category I–IV firms are required to monitor sources of liquidity risk and establish limits on liquidity risk that are consistent with their established liquidity risk tolerance and that reflect the firm's capital structure, risk profile, complexity, and activities.

Category, I, II, and III firms are required to establish and maintain liquidity risk limits that include limits on

- concentrations of funding sources by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other forms of liquidity risk, as applicable;
- the amount of liabilities that mature within various time horizons; and
- off-balance-sheet exposures and other exposures that could create funding needs during liquidity stress events.

Collateral, legal entity, and intraday liquidity risk monitoring

Category I–IV firms must establish and maintain procedures for monitoring liquidity risk related to collateral positions, liquidity risks across the enterprise, and intraday liquidity positions. Firms are required to establish and maintain procedures for monitoring

- assets they have pledged as collateral and assets that are available to be pledged, including by calculating and monitoring:
  - collateral positions at specified frequencies,
  - the level of unencumbered assets available to be pledged by legal entity, jurisdiction, and currency exposure,
  - shifts in the firm's funding patterns, and
  - operational and timing requirements associated with accessing collateral;
- liquidity exposures and funding needs within and across significant legal entities, currencies, and business lines, taking into account legal and regulatory restrictions on the transfer of liquidity between legal entities; and
- intraday liquidity risk exposures that are consistent with the firms' capital structure, risk profile, complexity, activities, and size.

Category I, II, and III firms' intraday liquidity risk exposure monitoring procedures must address how management will monitor and measure daily liquidity inflows and outflow, manage and transfer collateral to obtain intraday credit, identify and prioritize time-specific payment obligations, manage credit extensions to customers, and consider the amount of collateral and liquidity needed to meet payment systems obligations.

1060.20.3.1.2 Liquidity Stress Testing and Buffer Requirements

In addition to requiring firms to establish and maintain robust liquidity risk management, Regulation YY requires large BHCs (12 C.F.R. 252.35) and FBOs (12 C.F.R. 252.157) to conduct internal liquidity stress tests and maintain buffers of highly liquid assets sufficient to meet projected 30-day stressed cash-flow needs under internal stress scenarios. A firm that is subject to Regulation YY must conduct stress tests to assess the potential impact of the liquidity stress scenarios on its cash flows, liquidity position, profitability, and solvency, accounting for its current liquidity condition, risks, exposures, strategies, and activities. Category I, II, and III firms must perform the liquidity stress tests at least monthly, while Category IV firms must perform the liquidity stress tests at least quarterly.[15]

In conducting a liquidity stress test, the firm must address the potential direct adverse impact of associated market disruptions on the firm. Further the firm must incorporate the potential actions of other market participants experiencing liquidity stresses under the market disruptions that would adversely affect the firm. Stress testing should be sufficiently dynamic and incorporate a variety of changes in the firm's internal position and external circumstances, including risks that may arise over time. Liquidity stress tests must incorporate, at minimum, stress scenarios that reflect adverse market conditions, an

15. 12 C.F.R. 252.35(a)(2) and 252.157(a)(2).

idiosyncratic stress event, and combined market and idiosyncratic stresses. Additional scenarios, based on the firm's financial condition, size, complexity, risk profile, scope of operations, or activities, should be used as needed to ensure that all significant aspects of liquidity risks to the firm have been modeled.

A complementary requirement to the stress testing requirement is a liquidity buffer requirement. Regulation YY requires a firm to maintain a liquidity buffer composed of unencumbered highly liquid assets sufficient to meet projected net stressed cash-flow needs over a 30-day planning horizon (for BHCs and U.S. intermediate holding companies of FBOs) or the first 14 days of a 30-day planning horizon (for U.S. branches and agencies of FBOs) of its internal liquidity stress test. Highly liquid assets included in the liquidity buffer also must meet certain operational and diversification requirements. In particular, a firm must discount the fair market value of the asset to reflect any credit risk and market volatility, establish and implement policies and procedures that require highly liquid assets comprising the buffer be under control of the management function charged with managing liquidity risk, demonstrate the capability to monetize a highly liquid asset under each stress test scenario, and generally ensure the buffer does not contain significant concentrations of highly liquid assets by issuer, business sector, region, or other factor related to the firm's risk.

1060.20.4 REGULATION WW (12 C.F.R. PART 249)

The Board's Regulation WW establishes a liquidity coverage ratio (LCR) requirement and net stable funding ratio (NSFR) requirement for certain large firms on a consolidated basis.[16] Firms subject to Regulation WW include

- Global systemically important BHCs;
- Large depository institutions of global systemically important BHCs;
- Category II firms;
- Category III firms; and
- Category IV holding companies with $50 billion or more in average weighted short-term wholesale funding.

The stringency of LCR and NSFR requirements is tailored based on a firm's category and level of weighted short-term wholesale funding.

1060.20.4.1 Liquidity Coverage Ratio Rule

In 2014, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, "the agencies") adopted the LCR rule.[17] The LCR rule is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations, thereby improving the banking sector's ability to absorb shocks arising from financial and economic stress, and to further improve the measurement and management of liquidity risk.

The LCR rule implements a quantitative minimum liquidity requirement consistent with the liquidity coverage ratio standard established by the BCBS.[18] Specifically, the LCR rule requires a firm subject to the rule to maintain an amount of high-quality liquid assets (HQLA)—the numerator of the ratio—that is equal to or greater than its total net cash outflows over a prospective 30 calendar-day stress period (the denominator of the ratio).[19]

$$\frac{\text{HQLA amount}}{\text{Net cash outflow amount}} \geq 1.00$$

The Board's Regulation WW (12 C.F.R. part 249) provides more information on calculating the LCR. The LCR complements the liquidity requirements related to firm-specific measures of liquidity risk under the Board's Regulation YY.

1060.20.4.1.1 High-Quality Liquid Assets

HQLA are assets that generally maintain their value in stress and can be easily converted to cash. The LCR rule sets criteria for the catego-

16. Regulation WW applies to certain top-tier BHCs and SLHCs, U.S. intermediate holding companies, and state member banks.

17. See 79 Fed. Reg. 61,440 (October 10, 2014), codified at 12 C.F.R. part 249.

18. See also SR-17-11, "Interagency Frequently Asked Questions on Implementation of the Liquidity Coverage Ratio (LCR) Rule."

19. The firm's HQLA amount as of the calculation date, calculated under 12 C.F.R. part 249, subpart C. The firm's total net cash outflow amount as of the calculation date, calculated under 12 C.F.R. part 249, subpart D.

ries of assets that qualify as HQLA and divides HQLA into three categories: level 1, level 2A, and level 2B liquid assets.

Level 1 liquid assets include Reserve Bank balances and U.S. Treasury securities, which are the highest quality and most liquid assets. These assets are included in a firm's HQLA amount without a limit and without haircuts. Level 2A liquid assets include securities issued by U.S. government-sponsored enterprises and are subject to a 15 percent haircut. Level 2B liquid assets include certain debt and equity securities and municipal obligations and are subject to a 50 percent haircut. Level 2A and level 2B liquid assets together may not exceed 40 percent of the total HQLA amount and level 2B liquid assets alone may not exceed 15 percent of the total HQLA amount.

A firm must satisfy certain operational requirements to include an asset that qualifies as HQLA in the firm's HQLA amount, including that the HQLA be unencumbered, able to be efficiently monetized, and under control of the firm's liquidity management function. For more information on the qualifying criteria for HQLA and the operational requirements for inclusion in the HQLA amount, see the Board's Regulation WW.

1060.20.4.1.2 Total Net Cash Outflow Amount

Subpart D of Regulation WW (12 C.F.R. part 249, subpart D) establishes the total net cash outflows (the denominator of the LCR), which is the difference between projected outflows and inflows over a 30 calendar-day period, with an adjustment to address mismatches in timing of outflows and inflows. Inflow amounts cannot offset more than 75 percent of total outflow amounts. A firm must determine outflow and inflow amounts by applying a standardized set of outflow and inflow rates to various asset and liability balances, together with certain off-balance-sheet commitments. These standardized outflow and inflow rates reflect the likelihood of an outflow or inflow in a time of stress. The LCR rule requires firms to employ standardized maturity assumptions to determine whether an outflow or inflow amount occurs within the 30 calendar-day period following the calculation date. To address the risk that a firm's outflows may mature before its inflows, a firm must include in its total net cash outflow amount a maturity mismatch add-on, which is calculated as the difference (if greater than zero) between the firm's largest net cumulative maturity outflow amount for any of the 30 calendar days following the calculation date and the net day 30 cumulative maturity outflow amount.

1060.20.4.1.3 Adjustment Percentage

The stringency of the LCR rule's minimum requirement is tailored to a firm's risk profile. The LCR rule calibrates a firm's minimum LCR requirement by multiplying the net cash outflow amount by an adjustment percentage based on the firm's category of standards and degree of reliance on short-term wholesale funding. Category I and II firms as well as Category III firms with $75 billion or more in average weighted short-term wholesale funding are subject to the full LCR requirement. Other Category III firms and Category IV holding companies with $50 billion or more in average weighted short-term wholesale funding are subject to reduced LCR requirements (adjustment percentages of 85 and 70 percent, respectively). See table 1 below for information on how the adjustment percentage is determined for these firms.

Table 1. Adjustment percentage

Type of firm	Percentage
Global systemically important BHC or G-SIB depository institution	100%
Category II firm	100%
Category III firm with $75 billion or more in average weighted short-term wholesale funding and any Category III firm that is a consolidated subsidiary of such a Category III firm	100%
Category III firm with less than $75 billion in average weighted short-term wholesale funding and any Category III firm that is a consolidated subsidiary of such a Category III firm	85%
Category IV holding company with $50 billion or more in average weighted short-term wholesale funding	70%

1060.20.4.1.4 LCR Shortfall Remediation

Under certain circumstances, a firm's LCR might temporarily fall below 1.0. Given the range of reasons a firm's LCR could fall below 1.0 (for example, the firm might temporarily fall below 1.0 during a period of extreme liquidity stress), Regulation WW establishes a framework for a flexible supervisory response percent to address a firm's LCR shortfall. A firm must notify the appropriate federal banking agency on any business day that its LCR is calculated to be less than its minimum requirement (12 C.F.R. 249.40). In addition, if a firm's LCR is below 1.0 for three consecutive business days, the firm must submit to its appropriate federal banking agency a plan for remediation of the shortfall.[20] These procedures are intended to enable supervisors to monitor and respond appropriately to the unique circumstances that give rise to a firm's LCR shortfall.

1060.20.4.2 Net Stable Funding Ratio Rule

In 2021, the OCC, Board, and the FDIC adopted the NSFR rule.[21] The NSFR rule is designed to reduce the likelihood that disruptions to a firm's regular sources of funding will compromise its liquidity position, promote effective liquidity risk management, and support the ability of firms to continue to lend to businesses and households across a range of market conditions.

The NSFR requires large firms to maintain a minimum level of stable funding based on the liquidity characteristics of the firm's assets, commitments, and derivative exposures. The NSFR rule requires a firm to calculate a weighted measure of the stability of its equity and liabilities over a one-year time horizon, known as its available stable funding amount (numerator of the ratio).[22] A firm also is required to calculate a minimum level of required stable funding, known as its required stable funding amount, based on the liquidity characteristics of its assets, derivative exposures, and commitments over the same one-year time horizon (denominator of the ratio).[23] Firms subject to the rule are required to keep their ratio of available stable funding to required stable funding equal to at least 1.0 on an ongoing basis.

$$\frac{\text{Available stable funding amount}}{\text{Required stable funding amount}} \geq 1.00$$

Consistent with the LCR rule, the NSFR rule calibrates a firm's minimum NSFR requirement by multiplying the required stable funding amount by an adjustment percentage based on the firm's category of standards and degree of reliance on short-term wholesale funding.[24] See table 1 for information on how the adjustment percentage is determined for these firms. The Board's Regulation WW (12 C.F.R. part 249) provides more information on calculating the NSFR. The NSFR complements the LCR rule, which focuses on short-term liquidity risks, and the firm-specific measures of funding risk under the Board's Regulation YY.

1060.20.4.2.1 NSFR Numerator — Available Stable Funding Amount

A firm's available stable funding amount measures the stability of its regulatory capital elements and liabilities. The available stable funding amount equals the sum of the carrying values of the firm's NSFR regulatory capital elements and NSFR liabilities, in each case multiplied by the available stable funding factor applicable.[25] The available stable funding factor represents the extent to which the capital element or liability is considered available for use by the firm over a one-year time horizon. The available stable funding factors are scaled from zero (least stable) to 100 percent (most stable) and were determined by taking into account the tenor of the funding, type of funding, and type of counterparty. See table 2 for more information on the available stable funding factor assignments.

20. During the period when a firm is required to calculate its LCR monthly, the firm must promptly consult with the appropriate federal banking agency to determine whether a plan would be required if the firm's LCR is below the minimum requirement for any calculation date that is the last business day of the calendar month.

21. 86 Fed. Reg. 9,120 (Feb. 11, 2021).

22. Calculated pursuant to 12 C.F.R. 249.103, as of the calculation date.

23. Calculated pursuant to 12 C.F.R. 249.105, as of the calculation date.

24. 12 C.F.R. 249.105(b).

25. "Carrying value" is the value of an asset, liability, or regulatory capital element on a banking organization's balance sheet as determined in accordance with U.S. Generally Accepted Accounting Principles.

Table 2. Summary of available stable funding factors

Available stable funding factor	Equity and liabilities assigned the available stable funding factor
100%	• Regulatory capital elements and liabilities with a remaining maturity of one year or more.
95%	• Fully insured stable retail deposits. • Certain fully insured affiliate sweep deposits.
90%	• Retail deposits that are neither fully insured stable retail deposits nor retail brokered deposits. • Certain more stable retail brokered deposits. • Non-fully insured affiliate sweep deposits.
50%	• Unsecured wholesale funding and secured funding transactions with a remaining maturity of less than one year that are provided by wholesale customers that are not financial sector entities or central banks.[1] • Unsecured wholesale funding and secured funding transactions with a remaining maturity of six months or more, but less than one year and that are provided by financial sector entities or central banks. • Securities issued by a banking organization with a remaining maturity of six months or more but less than one year. • Operational deposits received by a banking organization. • Certain retail brokered deposits with intermediate stability. • Retail funding that is not a deposit or security. • Any liability with a remaining maturity of six months or more but less than one year that is not described above.
0%	All other funding not described above, including • Funding (other than operational deposits) where the counterparty is a financial sector entity or a central bank, and the transaction matures within six months. • Retail brokered deposits that are not stable. • Derivatives liabilities. • Trade date payables.

1. Wholesale customers or counterparties that are not financial sector entities or central banks include sovereigns, certain multilateral development banks, public sector entities, and U.S. government-sponsored entities.

Note: See 12 C.F.R. 249.104.

1060.20.4.2.2 NSFR Denominator — Required Stable Funding Amount

A firm's required stable funding amount, the denominator of the NSFR, is based on the liquidity characteristics of the firm's assets, commitments, and derivative exposures. The required stable funding amount is the sum of the required stable funding amount for non-derivative assets and commitments and the required stable funding amount for derivative transactions.

A firm determines its required stable funding amount for non-derivative assets and commitments by

1. multiplying the carrying value of each asset and commitment by a required stable funding factor, and
2. summing these amounts.

The required stable funding factors are scaled from zero (most liquid and least likely to need ongoing funding during the one-year time horizon) to 100 percent (least liquid and most likely to need ongoing funding during the one-year time horizon) and were determined by taking into account the non-derivative assets' and commitments' tenor, credit quality, type of counterparty, market liquidity, and encumbrances. See table 3 for more information on required stable funding factor assignments.

Table 3. Summary of required stable funding factors excluding derivative calculations

Required stable funding factor	Assets and commitments assigned the required stable funding factor
0%	• Reserve Bank balances or other claims on a Reserve Bank that mature within six months. • Claims on a foreign central bank that mature within six months. • Currency, coin, and items in the process of collection. • Trade date receivables. • Level 1 liquid asset securities, including U.S. Treasury securities. • Secured lending transactions (e.g., reverse repurchase transactions) where the counterparty is a financial sector entity that mature within six months and are secured by level 1 liquid assets.
5%	• The undrawn amount of committed credit and liquidity facilities.
15%	• Level 2A liquid assets, including certain obligations issued or guaranteed by a U.S. government sponsored enterprise. • Secured lending transactions where the counterparty is a financial sector entity that mature within six months and are secured by assets other than level 1 liquid assets. • Unsecured wholesale lending that matures within six months and the counterparty is a financial sector entity.
50%	• Level 2B liquid assets, including certain publicly traded corporate equity and debt securities and certain U.S. municipal obligations. • Secured lending transactions and unsecured wholesale lending that mature in six months or more, but less than one year, where the counterparty is a financial sector entity or central bank. • Secured lending transactions and unsecured wholesale lending that mature in less than one year, where the counterparty is not a financial sector entity or central bank. • Lending to retail customers or counterparties that matures in less than one year. • Operational deposits placed by a banking organization at financial sector entities. • All other assets that mature in less than one year.
65%	• Retail mortgages with a remaining maturity of one year or more that are assigned a risk weight of no greater than 50 percent under the Board's capital regulations. • Other lending that has a remaining maturity of one year or more, is assigned a risk weight of no greater than 20 percent under the Board's capital regulations, and where the borrower is not a financial sector entity.
85%	• Retail mortgages with a remaining maturity of one year or more that are assigned a risk weight of greater than 50 percent under the Board's capital regulations. • Other lending that has a remaining maturity of one year or more and is assigned a risk weight greater than 20 percent under the Board's capital regulations, where the borrower is not a financial sector entity. • Publicly traded common equity shares that are not HQLA. • Other securities that are not HQLA and have a remaining maturity of one year or more. • Commodities for which derivative transactions are traded on a U.S. designated contract market, U.S. swap execution facility, or an exchange located outside the United States.
100%	All other assets not described above, including • Lending that has a remaining maturity of one year or more, where the borrower is a financial sector entity. • Nonperforming assets. • Equity securities that are not publicly traded. • Commodities that do not qualify to be assigned an 85% required stable funding factor.

Note: See 12 C.F.R. 249.106.

Derivative transactions present unique risks and generally retain more complex features relative to other assets and liabilities. As such, the NSFR rule requires a firm to calculate the required stable funding amount relating to its derivative transactions separately from its other assets and commitments. The required stable funding amount for a firm's derivatives reflects

- the current net value of the firm's derivatives assets and liabilities, taking into account variation margin provided and received (current net value component);
- contributions by the firm to a central counterparty's default fund in connection with cleared derivative transactions and initial margin provided by the firm pursuant to the derivative transactions (initial margin component); and
- potential changes in the value of the firm's derivative transactions (future value component).

See 12 C.F.R. 249.107 for more information on the calculation of the required stable funding amount for derivatives.

1060.20.4.2.3 NSFR Shortfall Remediation

If a firm has an NSFR shortfall, a firm is required to notify the appropriate federal banking agency of the shortfall within 10 business days. In addition, the NSFR rule requires a firm to develop a remediation plan that would be submitted to the appropriate federal banking agency. The agencies have flexibility in providing a supervisory response to address an NSFR shortfall, which should consider the circumstances of a particular case. In general, the agencies support a firm that chooses to reduce its NSFR during a liquidity stress period in order to continue to lend and undertake other actions to support the broader economy in a safe and sound manner.

1060.20.5 LIQUIDITY REPORTING

Federal Reserve supervision staff use data reported on the FR 2052a, "Complex Institution Liquidity Monitoring Report," to monitor the overall liquidity profile of large firms supervised by the Board. The FR 2052a is required to be submitted by top-tier BHCs, top-tier SLHCs, and FBOs subject to Category I, II, III, or IV standards under the Board's Regulation YY and Regulation LL. The FR 2052a is required to be submitted at the following frequencies:

- For U.S. firms, firms that are identified as
  - o (1) Global systemically important bank holding companies, (2) Category II banking organizations, or (3) Category III banking organizations and have average weighted short-term wholesale funding of $75 billion or more must submit a report *on each business day*; and
  - o (1) Category III banking organizations and have average weighted short-term wholesale funding of less than $75 billion, or (2) Category IV banking organizations must submit a report *monthly*.
- For FBOs, FBOs that are categorized based on the risk profile of their combined U.S. operations as
  - o (1) Category II FBOs, or (2) Category III FBOs with average weighted short-term wholesale funding of $75 billion or more must submit a *report on each business day*; and
  - o (1) Category III FBOs with average weighted short-term wholesale funding of less than $75 billion, or (2) Category IV FBOs must submit a report *monthly.*

Data from the FR 2052a provide detailed information on the liquidity risks within different business lines (for example, financing of securities positions, prime brokerage activities). FR 2052a data assist Federal Reserve supervision staff in monitoring compliance with the LCR rule and NSFR rule. The data serve as part of the Federal Reserve's liquidity risk-management supervisory surveillance program and provide timely information on firm-specific liquidity risks during periods of stress. The Board uses analyses of systemic and idiosyncratic liquidity risk to inform its supervisory processes, including the preparation of analytical reports that detail funding vulnerabilities. As the information required by the FR 2052a is collected as part of the Board's supervisory process, such information is entitled to confidential treatment.[26]

26. See exemption 8 of the Freedom of Information Act (FOIA) (5 U.S.C. 552(b)(8)).

1060.20.6 Table 4. Overview of liquidity requirements for domestic and foreign banking organizations

Requirement	**C.F.R. reference(s)**	**Category I**	**Category II**	**Category III**	**Category IV**
Liquidity risk management	12 C.F.R. 252.34 12 C.F.R. 252.156	Full set of liquidity risk-management requirements	Full set of liquidity risk-management requirements	Full set of liquidity risk-management requirements	Tailored liquidity risk-management
Liquidity stress tests	12 C.F.R. 252.35 12 C.F.R. 252.157	At least **monthly**	At least **monthly**	At least **monthly**	At least **quarterly**
Liquidity coverage ratio (LCR)	12 C.F.R. 249.10h	Full **daily** LCR (100%)	Full **daily** LCR (100%)	If $75 billion or more in weighted short-term wholesale funding (wSTWF), full **daily** LCR (100%) If less than $75 billion in wSTWF, reduced **daily** LCR (85%)	If $50 billion or more in wSTWF, reduced **monthly** LCR (70%) If less than $50 billion in wSTWF, **no LCR requirement**
Net stable funding ratio (NSFR)	12 C.F.R. 249.100	Full NSFR (100%)	Full NSFR (100%)	If $75 billion or more in wSTWF, full NSFR (100%) If less than $75 billion in wSTWF, reduced NSFR (85%)	If $50 billion or more in wSTWF, reduced NSFR (70%) If less than $50 billion in wSTWF, **no NSFR requirement**
Liquidity reporting (FR 2052a)		**Daily** T+2 FR 2052a reporting	**Daily** T+2 FR 2052a reporting	If wSTWF ≥ $75b: **Daily** T+2 FR 2052a reporting If wSTWF < $75b: **Monthly** T+2 FR 2052a reporting	**Monthly** T+10 FR 2052a reporting

Note: Certain requirements for a foreign bank are determined by the risk profile of its intermediate holding company, whereas other requirements are determined by the risk profile of the firm's combined U.S. operations. Standardized liquidity requirements are determined by the risk profile of the intermediate holding company and other liquidity requirements are determined by the risk profile of the foreign bank's combined U.S. operations. Other foreign banks with limited U.S. presence and global assets of $100 billion ormore would be subject to certain minimum liquidity risk-management requirements.

1060.20.7 SUPERVISORY CONSIDERATIONS FOR ASSESSING LIQUIDITY

Through the supervisory process, the Federal Reserve assesses a firm's compliance with liquidity regulations and ability to manage liquidity risk. The Federal Reserve has issued the "Consolidated Supervision Framework for Large Financial Institutions," which describes the supervisory framework for the consolidated supervision of large U.S. and foreign financial institutions.[27]

The consolidated supervision framework for large financial institutions has two primary objectives: (1) to enhance the resiliency of a firm to lower the probability of its failure or an inability to serve as a financial intermediary and (2) to reduce the effect on the financial system and the broader economy of a firm's failure or material weakness.

The consolidated supervision framework guidance outlines expectations for effective liquidity planning for large financial institutions. To support effective liquidity planning and adequate liquidity positions, a firm should

- maintain strong liquidity positions that not only comply with regulatory requirements, but also support the firm's ongoing ability to meet its obligations to creditors and other counterparties, as well as continue to serve as a financial intermediary through periods of stress;
- have in place robust internal processes that enable the firm to maintain liquidity commensurate with its unique risks under normal and stressful conditions;
- maintain processes that enable the identification and measurement of potential risks to cash flows and other primary determinants of liquidity positions;
- utilize comprehensive projections of the level and composition of liquidity resources, supported by regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios;
- maintain sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, policies, and controls;[28]
- establish goals for liquidity positions and reflect the potential impact of legal or regulatory restrictions on the transfer of liquidity between legal entities; and
- maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of liquidity risk-measurement and management processes.

1060.20.7.1 Comprehensive Liquidity Analysis and Review

The Comprehensive Liquidity Analysis and Review (CLAR) program is an annual horizontal supervisory program for Large Institution Supervision Coordinating Committee (LISCC) firms subject to Federal Reserve System oversight.[29] The purpose of the CLAR program is to assess liquidity risk and evaluate each LISCC firm's liquidity position and liquidity risk-management practices. The CLAR program is divided into three pillars covering the various topics for assessing each firm's liquidity position and liquidity risk-management practices.

- Pillar I evaluates a firm's internal liquidity risk-measurement capabilities and practices. This assessment includes an evaluation of the internal stress testing frameworks used to evaluate a firm's liquidity position based on that firm's assumptions.
- Pillar II performs an independent liquidity risk analysis for each firm and measures the liquidity position of a firm using the Federal Reserve's internal metrics and publicly available models and data. This pillar assesses whether a firm has sufficient liquid assets to match its outflows and an adequate funding structure to decrease the likelihood that disruptions to its regular funding sources will affect that firm's liquidity position.

27. See SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions."

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

29. A horizontal examination is a review of a specific activity, business line, or risk-management practice across a group of firms. Horizontal examinations are conducted to understand the range of industry practices for a specific activity, product, risk-management practice, or control; to ensure the consistent application of established supervisory expectations; and to confirm the consistent assignment of ratings. For more information on the criteria for determining which firms are in the LISSC supervisory program, see SR-20-30, "Financial Institutions Subject to the LISCC Supervisory Program."

- Pillar III evaluates a firm's liquidity risk management using methods other than internal stress testing. This component of the program informs the overall assessment of each firm's risk-management practices. This pillar, in conjunction with Pillar I, is also responsible for coordinating the completion of any liquidity risk reviews necessary for the Supervisory Assessment of Resolution and Recovery Preparedness.

The results from each pillar contribute to an assessment that includes each firm's final liquidity rating and overall liquidity assessment. Supervisors frequently use these horizontal examinations or reviews on a single topic across several firms to identify risks and common trends. Horizontal reviews may be conducted by a centralized team of examiners or through a common scope or work program executed by the dedicated supervisory teams. Unlike the Comprehensive Capital Analysis and Review, the LISCC liquidity program's assessment does not result in an objection or non-objection. Rather the LISCC liquidity program's assessment results in supervisory findings communicated to the firm, which may include "matters requiring attention" and "matters requiring immediate attention," as applicable.[30]

1060.20.7.2 Liquidity Reviews at Large and Foreign Banking Organizations

The Federal Reserve conducts various horizontal reviews to evaluate the adequacy of liquidity positions and the effectiveness of liquidity risk-management practices and liquidity stress testing of firms in the Large and Foreign Banking Organization (LFBO) supervisory portfolio. Additionally, the Federal Reserve completes focused analysis on firms' liquidity positions using data derived from the FR 2052a and other reports to supplement the horizontal reviews. These reviews are tailored to account for differences in the size, complexity, and risk profile among firms.

The Federal Reserve completes an annual Horizontal Liquidity Review (HLR) for the following large firms that are not in the LISCC portfolio:

- domestic firms with $100 billion or more in total consolidated assets; and
- foreign banking organizations with $50 billion or more in total consolidated assets.

Similar to the CLAR program, examiners complete forward-looking assessments of liquidity risk management and liquidity positions for firms in the LFBO portfolio. The HLR assessment evaluates similar liquidity risk topics as the CLAR pillars. However, the examination scope and expectations are tailored based on LFBO firms' risk profile, which pose lower systemic risk than LISCC firms. The HLR targets a select number of liquidity risk topics in a given year.

As discussed in this manual's section 1060.0, "Large Financial Institution Rating System," the Federal Reserve assigns a liquidity risk management and positions component rating to each LFBO. The liquidity risk management and positions component rating is not based solely on the outcome of HLR. The full body of related supervisory work and monitoring is considered, including from other regulators, since the previous ratings communication to a firm.

1060.20.7.3 Assessment of Liquidity at Firms Covered by the Large Financial Institution Ratings System

Given the Federal Reserve's development of a supervisory program to enhance resiliency and address the risks posed by large financial institutions, the Federal Reserve developed the Large Financial Institution (LFI) rating system to better assess these firms. Under the LFI rating system, examiners assign component ratings for capital planning and positions, liquidity risk management and positions, and governance and controls. Further, examiners assign each rating into one of the following rating categories: Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2. For more information on the LFI Rating System see this manual's section 1060.0, "Large Financial Institution Rating System."

1060.20.7.4 Assessment of Liquidity at the Depository Institution

The Uniform Financial Institutions Rating System (UFIRS), commonly referred to as the "CAMELS" rating system, establish criteria for rating a bank or thrift, including bank or thrift subsidiaries of holding companies. Under the UFIRS, each depository institution is assigned a composite rating based on an evaluation and rating

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

of six essential components of its financial condition and operations. These component factors address the adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. For more information on the UFIRS, see the *Commercial Bank Examination Manual*, and "Uniform Financial Institutions Rating System."[31]

In evaluating the adequacy of a depository institution's liquidity position, consideration is given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the firm's size, complexity, and risk profile. In general, funds management practices should ensure that a depository institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the firm to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

31. See SR-96-38, "Uniform Financial Institutions Rating System."

1060.30.1 OVERVIEW AND APPLICABILITY

The Federal Reserve expects the board of directors (board) of a large financial institution (LFI) to be effective in its oversight of the firm. The board plays a critical role in maintaining the firm's safety and soundness and continued financial and operational resilience of its consolidated operations. The supervisory assessment of the board's effectiveness is one of the elements within the Governance and Controls component rating of the LFI rating system. In February 2021, the Federal Reserve issued guidance describing the key attributes of effective boards at large domestic bank holding companies and savings and loan holding companies, and systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve (board effectiveness guidance).

The board effectiveness guidance is intended to promote firms' safety and soundness and compliance with laws and regulations by better distinguishing supervisory expectations for boards from those of senior management and refocusing supervisory expectations on boards' performance of their core responsibilities. The Federal Reserve recognizes that boards can effectively fulfill their core responsibilities in a variety of ways. As such, the board effectiveness guidance adopts a principles-based approach to provide each board with flexibility to determine how to most effectively fulfill its responsibilities. Responsibilities that are typically the purview of senior management, including most daily and operational decisions, are not described in the board effectiveness guidance.

The board effectiveness guidance applies to

- domestic bank holding companies with total consolidated assets of $100 billion or more;[1]
- domestic savings and loan holding companies with total consolidated assets of $100 billion or more;[2] and
- systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve.

1. The guidance does not apply to U.S. intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY.

2. This guidance applies to state regulated insurance companies that are also savings and loan holding companies to the extent it does not conflict with state insurance laws or regulatory requirements.

1060.30.2 KEY ATTRIBUTES OF AN EFFECTIVE BOARD OF DIRECTORS

The board effectiveness guidance describes the five key attributes of an effective board of directors in overseeing the firm's safe and sound conduct of consolidated operations; compliance with laws and regulations, including those related to consumer protection; and financial and operational strength and resilience necessary to carry out its business activities. The entire board effectiveness guidance is provided in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness."

1060.30.2.1 Set Clear, Aligned, and Consistent Direction Regarding the Firm's Strategy and Risk Appetite

An effective board oversees the development of, reviews, approves, and periodically monitors the firm's strategy and risk appetite.[3] Such a strategy and risk appetite are clear and aligned, and include a long-term perspective on risks and rewards that is consistent with the capacity of the firm's risk-management framework. The alignment of strategy and risk appetite helps the firm to maintain sufficient financial and operational strength and resilience for safety and soundness and to promote compliance with laws and regulations.

A clear strategy articulates a firm's strategic objectives for its businesses, while helping to establish and maintain

1. an effective risk-management structure;
2. appropriate processes and resources for strategy implementation, plans, and budgets for each business line and risk-management or control function; and
3. an effective risk-management and control function.

A clear strategy also provides direction to senior management about how to determine which business opportunities to pursue consis-

3. "Risk appetite" is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm's strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.

tent with the firm's risk appetite and risk-management capacity.

A clear risk appetite

- includes sufficient detail to enable the firm's chief risk officer (CRO) and its independent risk-management function to set firm-wide risk limits.[4]
- specifies the level and types of risk that the board is willing to assume, that the board believes the firm is capable of managing, and that allows senior management to establish risk-management expectations and monitor risk-taking for the full set of risks.

A firm's strategy and risk appetite are aligned when they are developed, reviewed, and approved consistent with one another even though they are not necessarily developed and approved simultaneously.

An effective board also considers the capacity of the firm's risk-management framework when overseeing aspects of the firm's strategy and risk appetite. This practice helps to confirm that strategic plans are commensurate with the firm's ability to identify and manage risks, including identifying activities that could pose a material risk to the safety and soundness of the firm, threaten the financial system, violate the law, or harm consumers.

For example, if the firm is considering a new line of business, a clear strategy explains how conducting the business would be consistent with the firm's risk appetite and changes that would need to be made to the firm's risk-management program and its controls to effectively manage different or additional risks posed by the new business. If the strategy calls for expansion into a new line of business or a new jurisdiction, the board evaluates the increased level of risk. In addition, an effective board reviews any corresponding risk management or controls enhancements, including those related to compliance with U.S. laws, that are necessary to align with the risk appetite.[5] The same evaluation is conducted on a regular basis to assess growth strategies within current businesses and products.

A firm's policies, programs, and plans are sufficiently clear regarding the allocation of responsibilities to enable the board to evaluate senior management's execution of the firm's strategic plan. An effective board reviews and approves significant policies, programs, and plans based on the firm's strategy, risk appetite, risk-management capacity, and structure. These include but are not limited to the firm's

- capital plan,[6]
- recovery and resolution plans,[7]
- audit plan,[8]
- enterprise-wide risk-management policies,[9]
- liquidity risk-management policies,[10]
- compliance risk-management program,[11] and
- performance management and compensation programs.

An effective board might review summarized forms of policies, programs, and plans, with the summarized form including sufficient detail and context for the board to make an informed decision and to consider consistency with the firm's strategy, risk appetite, and risk-management capacity.

1060.30.2.2 Direct Senior Management Regarding the Board's Information Needs

An effective board directs senior management to provide directors with information that is sufficient in scope, detail, and analysis to enable

4. An "independent risk-management function" is responsible for identifying, measuring, aggregating, and reporting risks in a comprehensive and independent manner. The term "risk limits" refers to thresholds that constrain risk-taking so that the level and type of risks assumed remains consistent with the firm-wide risk appetite. Internal risk management sets risk limits in aggregate by concentration and risk type, as well as at more granular levels as appropriate.

5. U.S. laws include, without limitation, the Bank Secrecy Act and the Foreign Corrupt Practices Act.

6. 12 CFR 225.8(e)(iii); 12 CFR 252.47(a); SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards;" SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards;" and Federal Reserve paper on *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (Federal Reserve Board press release issued on August 19, 2013).

7. 12 CFR part 243; SR-14-8, "Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies;" and SR-14-1, "Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies - Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions (SR-12-17/CA-12-14)."

8. SR-13-1/CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing," and SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing."

9. 12 CFR 252.33.

10. 12 CFR 252.34(a).

11. SR-08-8/CA-08-11, "Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles."

the board to make sound, well-informed decisions and consider potential risks.

An effective board directs senior management to provide it with information that is timely, accurate, and well organized. An effective board also evaluates the sufficiency and quality of information it receives and directs senior management to

1. provide more information;
2. address any concerns regarding the volume, structure, content, or quality of the information it receives; or
3. improve relevant firm processes and practices for the preparation of such information.

An effective board seeks, outside of regular board and committee meetings, information about the firm and its activities, emerging and ongoing risks, personnel, compensation, and other matters. Such additional inquiries are often conducted through special sessions of the board, outreach to staff other than the Chief Executive Officer (CEO) and their direct reports, and discussions with Federal Reserve senior supervisors. Director training is another way directors may learn more about topics relevant to their responsibilities and may highlight the need for further director inquiries.

Directors of an effective board, particularly the lead independent director or independent board chair and committee chairs, take an active role in setting board and committee meeting agendas. Directors provide input such that the content, organization, and time allocated to each topic allow the board and committees to make sound, well-informed decisions. If the board's agenda includes a discussion of growth into a new business, an effective board typically discusses the firm's risk management and control capabilities that reflect the views of the independent risk-management and internal audit functions.

1060.30.2.3 Oversee and Hold Senior Management Accountable

An effective board oversees and holds senior management accountable for effectively implementing the firm's strategy, consistent with its risk appetite, while maintaining an effective risk-management framework and system of internal controls. An effective board executes these responsibilities consistent with safety and soundness and in compliance with laws and regulations, including those related to consumer protection, under a range of conditions. An effective board also oversees and regularly evaluates the performance and compensation of senior management.

To facilitate accountability, an effective board engages senior management in a variety of ways. For instance, at board meetings, engagement is supported by allocating sufficient time to facilitate a candid discussion and debate of information while encouraging diverse views. Directors consider whether and how senior management's conclusions and recommendations align and support the firm's strategy and risk appetite. If weaknesses or gaps are identified, the information provided is incomplete, or as otherwise warranted, directors challenge senior management's assessments and recommendations. Engagement may also take place outside board and committee meetings.

An effective board engages in robust inquiry into, among other things,

- drivers, indicators, and trends related to current and emerging risks;
- adherence to the board-approved strategy and risk appetite by relevant lines of business; and
- material or persistent deficiencies in risk management or control practices, whether in policy or in practice.

An effective board also reviews reports of internal and external complaints, including "whistleblower" reports.

An effective board has independent directors who are sufficiently empowered to serve as an effective check against firm executives who sit on the board and against senior management. For example, if the board has an executive chair, independent directors may be empowered through the election of a lead independent director with the authority, among others, to call board meetings with or without the chair present.

A crucial aspect of holding senior management accountable is regular board oversight and evaluation of the performance and compensation of senior management. An effective board oversees and evaluates the development and implementation of performance management and compensation programs that encourage behaviors and business practices consistent with the firm's strategy, risk appetite, and safety and soundness. This includes promoting compliance with laws and regulations, including those related to consumer protection.

In addition, each component of senior management's total compensation is informed by the board's evaluation of the individual's performance against performance objectives. An effective board approves clear financial and nonfinancial performance objectives aligned with the firm's strategy and risk appetite for the CEO and business line executives and nonfinancial performance objectives for the CRO and chief audit executive. Similar performance objectives are developed for other members of senior management. An effective board of directors also holds senior management accountable for the implementation of performance management and compensation programs that promote sound risk management: compliance with laws and regulations; and internal standards, including for conduct. Performance management and compensation programs, when combined with business strategies, discourage risk-taking inconsistent with the firm's strategy and safety and soundness, including compliance with laws, regulations, and internal standards, and promote the firm's risk-management goals. Consistent with safety and soundness, compliance with laws and regulations, and the firm's strategy, an effective board oversees succession plans for the CEO, and depending on the size, complexity, and nature of the firm, the CRO, chief audit executive, or other senior management officials.[12]

1060.30.2.4 Support the Independence and Stature of Independent Risk Management and Internal Audit

An effective board of directors, through its risk and audit committees, assesses and supports the stature and independence of the firm's independent risk-management and internal audit functions. An effective risk committee and an effective audit committee engage in robust inquiry into, among other matters,[13]

- the causes and consequences of material or persistent breaches of the firm's risk appetite and risk limits,
- the timeliness of remediation of material or persistent internal audit and supervisory findings, and
- the appropriateness of the annual audit plan.

An effective risk committee supports the stature and independence of the independent risk-management function by:

- communicating directly with the CRO on material risk-management issues;
- overseeing the appropriateness of independent risk management function's budget, staffing, and systems of internal controls;
- coordinating with the compliance function; and
- providing the independent risk management function with direct and unrestricted access to the risk committee.[14]

After reviewing the risk-management framework relative to the firm's structure, risk profile, complexity, activities, and size, an effective risk committee effects changes that align with the firm's strategy and risk appetite.

An effective audit committee

- supports the stature and independence of internal audit by meeting directly with the chief audit executive regarding the internal audit function, organizational concerns, and industry concerns.
- supports internal audit's budget, staffing, and systems of internal controls relative to the firm's asset size, complexity, and the pace of technological and other changes.
- reviews the status of actions recommended by internal audit and external auditors to remediate and resolve material or persistent deficiencies identified by internal audit, external audit, and findings identified by supervisors.

An effective board monitors the independence and stature of independent risk management and internal audit and takes action if the views of these functions are not taken into

12. This may extend beyond requirements to which firms may be subject under other statutory and regulatory authorities. For example, the NYSE requires formalized succession planning for the CEO only. See NYSE Listed Company Manual, section 303A.09. The CRO and chief audit executive are named here given the independence of those positions and the control function each serves.

13. The risk committee is responsible for the firm's global risk-management policies and oversight of the firm's global risk-management framework. 12 CFR 252.33(a). Nonbank financial companies supervised by the Federal Reserve are required to establish a risk committee pursuant to section 165 of the Dodd-Frank Act. 12 U.S.C. 5365(h)(1). Savings and loan holding companies subject to this guidance should maintain a risk committee that meets the supervisory expectations discussed herein in order to enhance its safety and soundness. Also, see SR-13-1/CA-13-1. Firms that are publicly traded are subject to the audit committee requirements contained in the U.S. Securities and Exchange Commission's Rule 10A-3 ("Rule 10A-3") under the Exchange Act of 1934, in addition to any requirements imposed by the applicable stock exchange on which the firm is listed. See, for example, NYSE Listed Company Manual, sections 303A.06 and 303A.07, and the Nasdaq Stock Market Rules, section 5605(c).

14. See, e.g., 12 CFR 252.33(a)(3).

account when decisions are made, or if these functions are unduly influenced by business lines.

1060.30.2.5 Maintain a Capable Board Composition and Governance Structure

An effective board considers whether its composition, governance structure, and practices support the firm's safety and soundness and the ability to promote compliance with laws and regulations based on factors such as the firm's asset size, complexity, scope of operations, risk profile, and other changes that occur over time. Reflecting these factors, an effective board establishes a process designed to identify and select potential director nominees with a mix of skills, knowledge, experience, and perspectives. This process takes into account, for example, a potential nominee's expertise, availability, integrity, and potential conflicts of interest and considers a diverse pool of potential nominees, including women and minorities.[15]

An effective board maintains a governance structure capable of overseeing senior management and addressing issues arising from the firm's size, scope of operations, activities, risk profile, and resolvability. In addition, an effective board establishes committees and management-to-committee reporting lines to support effective oversight, timely access to information, and sound decisionmaking. An effective board also has the capacity to engage third-party advisors and consultants, when appropriate, to supplement the board's knowledge, expertise, and experience and support the board in making sound, well-informed decisions.

An effective board evaluates on an ongoing basis its strengths and weaknesses, including the performance of the board committees, particularly the risk, audit, and other key committees. An effective board adapts its structure and practices to address identified weaknesses or deficiencies and as the firm's asset size, scope of operations, risk profile, and other characteristics change over time.

15. "Final Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies," 80 Fed. Reg. 33,016 (June 10, 2015). The use of the term "minority" is consistent with the use of such term in this interagency policy statement and in section 342(g)(3) of the Dodd-Frank Act.

1060.30.3 SUPERVISORY CONSIDERATIONS IN ASSESSING BOARD EFFECTIVENESS

The board effectiveness guidance emphasizes the key aspects of board responsibilities and clarifies how supervisors assess board oversight. As the board effectiveness guidance builds on the principles set forth in the LFI ratings framework, the Federal Reserve uses the board effectiveness guidance to inform its assessment of the governance and controls for all firms to which the guidance applies. In addition to the board effectiveness guidance, the Federal Reserve considers applicable statutes, regulations, and guidance on specific risks or business activities.

Federal Reserve supervisory staff should base their assessment of board effectiveness on supervisory work that may include

- engaging directly with directors in meetings or other venues on how a board's structures and practices reflect the key attributes of an effective board. For example, the Federal Reserve supervisory staff may inquire as to how the board achieves the proper alignment of its strategy with its risk appetite;
- obtaining and reviewing information that the directors receive, including escalated issues, board packages, findings, and internal reports;
- meeting with firm management and other personnel;
- evaluating publicly available information as well as information obtained from examinations conducted by the Federal Reserve or other federal or state financial supervisors that relate to the expectations for boards;[16] and
- communicating with directors at firms with significant supervisory issues outside of board meetings (including meetings of the audit or risk committees) on a more frequent basis.

Ratings assigned under the LFI rating system are communicated by the Federal Reserve to the firm, but individual ratings are not disclosed

16. In assessing board effectiveness for insurance savings and loan holding companies, the Federal Reserve tailors its supervisory expectations based on each firm's size, risk profile, complexity, organizational structure, business model, and information gathered and assessments obtained from each firm's primary functional state insurance regulators and other functional regulators. The Federal Reserve relies, to the greatest extent possible, on the work and examination reports of state insurance regulators for its assessment of state regulated insurance companies within an insurance savings and loan holding companies' structure.

publicly. The Federal Reserve assigns LFI ratings and communicates ratings to large firms on an annual basis and more frequently as warranted.

Examiners will not criticize—through the issuance of "matters requiring attention" in an examination report or supervisory letter—a supervised financial institution for, and the Board will not issue an enforcement action on the basis of, a "violation" of or "non-compliance" with supervisory guidance, such as the board effectiveness guidance. However, in some situations, examiners may provide a written reference to the board effectiveness guidance in examination reports or supervisory letters to provide examples of safe and sound conduct.[17]

17. See 12 CFR part 263, appendix A.

1060.31.1 GOVERNANCE AND CONTROLS RATING AND APPLICABILITY

As described in section 1060.0, the “Governance and Controls” component rating of the Large Financial Institutions (LFI) rating system reflects Federal Reserve supervisory staff’s evaluation of the effectiveness of a firm’s (1) board of directors, (2) management of business lines and independent risk management and controls, and (3) recovery planning (for domestic Large Institution Supervision Coordinating Committee firms only). This component rating represents the Federal Reserve’s supervisory assessment of a firm’s effectiveness in aligning strategic business objectives with the firm’s risk appetite and risk-management capabilities; maintaining effective and independent risk-management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.

This section provides guidance for examiners in the assessment of risk management, processes, and internal controls of bank holding companies that have $100 billion or more in total assets. The supervisory assessment of a state member bank’s risk management would be reflected in the management component (M) of the CAMELS rating framework as well as the Risk Management rating. For information on the CAMELS rating framework, refer to the Federal Reserve’s *Commercial Bank Examination Manual*.

Examiners should recognize that the matters discussed in this section are intended only to assist an examiner in evaluating a firm’s risk-management practices. Therefore, *the information in this section should not be treated as a checklist of requirements for an individual organization*. Moreover, while a bank holding company should be able to assess the major risks of the consolidated organization, examiners should expect a holding company that centrally manages the operations and functions of its subsidiary banks to have more-comprehensive, detailed, and developed risk-management systems than a company that delegates risk management to relatively autonomous banking subsidiaries. For more information, see the “Elements of Risk Management” discussion in SR-95-51, “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.”[1]

1060.31.2 OVERVIEW

The Federal Reserve places significant supervisory emphasis on the importance of a bank holding company’s sound risk-management processes and strong internal controls when evaluating the activities of a supervised financial institution. A bank holding company’s failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Serious lapses or deficiencies in a bank holding company’s internal controls, including inadequate separation of duties, can constitute an unsafe and unsound practice and possibly lead to significant losses or otherwise compromise the financial integrity of the institution.[2] Accordingly, while a bank holding company’s financial performance is an important indicator of the adequacy of management, examiners should give significant weight to the quality of risk-management practices and internal controls when they evaluate the management and overall financial condition of bank holding companies. Properly managing risks is even more important as new technologies, product innovation, and the size and speed of financial transactions change the nature of banking markets.

1. Since the issuance of SR-95-51, the Federal Reserve revised the supervisory ratings frameworks for holding companies. Therefore, refer to this manual’s sections entitled, “Large Financial Institution Rating System,” (SR-19-3/CA-19-2) and “RFI Rating System,” (SR- 19-4/CA-19-3) for the supervisory ratings frameworks used for holding companies. The Risk Management rating, as described in SR-95-51, applies to all state member banks, regardless of their size. For more information on the Risk Management rating criteria and CAMELS ratings framework, see the *Commercial Bank Examination Manual*.

2. If appropriate, the institution should be advised that the Federal Reserve will initiate supervisory actions if its failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of its activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank or bank holding company, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

The principles of sound management should apply to the entire spectrum of risks which include, but are not limited to, credit, market, liquidity, operational, legal, and reputational risk:

- ***Credit risk*** arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- ***Market risk*** is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- ***Liquidity risk*** is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").
- ***Operational risk*** arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- ***Legal risk*** arises from the potential that unenforceable contracts, lawsuits, or adverse judgements can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- ***Reputational risk*** is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

The supervisory assessment of a firm's risk-management process is designed to bring together and summarize much of the analysis of and many of the findings about a bank holding company's process for managing and controlling risks. This assessment is intended to highlight and incorporate both the quantitative and qualitative aspects of an examiner's review of a firm's overall process for identifying, measuring, monitoring, and controlling risks and to facilitate appropriate follow-up action.

The overall profitability, asset quality, and capital adequacy of a bank holding company should be considered in the examiner's assessment of management. These indicators can to some extent be affected, either favorably or adversely, by factors outside management's control. For this reason, examiners' evaluation of the risk-management process should be a primary factor when assessing management at larger firms whose activities and structures require more formal and extensive procedures.

1060.31.3 ELEMENTS OF RISK MANAGEMENT

When assessing the quality of risk management at bank holding companies, examiners should consider the adequacy, effectiveness, and comprehensiveness of the key elements of a sound risk-management system:

1. roles and responsibilities of board of directors and senior management
2. policies, procedures, and limits
3. risk measurements, risk monitoring, and management information systems
4. internal controls

1060.31.3.1 Board of Directors and Senior Management

In assessing the quality of oversight by the board of directors and senior management, examiners should consider whether the bank holding company follows policies and practices such as those described below:

Board of Directors

1. The board of directors makes appropriate efforts to remain informed about the risks inherent in the bank holding company's activities.
2. The board of directors reviews and approves significant policies to limit risks inherent in the bank holding company's lending, investing, trading, trust, fiduciary, and other significant activities or products.
3. The board of directors or the responsible committee of the board:
   a. reviews and approves risk-exposure limits to conform with any changes in the bank holding company's strategies,
   b. addresses new products, and
   c. reacts to changes in market conditions.
4. The board of directors holds senior management accountable as financial markets, risk-management practices, and the bank holding company's activities evolve.

Senior Management

1. Senior management has identified and has a clear understanding and working knowledge of the types of risks inherent in the bank holding company's activities.
2. Senior management is sufficiently familiar with and is using adequate recordkeeping and reporting systems to measure and monitor the major sources of risk to the organization.
3. Senior management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise are consistent with the nature and scope of the bank holding company's activities.
4. Senior management ensures that the depth of staff resources is sufficient to operate and soundly manage the bank holding company's activities and that its employees have the integrity, ethics, and competence that are consistent with a prudent management philosophy and operating style.
5. Senior management adequately oversees business line management who are responsible for carrying out the institution's day-to-day activities and implementing its strategic plan.
6. Senior management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
7. Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

1060.31.3.2 Policies, Procedures, and Limits

A bank holding company's board of directors should set clear, aligned, and consistent direction regarding the firm's strategy and risk appetite. The following guidelines should assist examiners in evaluating the adequacy of a bank holding company's policies, procedures, and limits:

1. The bank holding company's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, fiduciary, and other significant activities.
2. The policies, procedures, and limits are consistent with senior management's experience level, the organization's stated goals and objectives, and its overall financial strength.
3. Policies clearly delineate accountability and lines of management authority across the organization's activities.
4. Policies provide for the review of new activities to ensure that the organization's infrastructure is adequate to identify, monitor, and control risks associated with an activity and that the control infrastructure is in place before the activity is initiated.

1060.31.3.3 Risk Monitoring Activities and Management Information System

As part of its risk monitoring activities and management information system (MIS), a firm should be able to identify and measure all material risk exposures. Therefore, a firm's MIS should be able to provide senior management and board of directors with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization. Further, the MIS should be able to provide regular and sufficiently detailed reports for line managers engaged in the organization's day-to-day activities.

In assessing the adequacy of a bank holding company's measurement and monitoring of risk and the adequacy of its MIS, examiners should consider whether the following conditions exist:

1. The bank holding company's risk-monitoring practices and reports address material risks.
2. Key assumptions, data sources, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an ongoing basis.
3. Reports and other forms of communication are consistent with the bank holding company's activities; are structured to monitor exposures and compliance with internal limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
4. Reports to senior management or the board of directors are accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to adequately evaluate the level of a firm's risk exposure.

1060.31.3.4 Internal Controls

A bank holding company's internal control structure is critical to promoting safe-and-sound operations and an effective risk-management system. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities.

Appropriate segregation of duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise a firm's financial integrity. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, an internal control system promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and promotes compliance with relevant laws, regulations, and bank holding company policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the bank holding company's board of directors or a designated board committee, typically the audit committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls, the results of audits or reviews, whether conducted by an internal auditor or other personnel, should be adequately documented, as well as senior management's responses to review findings. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee.

In evaluating the adequacy of a bank holding company's internal controls and audit procedures, examiners should consider the following:

1. The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
2. The bank holding company's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
3. Reporting lines ensure that control areas are sufficiently independent from the business lines, and the reporting lines adequately separate duties throughout the organization, such as those duties relating to trading, custodial, and back-office activities.
4. Official organizational structures reflect actual operating practices.
5. Financial, operational, and regulatory reports are reliable, accurate, and timely. When applicable, policy exceptions are noted and promptly investigated.
6. Adequate procedures exist for ensuring compliance with applicable laws and regulations.
7. Internal audit or other control review practices ensure independence and objectivity of an audit or review.
8. Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
9. The board of directors or its audit committee engages in robust inquiry into the effectiveness of internal audits and other control review activities.

1062.0.1 RFI RATING SYSTEM INTRODUCTION

Since 2004, the Federal Reserve has used the "RFI/C(D)" rating system (referred to as the "RFI rating system") to communicate its supervisory assessment of bank holding companies (BHCs) regardless of their asset size, complexity, or systemic importance.[1] In 2018, the Board adopted the RFI rating system for non-insurance and non-commercial savings and loan holding companies (SLHCs) with less than $100 billion in total consolidated assets.[2] At the same time, the Board also adopted a rating system for BHCs and non-insurance and non-commercial savings and loan holding companies with total consolidated assets of $100 billion or more (referred to as the "LFI rating system").[3] As a result, the Federal Reserve has two frameworks for rating holding companies.

1062.0.2 RFI RATING SYSTEM APPLICABILITY

The RFI rating system generally applies to BHCs and non-insurance and non-commercial savings and loan holding companies with less than $100 billion in total consolidated assets. Examination staff assign and communicate ratings to BHCs and non-insurance and non-commercial savings and loan holding companies with total consolidated assets between $10 billion and $100 billion assets on at least an annual basis, and more frequently as warranted. However, U.S. intermediate holding companies of foreign banking organizations (FBOs) established under the Board's Regulation YY that have $50 billion or more in total consolidated assets would be subject to the LFI rating system.

1. 69 Fed. Reg. 70,444 (December 6, 2004).

2. SLHCs that are excluded from the definition of "covered holding company" in section 217.2 of the Board's Regulation Q receive indicative supervisory ratings. Section 271.2 excludes the following SLHCs: (1) SLHCs that derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)) (commercial SLHCs), and (2) SLHCs that are insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies (insurance SLHCs).

3. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019).

1062.0.3 RFI RATING AND SAVINGS AND LOAN HOLDING COMPANIES

The Dodd-Frank Wall Street Reform and Consumer Protection Act transferred to the Federal Reserve the supervisory functions of the Office of Thrift Supervision related to SLHCs and their nondepository subsidiaries beginning on July 21, 2011. At that time, the Federal Reserve decided to issue "indicative RFI ratings" to SLHCs until such time that a rating system was formally adopted for these companies.

In November 2018, the Federal Reserve adopted a final rule to apply the RFI rating system on a fully implemented basis to SLHCs with less than $100 billion in total consolidated assets, excluding SLHCs engaged in significant insurance or commercial activities.[4] Therefore, starting on February 1, 2019, the Federal Reserve will assign an RFI rating to non-insurance and non-commercial SLHCs with less than $100 billion in total consolidated assets. Non-insurance and non-commercial SLHCs face similar risks and engage largely in the same activities as BHCs. As such, it is appropriate for the RFI rating system to apply to non-insurance and non-commercial SLHCs to ensure that they are subject to standards and supervisory programs that are consistent with those that apply to BHCs. Inspection frequency and scope guidance for non-insurance and non-commercial SLHCs with $10 billion or less in total consolidated assets are described in SR letter 13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less." Further, in November 2018, the Federal Reserve adopted the LFI rating system for non-insurance or non-commercial SLHCs with total consolidated assets of $100 billion or more.

The Federal Reserve will continue to assign an indicative RFI rating to SLHCs engaged in significant insurance or commercial activities, regardless of asset size. The Federal Reserve is in the process of reviewing whether a modified version of the RFI rating system, LFI rating system, or some other supervisory rating system is appropriate for these firms on a permanent basis.

4. 83 Fed. Reg. 56,081 (November 7, 2018).

1062.0.4 RFI RATING SYSTEM

The RFI rating system provides an assessment of certain risk management and financial condition factors that are common to holding companies,[5] as well as an assessment of the potential impact of the parent holding company and its nondepository subsidiaries (collectively, nondepository entities) on the holding company's subsidiary depository institutions. Under this system, the Federal Reserve endeavors to ensure that applicable BHCs, including financial holding companies, and non-insurance and noncommercial SLHCs are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the holding companies that exhibit financial and operational weaknesses or adverse trends. The RFI rating system serves as a useful vehicle for identifying problem or deteriorating holding companies, as well as for categorizing holding companies with deficiencies in particular areas. Further, the RFI rating system assists the Federal Reserve in following safety-and-soundness trends and in assessing the aggregate strength and soundness of the financial industry.

Each holding company subject to the RFI rating system is assigned a composite rating (C) based on an overall evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s).[6] The main components of the rating system represent: Risk Management (R); Financial Condition (F); and Impact (I) of the nondepository entities on the subsidiary depository institutions. While the Federal Reserve expects holding companies to act as a source of strength to their subsidiary depository institutions, the Impact rating focuses on downside risk—that is, on the likelihood of significant negative impact by the nondepository entities on the subsidiary depository institution(s).[7] A fourth rating, Depository Institution(s) (D), will generally mirror the primary regulator's assessment of the subsidiary depository institution(s). Thus, the primary component and composite ratings are displayed:

R F I / C (D)

In order to provide a consistent framework for assessing risk management, the R component is supported by four subcomponents that reflect the effectiveness of the organization's risk management and controls. The subcomponents are Board and Senior Management Oversight; Policies, Procedures, and Limits; Risk Monitoring and Management Information Systems (MIS); and Internal Controls. The F component is also supported by four subcomponents reflecting an assessment of the quality of the consolidated organization's Capital, Asset Quality, Earnings, and Liquidity.

Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 numeric rating indicates the highest rating, strongest performance and practices, and least degree of supervisory concern, whereas a 5 numeric rating indicates the lowest rating, weakest performance, and the highest degree of supervisory concern.

The sections that follow contain detailed descriptions of the composite, component, and subcomponent ratings; implementation guidance by holding company type; and definitions of the ratings.

1062.0.5 DESCRIPTION OF THE RFI RATING SYSTEM ELEMENTS

1062.0.5.1 The Composite (C) Rating

C is the overall composite assessment of the holding company as reflected by consolidated risk management, consolidated financial strength, and the potential impact of the nondepository entities on the subsidiary depository institutions. The composite rating encompasses both a forward-looking and static assessment of the consolidated organization, as well as an assessment of the relationship between the depository and nondepository entities. The C rating is not derived as a simple numeric average of the R, F, and I components; rather, it reflects examiner judgment with respect to the relative importance

5. The information in this manual section largely conveys the information in the original 2004 RFI rating system document conveyed in 69 Fed. Reg. 70,444 (December 6, 2004). However, the information was revised to clarify the applicability of the rating system and to provide current references to regulations and guidance. The elements of the RFI rating system and the ratings' definitions are unchanged. See SR letter 19-4, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion."

6. A simplified version of the rating system that includes only the R and C components will be applied to noncomplex holding companies with assets at or below $3 billion. See SR-13-21 for more information.

7. In 2004, this risk-management rating replaced the risk-management rating required for bank holding companies by SR letter 95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

of each component to the safe-and-sound operation of the holding company.

1062.0.5.2 The Risk Management (R) Component

R represents an evaluation of the ability of the holding company's board of directors and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk. The R rating underscores the importance of the control environment, taking into consideration the complexity of the organization and the risk inherent in its activities.

The R rating is supported by four subcomponents that are each assigned a separate rating. The four subcomponents are as follows: (1) Board and Senior Management Oversight; (2) Policies, Procedures and Limits; (3) Risk Monitoring and Management Information Systems; and (4) Internal Controls. The subcomponents are evaluated in the context of the risks undertaken by and inherent in an organization and the overall level of complexity of the holding company's operations. They provide the Federal Reserve System with a consistent framework for evaluating risk management and the control environment. Moreover, the subcomponents provide a clear structure and basis for discussion of the R rating with holding company management, reflect the principles in supervisory guidance that are familiar to examiners, and parallel the existing risk assessment process.[8]

1062.0.5.2.1 Risk Management Subcomponents

Board and Senior Management Oversight

This subcomponent evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the holding company's activities, as well as the general capabilities of management.[9] It also includes consideration of management's ability to identify, understand, and control the risks undertaken by the institution, to hire competent staff, and to respond to changes in the institution's risk profile or innovations in the banking sector.

Policies, Procedures, and Limits

This subcomponent evaluates the adequacy of a holding company's policies, procedures, and limits given the risks inherent in the activities of the consolidated organization and its stated goals and objectives. This analysis will include consideration of the adequacy of the institution's accounting and risk disclosure policies and procedures.

Risk Monitoring and Management Information Systems

This subcomponent assesses the adequacy of a holding company's risk measurement and monitoring, and the adequacy of its management reports and information systems. This analysis will include a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities.

Internal Controls

This subcomponent evaluates the adequacy of a holding company's internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence, within the organization, of the internal audit team. This analysis will also include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

1062.0.5.3 The Financial Condition (F) Component

F represents an evaluation of the consolidated organization's financial strength. The F rating focuses on the ability of the holding company's resources to support the level of risk associated with its activities. The F rating is supported by four subcomponents: capital (C), asset quality (A), earnings (E), and liquidity (L). The CAEL subcomponents can be evaluated along

8. See SR-95-51 and SR letter 16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion." SR-95-51 and SR-16-11 contain a detailed description of the four risk-management subcomponents.

9. The board of directors is considered separate from management.

individual business lines, product lines, or on a legal entity basis, depending on what is most appropriate given the structure of the organization. The assessment of the CAEL components should utilize benchmarks and metrics appropriate to the business activity being evaluated.

Examination staff should continue to review relevant market indicators, such as external debt ratings, credit spreads, debt and equity prices, and qualitative rating agency assessments as a source of information complementary to examination findings.

1062.0.5.3.1 Financial Condition Subcomponents (CAEL)

Capital Adequacy

C reflects the adequacy of an organization's consolidated capital position, from a regulatory capital perspective and an economic capital perspective, as appropriate to the holding company.[10] The evaluation of capital adequacy should consider the risk inherent in an organization's activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the level and composition of the parent company and subsidiaries' debt.

Asset Quality

A reflects the quality of an organization's consolidated assets. The evaluation should include, as appropriate, both on-balance sheet and off-balance sheet exposures, and the level of criticized and nonperforming assets. Forward-looking indicators of asset quality, such as the adequacy of underwriting standards, the level of concentration risk, the adequacy of credit administration policies and procedures, and the adequacy of management information systems for credit risk may also inform the Federal Reserve's view of asset quality.

10. The regulatory minimum capital ratios for covered holding companies subject to the Board's Regulation Q (12 CFR part 217) are (1) a common equity tier 1 capital ratio of 4.5 percent; (2) a tier 1 capital ratio of 6 percent; (3) a total capital ratio of 8 percent; (4) a leverage ratio of 4 percent, and (5) for advanced approaches Board-regulated institutions, a supplementary leverage ratio of 3 percent.

Earnings

E reflects the quality of consolidated earnings. The evaluation considers the level, trend, and sources of earnings, as well as the ability of earnings to augment capital as necessary, to provide ongoing support for a holding company's activities.

Liquidity

L reflects the consolidated organization's ability to attract and maintain the sources of funds necessary to support its operations and meet its obligations. The funding conditions for each of the material legal entities in the holding company structure should be evaluated to determine if any weaknesses exist that could affect the funding profile of the consolidated organization.

1062.0.5.4 The Impact (I) Component

Like the other components and subcomponents, the I component is rated on a five-point numerical scale. However, the descriptive definitions of the numerical ratings for I are different than those of the other components and subcomponents. The I ratings are defined as follows:

1—low likelihood of significant negative impact;
2—limited likelihood of significant negative impact;
3—moderate likelihood of significant negative impact;
4—considerable likelihood of significant negative impact; and
5—high likelihood of significant negative impact.

The I component is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). The I assessment will evaluate both the risk-management practices and financial condition of the nondepository entities—an analysis that will borrow heavily from the analysis conducted for the R and F components. Nondepository entities will be evaluated using benchmarks and analysis appropriate for those businesses. In addition, for functionally regulated nondepository subsidiaries, examination staff will continue to rely, to the extent possible, on the work of those functional regulators to assess the risk management practices and financial condition of those entities. In rating the I component, examination staff is required to evaluate the degree to which current or potential issues within the nondepository entities present a threat to the safety and soundness of the subsidiary depository institution(s).

The I component focuses on the aggregate impact of the nondepository entities on the subsidiary depository institution(s). In this regard, the I rating does not include individual subcomponent ratings for the parent company and nondepository subsidiaries. An I rating is always assigned for each holding company; however, nonmaterial nondepository subsidiaries may be excluded from the I analysis at examiner discretion.[11]

Any risk-management and financial issues at the nondepository entities that potentially impact the safety and soundness of the subsidiary depository institution(s) should be identified in the written comments under the I rating. This approach is consistent with the Federal Reserve's objective not to extend bank-like supervision to nondepository entities.

The analysis of the parent company for the purpose of assigning an I rating should emphasize weaknesses that could directly impact the risk-management or financial condition of the subsidiary depository institution(s). Similarly, the analysis of the nondepository subsidiaries for the purpose of assigning an I rating should emphasize weaknesses that could negatively impact the parent company's relationship with its subsidiary depository institution(s) and weaknesses that could have a direct impact on the risk-management practices or financial condition of the subsidiary depository institution(s). The analysis under the I component should consider existing as well as potential issues and risks that may impact the subsidiary depository institution(s) now or in the future. Particular attention should be paid to the following risk-management and financial factors in assigning the I rating:

1062.0.5.4.1 Risk-Management Factors

- *Strategic Considerations:* The potential risks posed to the subsidiary depository institution(s) by the nondepository entities' strategic plans for growth in existing activities and expansion into new products and services;
- *Operational Considerations:* The spillover impact on the subsidiary depository institution(s) from actual losses, a poor control environment, or an operational loss history in the nondepository entities;
- *Legal and Reputational Considerations:* The spillover effect on the subsidiary depository institution(s) of complaints and litigation that name one or more of the nondepository entities as defendants, or violations of laws or regulations, especially pertaining to intercompany transactions where the subsidiary depository institution(s) is involved; and
- *Concentration Considerations:* The potential risks posed to the subsidiary depository institution(s) by concentrations within the nondepository entities in business lines, geographic areas, industries, customers, or other factors.

1062.0.5.4.2 Financial Factors

- *Capital Distribution:* The distribution and transferability of capital across the legal entities;
- *Intra-Group Exposures:* The extent to which intra-group exposures, including servicing agreements, have the potential to undermine the condition of subsidiary depository institution(s); and
- *Parent Company Cash Flow and Leverage:* The extent to which the parent company is dependent on dividend payments, from both the nondepository subsidiaries and the subsidiary depository institution(s), to service debt and cover fixed charges. Also, the effect that these upstreamed cash flows have had, or can be expected to have, on the financial condition of the holding company's nondepository subsidiaries and subsidiary depository institution(s).

1062.0.5.5 The Depository Institution(s) (D) Component

The (D) component will generally reflect the composite CAMELS rating assigned by the subsidiary depository institution's primary supervisor. In a multi-depository institution holding company, the (D) rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institutions, weighted by both asset size and the relative importance of each depository institution within the holding company structure. In this regard,

11. In general, nondepository subsidiaries should be included in the I analysis whenever their assets exceed 5 percent of the holding company's consolidated capital or $10 million, whichever is lower.

the CAMELS composite rating for a subsidiary depository institution that dominates the corporate culture may figure more prominently in the assignment of the (D) rating than would be dictated by asset size, particularly when problems exist within that depository institution.

The (D) component conveys important supervisory information, reflecting the primary supervisor's assessment of the legal entity. The (D) component stands outside of the composite rating although significant risk-management and financial condition considerations at the depository institution level are incorporated in the consolidated R and F ratings, which are then factored into the C rating.

In the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Federal Reserve and the depository institution's primary regulator, then the (D) rating should reflect the Federal Reserve's evaluation.

To highlight the presence of one or more problem depository institution(s) in a multi-depository institution holding company whose depository institution component, based on weighted averages, might not otherwise reveal their presence (i.e., depository institution ratings of 1, 2, or 3), a problem modifier, "P" would be attached to the depository institution rating (e.g., 1P, 2P, or 3P). Thus, 2P would indicate that, while on balance the depository subsidiaries are rated satisfactory, there exists a problem depository institution (composite 4 or 5) among the subsidiary depository institutions. The problem identifier is unnecessary when the depository institution component is rated 4 or 5.

1062.0.6 IMPLEMENTATION OF THE RFI RATING SYSTEM BY HOLDING COMPANY TYPE

Since 2004, the Federal Reserve has used the RFI rating system to communicate its supervisory assessment of BHCs regardless of their asset size, complexity, or systemic importance. In 2018, the Board adopted the RFI rating system for non-insurance and non-commercial SLHCs with less than $100 billion in total consolidated assets. The scope and frequency of inspections of holding companies under the RFI rating system will vary based upon whether a holding company has been determined to be "complex" or "noncomplex."[12] In addition, the resources dedicated to the inspection of each holding company will continue to be determined by the risk posed by the subsidiary depository institution(s) to the federal safety net and the risk posed by the holding company to the subsidiary depository institution(s).[13]

1062.0.6.1 Noncomplex Holding Companies with Assets of $3 Billion or Less (Shell Holding Companies) Rating: R and C

Examination staff will assign only an R and C rating for all noncomplex holding companies with assets under $3 billion.[14] The R rating is the M rating from the subsidiary depository institution's CAMELS rating. The C rating is the subsidiary depository institution's composite CAMELS rating.

1062.0.6.2 Noncomplex Holding Companies with Assets Greater than $3 Billion

1062.0.6.2.1 One-Depository Institution Holding Company Rating: RFI/C(D)

For all noncomplex, one-depository institution holding companies with assets of greater than $3 billion, examination staff will assign all component and subcomponent ratings; however, examination staff should rely heavily on information and analysis contained in the primary regulator's report of examination for the subsidiary depository institution to assign the R and F ratings. If examination staff have reviewed the

12. The determination of whether a holding company is "complex" versus "noncomplex" is made at least annually on a case-by-case basis taking into account and weighing a number of considerations, such as: the size and structure of the holding company; the extent of intercompany transactions between depository institution subsidiaries and the holding company or nondepository subsidiaries of the holding company; the nature and scale of any nondepository activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley authorized activities (e.g., insurance, securities, merchant banking); whether risk-management processes for the holding company are consolidated; and whether the holding company has material debt outstanding to the public. Size is a less important determinant of complexity than many of the factors noted above.

13. The federal safety net includes the federal deposit insurance fund, the payments system, and the Federal Reserve's discount window.

14. Refer to SR-13-21.

primary regulator's examination report and are comfortable with the analysis and conclusions contained in that report, then the holding company ratings should be supported with concise language that indicates that the conclusions are based on the analysis of the primary regulator. No additional analysis will be required.

Please note, however, in cases where the analysis and conclusions of the primary regulator are insufficient to assign the ratings, the primary regulator should be contacted to ascertain whether additional analysis and support may be available. Further, if discussions with the primary regulator do not provide sufficient information to assign the ratings, discussions with holding company management may be warranted to obtain adequate information to assign the ratings. In most cases, additional information or support obtained through these steps will be sufficient to permit the assignment of the R and F ratings. To the extent that additional analysis is deemed necessary, the level of analysis and resources spent on this assessment should be in line with the level of risk the subsidiary depository institution poses to the federal safety net. In addition, any activities that involve information gathering with respect to the subsidiary depository institution should be coordinated with and, if possible, conducted by, the primary regulator of that institution.

Examination staff are required to make an independent assessment in order to assign the I rating, which provides an evaluation of the impact of the holding company on the subsidiary depository institution. Analysis for the I rating in non-complex one-depository institution holding companies should place particular emphasis on issues related to parent company cash flow and compliance with sections 23A and 23B of the Federal Reserve Act.

1062.0.6.2.2 Multi-Depository Institution Holding Company Rating: RFI/C(D)

For all noncomplex holding companies with assets of greater than $3 billion and more than one subsidiary depository institution, examination staff will assign all component and subcomponent ratings of the RFI rating system. Examiners should rely, to the extent possible, on the work conducted by the primary regulators of the subsidiary depository institutions to assign the R and F ratings. However, any risk management or other important functions conducted by the nondepository entities of the holding company, or conducted across legal entity lines, should be subject to review by Federal Reserve examination staff. These reviews should be conducted in coordination with the primary regulator(s). The assessment for the I rating requires an independent assessment by Federal Reserve examination staff.

1062.0.6.3 Complex Holding Companies Rating: RFI/C(D)

For complex holding companies, examination staff will assign all component and subcomponent ratings of the RFI rating system. The ratings analysis should be based on the primary and functional regulators' assessment of the subsidiary entities, as well as on the examiners' assessment of the consolidated organization as determined through off-site review and the holding company inspection process, as appropriate. The resources needed for the inspection and the level of support needed for developing a full rating will depend on the complexity of the organization, including structure and activities, and should be commensurate with the level of risk posed by the subsidiary depository institution(s) to the federal safety net and the level of risk posed by the holding company to the subsidiary depository institution(s).

1062.0.6.4 Nontraditional Holding Companies Rating: RFI/C(D)

Examination staff are required to assign the full-rating system for nontraditional holding companies. Nontraditional holding companies include holding companies in which most or all nondepository entities are regulated by a functional regulator and in which the subsidiary depository institution(s) are small in relation to the nondepository entities.[15] The rating system is not intended to introduce significant additional work in the rating process for these organizations. As discussed above, the level of analysis conducted and resources needed to inspect the holding company and to assign the consolidated R and F ratings should be commensurate with the level

15. SLHCs that derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)) (commercial SLHCs), and SLHCs that are insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies (insurance SLHCs) will receive an "indicative" RFI rating regardless of size.

of risk posed by the subsidiary depository institution(s) to the federal safety net and the level of risk posed by the holding company to the subsidiary depository institution(s). The report of examination by, and other information obtained from, the functional and primary bank regulators should provide the basis for the consolidated R and F ratings. On-site work, to the extent it involves areas that are the primary responsibility of the functional or primary depository institution(s) regulator, should be coordinated with and, if possible, conducted by, those regulators. Examination staff should concentrate their independent analysis for the R and F ratings around activities and risk management conducted by the parent company and non-functionally regulated nondepository subsidiaries, as well as around activities and risk management functions that are related to the subsidiary depository institution(s), for example, audit functions for the depository institution(s) and compliance with sections 23A and 23B.

Examination staff are required to make an independent assessment of the impact of the nondepository entities on the subsidiary depository institution(s) in order to assign the I rating.

1062.0.7 RATING DEFINITIONS FOR THE RFI/C(D) RATING SYSTEM

All component and subcomponent ratings are rated on a five-point numeric scale. With the exception of the I component, ratings will be assigned in ascending order of supervisory concern as follows:

1—Strong; 2—Satisfactory; 3—Fair; 4— Marginal; and 5—Unsatisfactory.

A description of the I component ratings can be found below in subsection 1062.0.7.4, “Impact Component.”

The component ratings are not derived as a simple numeric average of the subcomponent ratings; rather, weight afforded to each subcomponent in the overall component rating will depend on the severity of the condition of that subcomponent and the relative importance of that subcomponent to the consolidated organization. Similarly, some components may be given more weight than others in determining the composite rating, depending on the situation of the holding company. Assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the holding company, although generally the composite rating bears a close relationship to the component ratings assigned.

1062.0.7.1 Composite Rating

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

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

Rating 3 (Fair). Holding companies in this group exhibit a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, these companies are vulnerable and require more than normal supervisory attention and financial surveillance. However, the risk management and financial capacity of the company, including the potential negative impact of the nondepository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

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

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

1062.0.7.2 Risk-Management Component

Rating 1 (Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the holding company's activities. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and are understood, reviewed, and approved by the board. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide management and the board with the information and analysis that is necessary to make timely and appropriate decisions in response to changing conditions. Risk-management practices and the organization's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient experience, expertise and depth to manage the risks assumed by the institution.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none are material. Management effectively and accurately monitors the condition of the institution consistent with the standards of safety and soundness, and in accordance with internal and supervisory policies and practices. Risk-management processes are fully effective in identifying, monitoring, and controlling the risks to the institution.

Rating 2 (Satisfactory). A rating of 2 indicates that the institution's management of risk is largely effective, but lacking in some modest degree. Management demonstrates a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are in the process of being resolved. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Risks are controlled in a manner that does not require more than normal supervisory attention.

The holding company's risk-management practices and infrastructure are satisfactory and generally are adjusted appropriately in response to changing industry practices and current regulatory guidance. Staff experience, expertise and depth are generally appropriate to manage the risks assumed by the institution.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management (active board and senior management oversight; adequate policies, procedures, and limits; adequate risk-management monitoring and management information systems; comprehensive internal controls) is considered less than acceptable,[16] and has precluded the institution from fully addressing one or more significant risks to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution. Also, the risk-management structure may need to be improved in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. In addition, management's response to changing industry practices and regulatory guidance may need to improve.

The internal control system may be lacking in some important aspects, particularly as indicated by continued control exceptions or by a failure to adhere to written policies and procedures. The risk-management weaknesses could

16. See SR - 95-51 and SR-16-11.

have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). A rating of 4 represents deficient risk-management practices that fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management is deficient and requires immediate and concerted corrective action by the board and management.

The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in internal control or accounting procedures, or improved adherence to supervisory standards or requirements. The risk-management deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk-management practices with respect to the identification, monitoring, or control over significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies.

Internal controls are critically weak and, as such, could seriously jeopardize the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not taken immediately. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

1062.0.7.2.1 Risk Management Subcomponents

Board and Senior Management Oversight

Rating 1 (Strong). An assessment of "Strong" signifies that the board and senior management are forward-looking, fully understand the types of risk inherent in the holding company's activities, and actively participate in managing those risks. The board has approved overall business strategies and significant policies, and ensures that senior management is fully capable of managing the activities that the holding company conducts. Consistent with the standards of safety and soundness, oversight of risk-management practices is strong and the organization's overall business strategy is effective.

Senior management ensures that risk-management practices are rapidly adjusted in accordance with enhancements to industry practices and regulatory guidance, and exposure limits are adjusted as necessary to reflect the institution's changing risk profile. Policies, limits, and tracking reports are appropriate, understood, and regularly reviewed.

Management provides effective supervision of the day-to-day activities of all officers and employees, including the supervision of the senior officers and the heads of business lines. It hires staff that possess experience and expertise consistent with the scope and complexity of the organization's business activities. There is a sufficient depth of staff to ensure sound operations. Management ensures compliance with laws and regulations and that employees have the integrity, ethical values, and competence consistent with a prudent management philosophy and operating style.

Management responds appropriately to changes in the marketplace. It identifies all risks associated with new activities or products before they are launched, and ensures that the appropriate infrastructure and internal controls are established.

Rating 2 (Satisfactory). An assessment of "Satisfactory" indicates that board and senior management have an adequate understanding of the organization's risk profile and provide largely effective oversight of risk-management practices. In this regard, the board has approved all major business strategies and significant policies, and ensures that senior management is capable of managing the activities that the holding company conducts. Oversight of risk-management practices is satisfactory and the organization's overall business strategy is generally sound.

Senior management generally adjusts risk-management practices appropriately in accordance with enhancements to industry practices and regulatory guidance, and adjusts exposure limits as necessary to reflect the institution's changing risk profile, although these practices may be lacking in some modest degree. Policies, limits, and tracking reports are generally appropriate, understood, and regularly reviewed, and the new product approval process adequately identifies the associated risks and necessary controls.

Senior management's day-to-day supervision of management and staff at all levels is generally effective. The level of staffing, and its experience, expertise, and depth, is sufficient to operate the business lines in a safe and sound manner. Minor weaknesses may exist in the staffing, infrastructure, and risk-management processes for individual business lines or products, but these weaknesses have been identified by management, are correctable in the normal course of business, and are in the process of being addressed. Weaknesses noted should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). An assessment of "Fair" signifies that board and senior management oversight is lacking in some important way and, therefore, is a cause for more than normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. Weaknesses in one or more aspect of board and senior management oversight have precluded the institution from fully addressing one or more significant risks to the institution. The deficiencies may include a lack of knowledge with respect to the organization's risk profile, insufficient oversight of risk-management practices, ineffective policies or limits, inadequate or under-utilized management reporting, an inability to respond to industry enhancements and changes in regulatory guidance, or failure to execute appropriate business strategies. Staffing may not be adequate or staff may not possess the experience and expertise needed for the scope and complexity of the organization's business activities. The day-to-day supervision of officer and staff activities, including the management of senior officers or heads of business lines, may be lacking. Certain risk-management practices are in need of improvement to ensure that management and the board is able to identify, monitor, and control all significant risks to the institution. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). An assessment of "Marginal" represents deficient oversight practices that reflect a lack of adequate guidance and supervision by management and the board. A number of significant risks to the institution have not been adequately addressed, and the board and senior management function warrants a high degree of supervisory attention. Multiple board and senior management weaknesses are in need of immediate improvement. They may include a significant lack of knowledge with respect to the organization's risk profile, largely insufficient oversight of risk-management practices, ineffective policies or limits, inadequate or considerably under-utilized management reporting, an inability to respond to industry enhancements and changes in regulatory guidance, or failure to execute appropriate business strategies. Staffing may not be adequate or possess the experience and expertise needed for the scope and complexity of the organization's business activities, and the day-to-day supervision of officer and staff activities, including the management of senior officers or heads of business lines, may be considerably lacking. These conditions warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of "Unsatisfactory" indicates a critical absence of effective board and senior management oversight practices. Problems may include a severe lack of knowledge with respect to the organization's risk profile, insufficient oversight of risk-management practices, wholly ineffective policies or limits, critically inadequate or underutilized management reporting, a complete inability to respond to industry enhancements and changes in regulatory guidance, or failure to execute appropriate business strategies. Staffing may be inadequate, inexpert, and/or inadequately supervised. The deficiencies require immediate and close supervisory attention, as management and the board have not demonstrated the capability to address them. Weaknesses could seriously jeopardize the continued viability of the institution.

Policies, Procedures, and Limits

Rating 1 (Strong). An assessment of "Strong" indicates that the policies, procedures, and limits provide for effective identification, measurement, monitoring, and control of the risks posed by all significant activities, including lending, investing, trading, trust, and fiduciary activities. Policies, procedures, and limits are consistent with the institution's goals and objectives and its overall financial strength. The policies clearly delineate accountability and lines of authority across the institution's activities. The policies also provide for the review of new activities to ensure that the infrastructure necessary to identify, monitor, and control the associated risks is in place before the activities are initiated.

Rating 2 (Satisfactory). An assessment of "Satisfactory" indicates that the policies, procedures, and limits cover all major business areas, are thorough and substantially up-to-date, and provide a clear delineation of accountability and lines of authority across the institution's activities. Policies, procedures, and limits are generally consistent with the institution's goals and objectives and its overall financial strength. Also, the policies provide for adequate due diligence before engaging in new activities or products. Any deficiencies or gaps that have been identified are minor in nature and in the process of being addressed. Weaknesses should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). An assessment of "Fair" signifies that deficiencies exist in policies, procedures, and limits that require more than normal supervisory attention. The deficiencies may involve a broad range of activities or be material to a major business line or activity. The deficiencies may include policies, procedures, or limits (or the lack thereof) that do not adequately identify, measure, monitor, or control the risks posed by significant activities; are not consistent with the experience of staff, the organization's strategic goals and objectives, or the financial strength of the institution; or do not clearly delineate accountability or lines of authority. Also, the policies may not provide for adequate due diligence before engaging in new activities or products. Weaknesses noted could have adverse effects on the safety and soundness of the institution unless corrective action is taken by management.

Rating 4 (Marginal). An assessment of "Marginal" indicates deficient policies, procedures, and limits that do not address a number of significant risks to the institution. Multiple practices are in need of immediate improvement, which may include policies, procedures, or limits (or the lack thereof) that ineffectively identify, measure, monitor, or control the risks posed by significant activities; are not commensurate with the experience of staff, the institution's strategic goals and objectives, or the financial strength of the institution; or do not delineate accountability or lines of authority. Moreover, policies may be considerably lacking with regards to providing for effective due diligence before engaging in new activities or products. These conditions warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of "Unsatisfactory" indicates a critical absence of effective policies, procedures, and limits. Policies, procedures, or limits (or the lack thereof) are largely or entirely ineffective with regard to identifying, measuring, monitoring, or controlling the risks posed by significant activities; are completely inconsistent with the experience of staff, the organization's strategic goals and objectives, or the financial strength of the institution; or do not delineate accountability or lines of authority. Also, policies may be completely lacking with regard to providing for effective due diligence before engaging in new activities or products. Critical weaknesses could seriously jeopardize the continued viability of the institution and require immediate and close supervisory attention.

Risk Monitoring and MIS

Rating 1 (Strong). An assessment of "Strong" indicates that risk-monitoring practices and MIS reports address all material risks. The key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate, thoroughly documented, and frequently tested for reliability. Reports and other forms of communication are consistent with activities, are structured to monitor exposures and compliance with established limits, goals, or objectives, and compare actual versus expected performance when appropriate. Management and board reports are accurate and timely and contain sufficient information to identify adverse trends and to thoroughly evaluate the level of risk faced by the institution.

Rating 2 (Satisfactory). An assessment of "Satisfactory" indicates that risk-monitoring practices and MIS reports cover major risks and business areas, although they may be lacking in some modest degree. In general, the reports contain valid assumptions that are periodically tested for accuracy and reliability and are adequately documented and distributed to the appropriate decisionmakers. Reports and other forms of communication generally are consistent with activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and compare actual versus expected performance when appropriate. Management and board reports are generally accurate and timely, and broadly identify adverse trends and the level of risk faced by the institution. Any weaknesses or deficiencies that have been identified are in the process of being addressed.

Rating 3 (Fair). An assessment of “Fair” signifies that weaknesses exist in the institution’s risk-monitoring practices or MIS reports that require more than normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. They may contribute to ineffective risk identification or monitoring through inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. In addition, MIS reports may not be distributed to the appropriate decisionmakers, adequately monitor significant risks, or properly identify adverse trends and the level of risk faced by the institution. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). An assessment of “Marginal” represents deficient risk-monitoring practices or MIS reports that, unless properly addressed, could seriously affect the safety and soundness of the institution. A number of significant risks to the institution are not adequately monitored or reported. Ineffective risk identification may result from notably inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. In addition, MIS reports may not be distributed to the appropriate decisionmakers, may inadequately monitor significant risks, or fail to identify adverse trends and the level of risk faced by the institution. The risk monitoring and MIS deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of “Unsatisfactory” indicates a critical absence of risk monitoring and MIS. They are wholly deficient due to inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. Moreover, MIS reports may not be distributed to the appropriate decisionmakers, fail to monitor significant risks, or fail to identify adverse trends and the level of risk faced by the institution. These critical weaknesses require immediate and close supervisory attention, as they could seriously jeopardize the continued viability of the institution.

Internal Controls

Rating 1 (Strong). An assessment of “Strong” indicates that the system of internal controls is robust for the type and level of risks posed by the nature and scope of the organization’s activities. The organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits, and wherever applicable, exceptions are noted and promptly investigated. Reporting lines provide clear independence of the control areas from the business lines and separation of duties throughout the organization. Robust procedures exist for ensuring compliance with applicable laws and regulations, including consumer laws and regulations. Financial, operational, and regulatory reports are reliable, accurate, and timely. Internal audit or other control review practices provide for independence and objectivity. Internal controls and information systems are thoroughly tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are well documented; identified material weaknesses are given thorough and timely high-level attention; and management’s actions to address material weaknesses are objectively reviewed and verified. The board or its audit committee regularly reviews the effectiveness of internal audits and other control review activities.

Rating 2 (Satisfactory). An assessment of “Satisfactory” indicates that the system of internal controls adequately covers major risks and business areas, with some modest weaknesses. In general, the control functions are independent from the business lines, and there is appropriate separation of duties. The control system supports accuracy in record-keeping practices and reporting systems, is adequately documented, and verifies compliance with laws and regulations, including consumer laws and regulations. Internal controls and information systems are adequately tested and reviewed, and the coverage, procedures, findings, and responses to audits and review tests are documented. Identified material weaknesses are given appropriate attention and management’s actions to address material weaknesses are objectively reviewed and verified. The board or its audit committee reviews the effectiveness of internal audits and other control review activities. Any weaknesses or deficiencies that have been identified are modest in nature and in the process of being addressed.

Rating 3 (Fair). An assessment of “Fair” signifies that weaknesses exist in the system of internal controls that require more than normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. The weaknesses may include insufficient oversight of internal controls and audit by the board or its audit committee; unclear or conflicting lines of authority and responsibility; a lack of independence between control areas and business activities; or ineffective separation of duties. The internal control system may produce inadequate or untimely risk coverage and verification, including monitoring compliance with both safety and soundness and consumer laws and regulations; inaccurate records or financial, operational, or regulatory reporting; a lack of documentation for work performed; or a lack of timeliness in management review and correction of identified weaknesses. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). An assessment of "Marginal" represents a deficient internal control system that does not adequately address a number of significant risks to the institution. The deficiencies may include neglect of internal controls and audit by the board or its audit committee; conflicting lines of authority and responsibility; a lack of independence between control areas and business activities; or no separation of duties in critical areas. The internal control system may produce inadequate, untimely, or nonexistent risk coverage and verification in certain areas, including monitoring compliance with both safety and soundness and consumer laws and regulations; inaccurate records or financial, operational, or regulatory reporting; a lack of documentation for work performed; or infrequent management review and correction of identified weaknesses. The internal control deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of "Unsatisfactory" indicates a critical absence of an internal control system. There may be no oversight by the board or its audit committee; conflicting lines of authority and responsibility; no distinction between control areas and business activities; or no separation of duties. The internal control system may produce totally inadequate or untimely risk coverage and verification, including monitoring compliance with both safety and soundness and consumer laws and regulations; completely inaccurate records or regulatory reporting; a severe lack of documentation for work performed; or no management review and correction of identified weaknesses. Such deficiencies require immediate and close supervisory attention, as they could seriously jeopardize the continued viability of the institution.

1062.0.7.3 Financial Condition Component

Rating 1 (Strong). A rating of 1 indicates that the consolidated holding company is financially sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. The capital adequacy, asset quality, earnings, and liquidity of the consolidated holding company are more than adequate to protect the company from reasonably foreseeable external economic and financial disturbances. The company generates more than sufficient cash flow to service its debt and fixed obligations with no harm to subsidiaries of the organization.

Rating 2 (Satisfactory). A rating of 2 indicates that the consolidated holding company is fundamentally financially sound, but may have modest weaknesses correctable in the normal course of business. The capital adequacy, asset quality, earnings and liquidity of the consolidated holding company are adequate to protect the company from external economic and financial disturbances. The company also generates sufficient cash flow to service its obligations; however, areas of weakness could develop into areas of greater concern. To the extent minor adjustments are handled in the normal course of business, the supervisory response is limited.

Rating 3 (Fair). A rating of 3 indicates that the consolidated holding company exhibits a combination of weaknesses ranging from fair to moderately severe. The company has less than adequate financial strength stemming from one or more of the following: modest capital deficiencies, substandard asset quality, weak earnings, or liquidity problems. As a result, the holding company and its subsidiaries are less resistant to adverse business conditions. The financial condition of the holding company will likely deteriorate if concerted action is not taken to correct areas of weakness. The company's cash flow is sufficient to meet immediate obligations, but may not remain adequate if action is not taken to correct weaknesses. Consequently, the holding company is vulnerable and requires more than normal supervision. Overall financial strength and capacity are still such as to pose only a remote threat to the viability of the company.

Rating 4 (Marginal). A rating of 4 indicates that the consolidated holding company has either inadequate capital, an immoderate volume of problem assets, very weak earnings, serious liquidity issues, or a combination of factors that are less than satisfactory. An additional weakness may be that the holding company's cash flow needs are met only by upstreaming imprudent dividends and/or fees from subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. Holding companies in this category require close supervisory attention and increased financial surveillance.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the volume and character of financial weaknesses of the holding company are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such a company to service its fixed obligations and/or prevent capital depletion due to severe operating losses places its viability in serious doubt. Such companies require immediate corrective action and constant supervisory attention.

1062.0.7.3.1 The Financial Condition Subcomponents

The financial condition subcomponents can be evaluated along business lines, product lines, or legal entity lines—depending on which type of review is most appropriate for the holding company structure.

Capital Adequacy

Rating 1 (Strong). A rating of 1 indicates that the consolidated holding company maintains more than adequate capital to support the volume and risk characteristics of all parent and subsidiary business lines and products; provide a sufficient cushion to absorb unanticipated losses arising from the parent and subsidiary activities; and support the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 1 has more than sufficient capital to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries.

Rating 2 (Satisfactory). A rating of 2 indicates that the consolidated holding company maintains adequate capital to support the volume and risk characteristics of all parent and subsidiary business lines and products; provide a sufficient cushion to absorb unanticipated losses arising from the parent and subsidiary activities; and support the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 2 has sufficient capital to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries.

Rating 3 (Fair). A rating of 3 indicates that the consolidated holding company may not maintain sufficient capital to ensure support for the volume and risk characteristics of all parent and subsidiary business lines and products; the unanticipated losses arising from the parent and subsidiary activities; or the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 3 may not maintain a sufficient capital position to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries. The capital position of the consolidated holding company could quickly become inadequate in the event of asset deterioration or other negative factors and therefore requires more than normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the capital level of the consolidated holding company is significantly below the amount needed to ensure support for the volume and risk characteristics of all parent and subsidiary business lines and products; the unanticipated losses arising from the parent and subsidiary activities; and the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 4 does not maintain a sufficient capital position to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries. If left unchecked, the consolidated capital position of the company might evolve into weaknesses or conditions that could threaten the viability of the institution. The capital position of the consolidated holding company requires immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the level of capital of the consolidated holding company is critically deficient and in need of immediate corrective action. The consolidated capital position threatens the viability of the institution and requires constant supervisory attention.

Asset Quality

Rating 1 (Strong). A rating of 1 indicates that the holding company maintains strong asset quality across all parts of the organization, with a very low level of criticized and nonperforming assets. Credit risk across the organization is commensurate with management's abilities and modest in relation to credit risk-management practices.

Rating 2 (Satisfactory). A rating of 2 indicates that the holding company maintains satisfactory asset quality across all parts of the organization, with a manageable level of criticized and nonperforming assets. Any identified weaknesses in asset quality are correctable in the normal course of business. Credit risk across the organization is commensurate with management's abilities and generally modest in relation to credit risk-management practices.

Rating 3 (Fair). A rating of 3 indicates that the asset quality across all or a material part of the consolidated holding company is less than satisfactory. The holding company may be facing a decrease in the overall quality of assets currently maintained on and off balance sheet. The holding company may also be experiencing an increase in credit-risk exposure that has not been met with an appropriate improvement in risk-management practices. Holding companies assigned a rating of 3 require more than normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the holding company's asset quality is deficient. The level of problem assets and/or unmitigated credit risk subjects the holding company to potential losses that, if left unchecked, may threaten its viability. Holding companies assigned a rating of 4 require immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the holding company's asset quality is critically deficient and presents an imminent threat to the institution's viability. Holding companies assigned a rating of 5 require immediate remedial action and constant supervisory attention.

Earnings

Rating 1 (Strong). A rating of 1 indicates that the quantity and quality of the holding company's consolidated earnings over time are more than sufficient to make full provision for the absorption of losses and/or accretion of capital when due consideration is given to asset quality and holding company growth. Generally, holding companies with a 1 rating have earnings well above peer-group averages.

Rating 2 (Satisfactory). A rating of 2 indicates that the quantity and quality of the holding company's consolidated earnings over time are generally adequate to make provision for the absorption of losses and/or accretion of capital when due consideration is given to asset quality and holding company growth. Generally, holding companies with a 2 rating have earnings that are in line with or slightly above peer-group averages.

Rating 3 (Fair). A rating of 3 indicates that the holding company's consolidated earnings are not fully adequate to make provisions for the absorption of losses and the accretion of capital in relation to company growth. The consolidated earnings of companies rated 3 may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality. Holding companies with a 3 rating generally have earnings below peer-group averages. Such holding companies require more than normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the holding company's consolidated earnings, while generally positive, are clearly not sufficient to make full provision for losses and the necessary accretion of capital. Holding companies with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. The earnings of such companies are generally substantially below peer-group averages. Such holding companies require immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the holding company is experiencing losses or a level of earnings that is worse than that described for the 4 rating. Such losses, if not reversed, represent a distinct threat to the holding company's solvency through erosion of capital. Such holding companies require immediate and constant supervisory attention.

Liquidity

Rating 1 (Strong). A rating of 1 indicates that the holding company maintains strong liquidity levels and well-developed funds-management practices. The parent company and subsidiaries have reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

Rating 2 (Satisfactory). A rating of 2 indicates that the holding company maintains satisfactory liquidity levels and funds-management practices. The parent company and subsidiaries have access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses in funds-management practices may be evident, but those weaknesses are correctable in the normal course of business.

Rating 3 (Fair). A rating of 3 indicates that the holding company's liquidity levels or funds-management practices are in need of improvement. Holding companies rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds-management practices at the parent company or subsidiary levels. However, these deficiencies are considered correctable in the normal course of business. Such holding companies require more than normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the holding company's liquidity levels or funds-management practices are deficient. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs at the parent company or subsidiary levels and require immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the holding company's liquidity levels or funds-management practices are critically deficient and may threaten the continued viability of the institution. Institutions rated 5 require constant supervisory attention and immediate external financial assistance to meet maturing obligations or other liquidity needs.

1062.0.7.4 Impact Component

The I component rating reflects the aggregate potential impact of the nondepository entities on the subsidiary depository institution(s). It is rated on a five-point numerical scale. Ratings will be assigned in ascending order of supervisory concern as follows:

1—low likelihood of significant negative impact;

2—limited likelihood of significant negative impact;

3—moderate likelihood of significant negative impact;

4—considerable likelihood of significant negative impact; and

5—high likelihood of significant negative impact.

Rating 1 (Low Likelihood of Significant Negative Impact). A rating of 1 indicates that the nondepository entities of the holding company are highly unlikely to have a significant negative impact on the subsidiary depository institution(s) due to the sound financial condition of the nondepository entities, the strong risk-management practices within the nondepository entities, or the corporate structure of the holding company. The holding company maintains an appropriate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are very unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is sufficient and not dependent on excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within or facing the nondepository entities are minor in nature and can be addressed in the normal course of business.

Rating 2 (Limited Likelihood of Significant Negative Impact). A rating of 2 indicates a limited likelihood that the nondepository entities of the holding company will have a significant negative impact on the subsidiary depository institution(s) due to the adequate financial condition of the nondepository entities, the satisfactory risk-management practices within the parent nondepository entities, or the corporate structure of the holding company. The holding company maintains adequate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is satisfactory and generally does not require excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within the nondepository entities are modest and can be addressed in the normal course of business.

Rating 3 (Moderate Likelihood of Significant Negative Impact). A rating of 3 indicates a moderate likelihood that the aggregate impact of the nondepository entities of the holding company on the subsidiary depository institution(s) will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk management practices of the nondepository entities. The holding company may have only marginally sufficient allocation of capital across the organization to support risks. Intra-group exposures, including servicing agreements, may have the potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may at times require excessive dividend payments from subsidiaries. Strategic growth plans, weaknesses in the control environment, risk concentrations or legal or reputational issues within the nondepository entities may pose significant risks to the subsidiary depository institution(s). A holding company assigned a 3 impact rating requires more than normal supervisory attention, as there could be adverse effects on the safety and soundness of the subsidiary depository institution(s) if corrective action is not taken by management.

Rating 4 (Considerable Likelihood of Significant Negative Impact). A rating of 4 indicates that there is a considerable likelihood that the nondepository entities of the holding company will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk-management practices of the nondepository entities. A 4-rated holding company may have insufficient capital within the nondepository entities to support their risks and activities. Intra-group exposures, including servicing agreements, may also have the immediate potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may be dependent on excessive dividend payments from subsidiaries. Strategic growth plans, weaknesses in the control environment, risk concentrations or legal or reputational issues within the nondepository entities may pose considerable risks to the subsidiary depository institution(s). A holding company assigned a 4 impact rating requires immediate remedial action and close supervisory attention because the nondepository entities could seriously affect the safety and soundness of the subsidiary depository institution(s).

Rating 5 (High Likelihood of Significant Negative Impact). A rating of 5 indicates a high likelihood that the aggregate impact of the nondepository entities of the holding company on the subsidiary depository institution(s) is or will become significantly negative due to substantial weaknesses in the financial condition and/or risk-management practices of the nondepository entities. Strategic growth plans, a deficient control environment, risk concentrations or legal or reputational issues within the nondepository entities may pose critical risks to the subsidiary depository institution(s). The parent company also may be unable to meet its obligations without excessive support from the subsidiary depository institution(s). The holding company requires immediate and close supervisory attention, as the nondepository entities seriously jeopardize the continued viability of the subsidiary depository institution(s).

1062.0.7.5 (D) Depository Institutions Component

The (D) component identifies the overall condition of the subsidiary depository institution(s) of the holding company. For holding companies with only one subsidiary depository institution, the (D) component rating generally will mirror the CAMELS composite rating for that depository institution. To arrive at a (D) component rating for holding companies with multiple subsidiary depository institutions, the CAMELS composite ratings for each of the depository institutions should be weighted, giving consideration to asset size and the relative importance of each depository institution within the overall structure of the organization. In general, it is expected that the resulting (D) component rating will reflect the lead depository institution's CAMELS composite rating.

If in the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Federal Reserve and the depository institution's primary regulator, then the (D) rating should reflect the Federal Reserve's evaluation.

Managing risks is fundamental to the business of banking. Accordingly, the Federal Reserve places significant supervisory emphasis on an institution's management of risk, including its system of internal controls, when evaluating the overall effectiveness of an institution's risk management. An institution's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks of its activities has long been considered unsafe-and-unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing an institution including, but not limited to, credit, market, liquidity, operational, compliance, and legal risk:

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.
- *Liquidity risk* is the potential that a financial institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market liquidity risk").
- *Operational risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events.[1]
- *Compliance risk* is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal risk* is the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

1. This definition conforms to the Basel Committee on Banking Supervision's "Principles for the Sound Management of Operational Risk," June 2011, Bank for International Settlements.

The risk-management expectations outlined in this guidance are applicable to all supervised institutions with total consolidated assets less than $100 billion, including state member banks, bank holding companies, savings and loan holding companies, and foreign banking organizations with combined total U.S. assets of less than $100 billion. This guidance also applies to insurance and commercial savings and loan holding companies with total consolidated assets less than $100 billion by providing core risk-management guidance. Reserve Bank staff may further consult with Board staff on appropriately tailoring this guidance for these institutions. This guidance is not applicable to intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY with total consolidated assets of $50 billion or more.

These risks and the activities associated with them are addressed in greater detail in the Federal Reserve's supervision manuals and other guidance documents.[2] In practice, an institution's business activities present various combinations, concentrations, and interrelationships of these risks depending on the nature and scope of the particular activity. The following discussion provides guidelines for the supervisory assessment of the overall effectiveness of an institution's risk management and its formal or informal systems for identifying, measuring, monitoring, and controlling these risks. Refer to SR-16-11 and its attachment.

1062.1.1 ELEMENTS OF RISK MANAGEMENT

When evaluating the risk management at an institution as part of the evaluation of the overall effectiveness of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:

2. Refer to the Federal Reserve's *Commercial Bank Examination Manual*, this *Bank Holding Company Supervision Manual, Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*, and relevant FFIEC Examination Manuals.

- board[3] and senior management oversight
- policies, procedures, and limits
- risk monitoring and management information systems
- internal controls

Each of these elements is described further below, along with a list of considerations relevant to assessing each element. Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk-management practices and are not a checklist of requirements for each institution.

An institution's risk-management processes are expected to evolve in sophistication, commensurate with the institution's asset growth, complexity, and risk. At a larger or more complex organization, the institution should have more sophisticated risk-management processes that address the full range of risks regardless of where the activity is conducted in the organization. Moreover, while a holding company should be able to assess the major risks of the consolidated organization, examiners should expect a parent company that centrally manages the operations and functions of its subsidiary banks to have more comprehensive, detailed, and developed risk-management systems than a parent company that delegates the management of risks to relatively autonomous subsidiaries.[4]

For a small community banking organization (CBO) engaged solely in traditional banking activities and whose senior management is actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. In accordance with the *Interagency Guidelines Establishing Standards for Safety and Soundness*, a CBO is expected, at a minimum, to have internal controls, information systems, and internal audits that are appropriate for the size of the institution and the nature, scope, and risk of its activities.[5]

The risk-management processes of a regional banking organization (RBO) would typically contain detailed guidelines that set specific prudent limits on the principal types of risks relevant to a RBO's consolidated activities.[6] Furthermore, because of the diversity and the geographic dispersion of their activities, these institutions will require relatively more sophisticated information systems that provide management with timely information that supports the management of risks. The information systems, in turn, should provide management with information that present a consolidated and integrated view of risks that are relevant to the duties and responsibilities of individual managers, senior management, and the board of directors.[7]

Consistent with the principle of national treatment,[8] the Federal Reserve has the same supervisory goals and standards for the U.S. operations of FBOs as for domestic organizations of similar size, scope, and complexity. Given the added element of foreign ownership, an FBO's risk-management processes and control functions for the U.S. operations may be implemented domestically or outside of the United States. In cases where these functions are performed outside of the United States, the FBO's oversight function, policies and procedures, and information systems need to be sufficiently transparent to allow U.S. supervisors to assess their adequacy. Additionally, the FBO's U.S. senior management need to demonstrate and maintain a thorough understanding of all relevant risks affecting the U.S. operations and the associated management information systems, used to manage and monitor these risks within the U.S. operations.

The information systems at a larger institution will naturally require frequent monitoring and testing by independent control areas and by both internal and external auditors, to ensure the integrity of the information used by the board of directors and senior management in overseeing compliance with policies and limits. Therefore,

3. For the purpose of this guidance, for foreign banking organizations, "board of directors" refers to the equivalent governing body of the U.S. operations of the FBO.

4. If these subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank. Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion."

5. Refer to 12 CFR 208, Appendix D-1, the *Interagency Guidelines Establishing Standards for Safety and Soundness*.

6. The Federal Reserve considers an RBO to be a midsize financial institution with total consolidated assets between $10 and $100 billion.

7. Subpart C of the Federal Reserve's Regulation YY includes risk committee requirements for bank holding companies with total consolidated assets between $50 billion and $100 billion.

8. National treatment requires nondiscrimination between domestic and foreign firms, or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. The International Banking Act of 1978 generally gives foreign banks operating in the United States the same powers as domestic banking organizations and subjects them to the same restrictions and obligations.

an institution's risk oversight function needs to be sufficiently independent of the business lines to achieve an adequate separation of duties and the avoidance of conflicts of interest.

1062.1.1.1 Board and Senior Management Oversight

The board of directors has the responsibility for establishing the level of risk that the institution should take. Accordingly, the board of directors should approve the institution's overall business strategies and significant policies, including those related to managing risks. Further, the board of directors should also ensure that senior management is fully capable of implementing the institution's business strategies and risk limits. In evaluating senior management, the board of directors should consider whether management is taking the steps necessary to identify, measure, monitor, and control these risks.

The board of directors should collectively have a balance of skills, knowledge, and experience to clearly understand the activities and risks to which the institution is exposed. The board of directors should take steps to develop an appropriate understanding of the risks the institution faces, through briefings from experts internal to their organization and potentially from external experts. The institution's management information systems should provide the board of directors with sufficient information to identify the size and significance of the risks. Using this knowledge and information, the board of directors should provide clear guidance regarding the level of exposures acceptable to the institution and oversee senior management's implementation of the procedures and controls necessary to comply with approved policies.

Senior management is responsible for implementing strategies set by the board of directors in a manner that controls risks and that complies with laws, rules, regulations, or other supervisory requirements on both a long-term and day-to-day basis. Accordingly, senior management should be fully involved in and possess sufficient knowledge of all activities to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Senior management is also responsible for establishing and communicating a strong awareness of the need for effective risk management, internal controls, and high ethical business practices. To fulfill these responsibilities, senior management needs to have a thorough understanding of banking and financial market activities and detailed knowledge of the institution's activities, including the internal controls that are necessary to limit the related risks.

In assessing the quality of the oversight provided by the board of directors and senior management, examiners should consider the following:

- The board of directors has approved significant policies to establish risk tolerances for the institution's activities and periodically reviews risk exposure limits to align with changes in the institution's strategies, address new activities and products, and react to changes in the industry and market conditions.
- Senior management has identified and has a clear understanding and working knowledge of the risks inherent in the institution's activities. Senior management also remains informed about these risks as the institution's business activities evolve or expand and as changes and innovations occur in financial markets and risk-management practices.
- Senior management has identified and reviewed risks associated with engaging in new activities or introducing new products to ensure that the necessary infrastructure and internal controls are in place to manage the related risks.
- Senior management has ensured that the institution's activities are managed and staffed by personnel with the knowledge, experience, and expertise consistent with the nature and scope of the institution's activities and risks.
- All levels of senior management provide appropriate management of the day-to-day activities of officers and employees, including oversight of senior officers or heads of business lines.
- Senior management has established and maintains effective information systems to identify, measure, monitor, and control the sources of risks to the institution.

1062.1.1.2 Policies, Procedures, and Limits

Although an institution's board of directors approves an institution's overall business strategy and policy framework, senior management develops and implements the institution's risk-management policies and procedures that address the types of risks arising from its activities. Once the risks are properly identified, the institution's policies and procedures should provide guidance for the day-to-day implementation of business strategies, including limits designed to prevent excessive and imprudent risks. An institution should have policies and procedures that address its significant activities and risks with the appropriate level of detail to address the type and complexity of the institution's operations. A smaller, less complex institution that has effective senior management directly involved in day-to-day operations would generally not be expected to have policies as sophisticated as larger institutions. In a larger institution, where senior managers rely on widely-dispersed staffs to implement strategies for more varied and complex businesses, far more detailed policies and procedures would generally be expected. In either case, senior management is expected to ensure that policies and procedures address the institution's material areas of risk and that policies and procedures are modified when necessary to respond to significant changes in the institution's activities or business conditions.

The following guidelines should assist examiners in evaluating an institution's policies, procedures, and limits

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its significant risk-taking activities.
- The institution's policies, procedures, and limits are consistent with its stated strategy and risk profile.
- The policies and procedures establish accountability and lines of authority across the institution's activities.
- The policies and procedures provide for the review and approval of new business lines, products, and activities, as well as material modifications to existing activities, services, and products, to ensure that the institution has the infrastructure necessary to identify, measure, monitor, and control associated risks before engaging in a new or modified business line, product, or activity.

1062.1.1.3 Risk Monitoring and Management Information Systems

Institutions of all sizes are expected to have risk monitoring and management information systems in place that provide the board of directors and senior management with timely information and a clear understanding of the institution's business activities and risk exposures. The sophistication of risk monitoring and management information systems should be commensurate with the complexity and diversity of the institution's operations. Accordingly, a smaller and less complex institution may require less frequent management and board reports to support risk monitoring activities. For example, these reports may include, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report on past due loans, an interest rate risk report, and similar items. In contrast, a larger, more complex institution would be expected to have much more comprehensive reporting and monitoring systems, which includes more frequent reporting to board and senior management, tighter monitoring of high-risk activities, and the ability to aggregate risks on a fully consolidated basis across all business lines, legal entities, and activities.

In assessing an institution's measurement and monitoring of risk and its management reports and information systems, examiners should consider whether these conditions exist:

- The institution's risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, models, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an ongoing basis.[9]
- Reports and other forms of communication address the complexity and range of an institution's activities, monitor key exposures and compliance with established limits and strategy, and as appropriate, compare actual versus expected performance.
- Reports to the board of directors and senior management are accurate, and provide timely and sufficient information to identify any adverse trends and to evaluate the level of risks faced by the institution.

1062.1.1.4 Internal Controls

An effective internal control structure is critical to the safe and sound operation of an institution. Effective internal controls promote reliable financial and regulatory reporting, safeguard assets, and help to ensure compliance with relevant laws, rules, regulations, supervisory require-

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

ments, and institutional policies. Therefore, an institution's senior management is responsible for establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate segregation of duties.

Adequate segregation of duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate segregation of duties can constitute an unsafe-and-unsound practice and possibly lead to serious losses or otherwise compromise the integrity of the institution's internal controls. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

Internal controls should be tested by an independent party who reports either directly to the institution's board of directors or its designated committee, which is typically the audit committee.[10] However, small CBOs whose size and complexity do not warrant a full scale internal audit function may rely on regular reviews of essential internal controls conducted by other institution personnel. Given the importance of appropriate internal controls to institutions of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to the findings. In addition, communication channels should allow for adverse or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

In evaluating internal controls, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the institution's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for risk management and for monitoring adherence to policies, procedures, and limits.
- Internal audit or other control functions, such as loan review and compliance, provide for independence and objectivity.
- The official organizational structures reflect actual operating practices and management responsibilities and authority over a particular business line or activity.
- Financial, operational, risk management, and regulatory reports are reliable, accurate, and timely; and wherever applicable, material exceptions are noted and promptly investigated or remediated.
- Policies and procedures for control functions support compliance with applicable laws, rules, regulations, or other supervisory requirements.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits, regulatory examinations, and other review tests are adequately documented; identified material weaknesses are given appropriate and timely, high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's board of directors, or audit committee, and senior management are responsible for developing and implementing an effective system of internal controls and that the internal controls are operating effectively.

1062.1.1.5 Conclusions

Examiners are expected to assess risk management for an institution and assign formal ratings of "risk management" as described in the *Commercial Bank Examination Manual* for state member banks, this manual for holding companies, and the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations.*[11] In reports of examination or inspection, and in transmittal letters to the boards of directors of state member banks, holding companies,[12] and to the FBO officer of the U.S. operations, examination staff should specifically

10. Given the importance of the internal audit function, several additional policy statements have been issued. For comprehensive guidance on internal audit, see SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing" and for institutions with more than $10 billion in assets, see SR-13-1/ CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

11. Refer to section 1200.1 of the *Commercial Bank Examination Manual*; section 1062.0 of the *Bank Holding Company Supervision Manual*; and section 2003.1 of the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*. For savings and loan holding companies, see also SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

12. SR-16-11 applies to insurance and commercial savings and loan holding companies with total consolidated assets less than $100 billion by providing core risk-management guidance. Reserve Bank staff should further consult with Board staff on appropriately tailoring this guidance for these institutions.

reference the types and nature of corrective actions that need to be taken by an institution to address noted risk management and internal control deficiencies. Where appropriate, the Federal Reserve will advise an institution that supervisory action will be initiated, if the institution fails to timely remediate risk-management weaknesses when such failures create the potential for serious losses or if material deficiencies or situations threaten its safety and soundness. Such supervisory actions may include formal enforcement actions against the institution, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

If bank or holding company subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion."

Holding Company Ratings Applicability and Inspection Frequency Section 1063.0

The purpose of this section is to provide an overview of the inspection scope and frequency expectations for bank holding companies (BHCs) and savings and loan holding companies (SLHCs) supervised by the Federal Reserve. The Federal Reserve utilizes different rating systems to assess these and other holding companies.

BHCs and non-insurance, non-commercial SLHCs with total consolidated assets of $100 billion or more generally are subject to the large financial institution (LFI) rating system. (See section 1060.0 of this manual.) U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of $50 billion or more established pursuant to the Federal Reserve's Regulation YY are also subject to the LFI rating system.

BHCs and non-insurance and non-commercial SLHCs with less than $100 billion in total consolidated assets generally are subject to the RFI rating system. (See section 1062.0 of this manual.) However, noncomplex holding companies with less than $3 billion in total consolidated assets only receive the risk-management rating and composite rating from the RFI rating system.

BHCs exempt from the prohibitions of section 4 of the Bank Holding Company Act of 1956, as amended, as a result of any of the following exemptions, will not be subject to any required periodic inspection:

1. section 4(a)(2)—permanent grandfather rights
2. section 4(c)(i)—labor, agricultural, or horticultural organization
3. section 4(c)(ii)—85 percent family-owned
4. section 4(c)(12)—irrevocable declaration to cease to be a BHC
5. section 4(d)—hardship exemption

However, the Reserve Bank should continue to monitor the financial condition of such holding companies and should conduct inspections whenever there is any indication of a potential problem in a subsidiary bank.

1063.0.1 RATING SYSTEMS FOR HOLDING COMPANIES

Rating System	Rating System Components	Applicability
LFI rating (SR-19-3/CA-19-2)	• Capital planning and positions • Liquidity risk management and positions • Governance and controls	• BHCs with total consolidated assets of $100 billion or more • Non-insurance, non-commercial SLHCs with total consolidated assets of $100 billion or more • U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of $50 billion or more established under the Board's Regulation YY
RFI rating (SR-19-4/CA-19-3)	• Risk management (4 subcomponents) ○ Board and senior management oversight, ○ Policies, procedures, and limits, ○ Risk monitoring and management information systems, and ○ Internal controls • Financial condition (4 subcomponents) ○ Capital, ○ Asset quality, ○ Earnings, and ○ Liquidity • Impact • Composite rating • Depository institutions	• BHCs with $3 billion or more and less than $100 billion in total consolidated assets • Non-insurance and non-commercial SLHCs with $3 billion or more and less than $100 billion in total consolidated assets • Complex BHCs and complex non-insurance and non-commercial SLHCs with less than $3 billion in total consolidated assets
Modified RFI rating (SR-13-21)	• Risk-management (no subcomponents) • Composite rating	Noncomplex BHCs and noncomplex non-insurance and non-commercial SLHCs with less than $3 billion in total consolidated assets
Supervised insurance organization rating (SR-22-8)	• Governance and controls, • Capital management, and • Liquidity management	Supervised insurance organizations[1]
Indicative RFI rating	Indicates to the firm how it would be rated if the RFI rating system was formally applied.	Commercial SLHCs[2]

1. A supervised insurance organization is a depository institution holding company that is an insurance underwriting company, or that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries or has been otherwise designated as a supervised insurance organization by Federal Reserve staff.

2. SLHCs are considered to be “commercial SLHCs” if they derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)).

1063.0.2 GENERAL INSPECTION FREQUENCY FOR A HOLDING COMPANY

<table>
<tr><th></th><th colspan="5">Total consolidated asset size</th></tr>
<tr><th>Type of holding company</th><td>$100 billion or more</td><td>$10 billion or more and less than $100 billion</td><td>$3 billion or more and less than $10 billion</td><td>Less than $3 billion (complex)</td><td>Less than $3 billion (non-complex)</td></tr>
<tr><td>Bank holding company[1]</td><td colspan="2" rowspan="3">Ratings (or indicative ratings) assigned and communicated to firms on at least an annual basis, and more frequently as warranted.</td><td colspan="3" rowspan="3">See the table below and SR letter 13-21, and its attachment for more information on inspection frequency and scope.</td></tr>
<tr><td>Non-insurance and non-commercial savings and loan holding company</td></tr>
<tr><td>Commercial savings and loan holding company[2]</td></tr>
<tr><td>Intermediate holding company</td><td colspan="5">U.S. intermediate holding companies of foreign banking organizations established under the Board’s Regulation YY that have $50 billion or more in total consolidated assets are assigned an LFI rating on at least an annual basis, and more frequently as warranted.</td></tr>
<tr><td>Supervised insurance organization</td><td colspan="5">“Complex” supervised insurance organizations are assigned ratings on an annual basis.[3] Noncomplex supervised insurance organizations are assigned ratings no less often than every other year.</td></tr>
</table>

1. BHCs exempt from the prohibitions of section 4 of the Bank Holding Company Act of 1956, as amended, are not subject to any required periodic inspection.

2. SLHCs are considered to be “commercial savings and loan holding companies” if they derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)).

3. A supervised insurance organization is automatically classified as “complex” if its depository institution’s average assets exceed $100 billion.

1063.0.3 Small Holding Company Inspection Scope and Frequency

<table>
<tr><th colspan="2">Asset size</th><th colspan="2">$3 billion or more and less than $10 billion</th><th colspan="2">Less than $3 billion</th></tr>
<tr><th colspan="2">Complexity[2]</th><th>Complex</th><th>Noncomplex</th><th>Complex</th><th>Noncomplex</th></tr>
<tr><th colspan="2">Type of rating</th><th>Complete RFI rating</th><th>Complete RFI rating</th><th>Complete RFI rating</th><th>Risk-management rating and composite rating only</th></tr>
<tr><td rowspan="2">Scope and frequency[1]</td><td>Rating of 1 or 2</td><td>Full scope on-site inspection is expected annually.
Additional targeted follow-up may be needed in response to off-site surveillance program results.</td><td>Off-site targeted inspection is expected every two years.
Additional targeted follow-up may be needed in response to off-site surveillance program results.</td><td rowspan="2">Off-site review should be conducted upon receipt of the lead DI exam report or an updated rating from the primary supervisor using surveillance results and relevant supervisory and financial information. If the information obtained off-site is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a complete RFI rating, the Reserve Bank should conduct an on-site review of the company.
Any on-site review should be targeted at those areas where additional information or analysis is needed to assign a complete supervisory rating.</td><td>If all subsidiary DIs have a management component rating and a composite supervisory rating of “1” or “2” and no material holding company issues are otherwise indicated, the Reserve Bank should assign only a composite rating and risk-management rating to the holding company based on the ratings of the lead DI.</td></tr>
<tr><td>Rating of 3, 4, or 5</td><td>Full scope on-site inspection is expected annually.
If the primary supervisor has conducted an interim examination or changed the rating at the lead depository institution (DI), the Reserve Bank should conduct an additional targeted inspection and update the rating if necessary. The targeted inspection may be conducted off-site and should start within 60 days of receiving the examination report for the lead DI.
Additional targeted follow-up may be needed in response to off-site surveillance program results.</td><td>Full-scope off-site inspection is expected annually.
If the primary supervisor has conducted an interim examination or changed the rating at the lead DI, the Reserve Bank staff should conduct an additional targeted inspection and update the rating if necessary. This targeted inspection may be conducted off-site and should start within 60 days of receiving the examination report for the lead DI.
Additional targeted follow-up may be needed in response to off-site surveillance program results.</td><td>If one or more subsidiary DIs have a management component rating or a composite supervisory rating of “3,” “4,” or “5” or a material holding company issue is otherwise indicated, an off-site review is expected upon receipt of the lead DI exam report or an updated rating from the primary supervisor using surveillance results and relevant supervisory and financial information. If the information obtained off-site is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a risk-management rating and a composite rating, contact the holding company to obtain more information.</td></tr>
<tr><td rowspan="2">Report expectations</td><td>Rating of 1, 2, or 3</td><td colspan="3">A letter-format report template has been developed for supervision staff completing reports for holding companies that receive a complete RFI rating and have a composite rating of 1, 2, or 3.</td><td rowspan="2">Off-site reviews culminate in the issuance of a transmittal letter communicating the ratings to the company. Information in the transmittal letter review focuses on parent and nonbanking activities. Examiners also rely on the primary regulator’s work on the subsidiary insured depository institution and relevant surveillance results.</td></tr>
<tr><td>Rating of 4 or 5</td><td colspan="3">Letter-format report of inspection may be prepared as indicated in the Community Bank Supervision Process section of the Commercial Bank Examination Manual.</td></tr>
</table>

1. Full-scope inspection covers all areas of interest to the Federal Reserve in depth; targeted inspections will focus intensely on one or two activities.

2. Complexity factors include the size and structure of the company; the extent of intercompany transactions between insured depository institution subsidiaries and the holding company or uninsured subsidiaries of the holding company; the risk, scale and complexity of activities of any nondepository subsidiaries; and the degree of leverage at the holding company, including the extent of its debt outstanding to the public. Other factors are also noted in the text of SR-13-21.

1065.0.1 LIMITED DISCLOSURE OF CONFIDENTIAL COMPOSITE AND COMPONENT RATINGS IN INSPECTIONS AND EXAMINATIONS

The Federal Reserve provides senior management and directors of supervised financial institutions the numeric and alphabetic component ratings assigned under various supervisory rating systems.[1] (See SR-96-26, "Provision of Individual Components of Supervisory Rating Systems to Management and Boards of Directors.") This disclosure includes the ratings assigned to management under the holding company rating systems.[2]

Depending upon the size and complexity of the organization, the disclosure of the rating and its components is made to the holding company in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, any other supervisory communication, or some combination thereof. In conjunction with disclosing the ratings and their components to a holding company, examiners or supervisory officials should clearly explain what the ratings mean to the board of directors and management. During the exit meeting, the examiner should discuss key overall inspection findings, including preliminary composite and component numeric ratings.

In disclosing the assigned ratings, the examiner-in-charge should remind the board of directors and management that the ratings are part of the findings of the inspection or supervisory activity and are privileged and confidential under applicable law.[3] When examiners change a firm's ratings, examiners need to inform the firm's board of directors and management about the rating change. Examiners should not disclose ratings to the holding company's directors and management until preliminary approval has been received from the appropriate senior Reserve Bank supervisory officials.

1065.0.2 CONFIDENTIALITY OF THE SUPERVISORY RATING AND OTHER NONPUBLIC SUPERVISORY INFORMATION

The holding company inspection report and other supervisory communications constitute or contain the Board's confidential supervisory information (CSI), which is nonpublic information belonging to the Board.[4] The Board's Rules Regarding Availability of Information specifically provide that, except in very limited circumstances, supervised financial institutions may not disclose CSI outside of the financial institution, including inspection or examination findings, nor make any representations concerning an examination or inspection report or the report's findings, without the prior written permission of the Board.[5] Any person who discloses or uses CSI except as expressly permitted by the appropriate federal banking agency or as provided by the agency's regulations may be subject to the criminal penalties provided in 18 USC 641.

The legal prohibition on the release of CSI applies to all financial institutions examined by the agencies, including bank and savings and loan holding companies, Edge corporations, and the U.S. branches or agencies of foreign banking organizations that receive confidential supervisory ratings, including the LFI rating, RFI/C(D) rating, ROCA rating, and CAMEO rating.[6] As

1. The supervisory ratings are disclosed for the following rating systems:
   - CAMELS (state member banks)
   - RFI/C(D) and Large Financial Institution (LFI) rating system (bank holding companies, and savings and loan holding companies)
   - CAMEO (Edge and agreement corporations and overseas subsidiaries of U.S. banks)
   - ROCA (U.S. branches and agencies of foreign banking organizations)
   - Uniform Interagency Trust Rating System (UITRS)
   - The interagency Uniform Rating System for Information Technology (URSIT)

2. See SR-19-3 / CA-19-2, "Large Financial Institution (LFI) Rating System" and SR-19-4 / CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion."

3. The inspection report should also include appropriate language stating that the findings of the inspection are privileged and confidential under applicable law.

4. See, e.g., 12 CFR 261.2(c)(1), 261.20(g), and 261.22(e).

5. 12 CFR part 261, subpart C. The regulation authorizes supervised financial institutions to disclose CSI to their directors, officers, and employees and to the directors, officers, and employees of their parent holding companies. 12 CFR 261.20(b)(1). In addition, institutions may also disclose CSI to their outside counsel and auditors on the premises of the institution. 12 CFR 261.20(b)(2).

6. RFI/C(D), LFI, ROCA, and CAMEO ratings are assigned by the Federal Reserve Board as a result of an examination or inspection. For noncomplex holding companies with assets of $3 billion or less, only risk-management and composite ratings are assigned. ROCA ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations. The ROCA rating components are risk management, operational controls, compliance,

with the CAMELS rating, examiners communicate these ratings to the regulated institutions in reports or other supervisory communications, which are the property of the Board.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to the following publicly available information in lieu of disclosing any CSI, including the CAMELS rating:

- for banks and savings associations, an institution's quarterly reports of condition (Call Reports) (see 12 USC 1817)
- for holding companies or foreign banks with U.S. operations, an institution's quarterly and annual FR Y or H-(b)11 reports (see 12 USC 1844, 3106, 3108, 601–604a, and 611–631)
- for national banks, the annual disclosure statement (see 12 CFR 18.3)
- for banks, an institution's Uniform Bank Performance Report (UBPR), which is available to all interested parties at www.ffiec.gov and is designed for summary and in-depth analysis of banks;
- an institution's publicly available filings, if any, filed with the appropriate federal banking agency (15 USC 78(I)(i)) or with the U.S. Securities and Exchange Commission
- any reports or ratings on the institution compiled by private companies that track the performance of financial institutions
- any reports or ratings issued by private rating services on public debt issued by an institution
- any publicly available cease-and-desist order or enforcement proceeding against an institution[7]
- any reports or other sources of information on institution performance or internal matters created by the institution that do not contain information prohibited from release by law or regulation

and asset quality. CAMEO ratings are assigned to Edge corporations and the overseas branches and subsidiaries of U.S. banks. The CAMEO ratings components are capital, asset quality, management, earnings, and operations and internal controls.

7. Information on enforcement actions taken by the Federal Reserve may be found at https://www.federalreserve.gov/apps/enforcementactions/search.aspx.

Information on enforcement actions taken by other federal agencies, such as the Securities and Exchange Commission, the Financial Crimes Enforcement Network, and the Department of Justice, as well as foreign authorities, may also be publicly available.

1065.0.3 CONFIDENTIALITY PROVISIONS IN THIRD-PARTY AGREEMENTS

Under the Federal Reserve's statutory examination authority, examiners may review all books and records maintained on the premises of a financial institution that is subject to Federal Reserve supervision. This authority extends to any and all documents on the premises. In addition, under the Board's Rules Regarding Availability of Information, other than as set forth in the rules, Board-supervised organizations are prohibited from disclosing CSI to third parties without prior written permission of the Board's General Counsel. CSI is defined to include any information related to the examination or inspection of a banking organization, including supervisory ratings.[8] Significantly, Board staff has taken the position that identification of information requested by, or provided to, supervisory staff—including the fact that an inspection has taken or will take place—is related to an inspection and falls within the definition of CSI. Accordingly, it is contrary to Federal Reserve regulation and policy for agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties to contain confidentiality provisions that

1. restrict the banking organization from providing information to Federal Reserve supervisory staff;
2. require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory staff; or
3. require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve inspection or any nonpublic Federal Reserve supervisory initiative or action.

Banking organizations that have entered into agreements containing such confidentiality provisions are subject to legal risk. (See SR-07-19, "Confidentiality Provisions in Third-Party Agreements," and SR-97-17, "Access to Books and Records of Financial Institutions During Examinations and Inspections.")

8. See 12 CFR 261.2(c)(1)(i).

1070.1.1 INTRODUCTION

This section on the communication of supervisory findings is based on the guidance in SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings," which applies to all Federal Reserve-supervised banking organizations. In a supervisory finding, examiners should convey, if evident, both the root cause of the finding and the potential effect of the finding on the organization. Examiners should also consider the "Statement Clarifying the Role of Supervisory Guidance," for more information on communication of supervisory findings, including the appropriate identification of issues that could have a negative effect on safety and soundness on the financial institution; could cause consumer harm; or could cause violations of laws, regulations, final agency orders, or other legally enforceable conditions.[1]

1070.1.2 COMMUNICATION OF SUPERVISORY FINDINGS

Communication of supervisory findings to the organization's board of directors is an important part of the supervision of a banking organization. While the board itself may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization's day-to-day operations, it is nevertheless important that the board be made aware of significant supervisory issues and ultimately be accountable for the safety and soundness and assurance of compliance with applicable laws and regulations of the organization.

Depending upon the size and complexity of the organization, supervisory findings are communicated in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, any other supervisory communication, or some combination thereof. These written communications (referred to collectively as "reports" in this section) are generally directed to the board of directors, or an executive-level committee of the board as appropriate.[2] In turn, the board of directors (or executive-level committee of the board) typically will direct the organization's management to take corrective action and will provide management with appropriate oversight, including approvals of proposed management actions as necessary.

To be effective, the communication of supervisory findings must be (1) written in clear and concise language, (2) prioritized based upon degree of importance, and (3) focused on any significant matters that require attention. Reserve Banks must formally communicate matters requiring immediate attention (MRIAs) and matters requiring attention (MRAs) resulting from any supervisory activity to the organization in these written reports. In order to promote an understanding of these terms, examiners should include definitions of MRIAs and MRAs in all supervisory documents communicating supervisory findings.[3] When included in a safety-and-soundness examination or inspection report, MRIAs and MRAs should be listed in the "Matters Requiring Attention" section. In the case of findings from consumer compliance examinations, MRIAs and MRAs should be reflected in the "Executive Summary and Examination Ratings" section of the consumer affairs report of examination. Only outstanding MRIAs and MRAs are required to be discussed in the report; however, examiners have discretion to discuss closed MRIAs and MRAs in the report if such discussion would be meaningful.

For large banking organizations, an annual roll-up report summarizes the significant findings, based on outstanding MRIAs or MRAs, included in the reports of targeted reviews or other supervisory activities conducted during the supervisory cycle. These findings may be grouped by major supervisory issues, rating components, risks, or themes. This information should enable the banking organization's board of directors and any executive-level committee of the board to understand the substance and status of outstanding MRIAs or MRAs and focus their attention on the most critical and time-sensitive issues.

1. 12 CFR part 262, appendix A and 86 Fed. Reg. 18,179 (April 8, 2021).

2. An executive-level committee of the board (such as, the audit committee or risk committee) typically meets regularly, keeps minutes of those meetings, and is accountable to and routinely reports to the board of directors.

3. In a safety-and-soundness report, these definitions could be included on the "Scope" page, in an appendix, or as a footnote on the "Matters Requiring Attention" section. In a consumer compliance report, these definitions could be included on the "Executive Summary and Examination Ratings" section.

Communications to banking organizations concerning safety-and-soundness or consumer compliance MRIAs or MRAs must specify a timeframe within which the banking organization must complete the corrective actions. In certain circumstances, examiners may require the banking organization to submit an action plan that identifies remedial actions to be completed within specified timeframes. Action plans with intermediate- and long-term timeframes that span more than one supervisory or examination cycle with regard to safety-and-soundness matters, or a 12-month period with regard to consumer compliance issues, should include interim progress targets. Both safety-and-soundness and consumer protection or compliance considerations will remain a priority in determining whether the organization's timeframes to correct the matter are reasonable.

1070.1.2.1 Matters Requiring Immediate Attention

MRIAs arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case of consumer compliance examinations, matters that have the potential to cause significant consumer harm. An MRIA will remain an open issue until resolution and examiners confirm the banking organization's corrective actions.

Required language. Federal Reserve examiners are expected to use the following standardized language to communicate MRIAs to the board of directors (or executive-level committee of the board):

"The board of directors (or executive-level committee of the board), or banking organization is *required to immediately...*"

Timeframe. The expected timeframe for a banking organization to address MRIAs is generally short, and may be "immediate," in the case of heightened safety-and-soundness or consumer compliance risk. For MRIAs that are necessary to preserve or restore the viability of a banking organization, the timeframe should take into account any potential losses to the Federal Deposit Insurance Corporation's Deposit Insurance Fund, including the possibility that a delay in action will increase the potential for loss or the cost of resolution.

Organization response. Following its review of MRIAs discussed in the report, the banking organization's board of directors is required to respond to the Reserve Bank in writing regarding corrective action taken or planned along with a commitment to corresponding timeframes.

Supervisory follow-up. The Reserve Bank must follow up on MRIAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe specified for the action being required, and should be appropriate for the severity of the matter requiring the corrective action. The means of follow-up may vary depending upon the nature and severity of the matter requiring the action. Follow-up may take the form of a subsequent examination, a targeted review, or any other supervisory activity deemed suitable for evaluating the issue at hand.

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In such cases, examiners should consult with enforcement staff.[4] In all instances, examiners are expected to exercise judgment as to the supervisory activities best suited for evaluating a particular issue. Once follow-up is completed, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners are also expected to communicate in writing the results of their work and findings to the banking organization.

1070.1.2.2 Matters Requiring Attention

MRAs constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period

4. Such consultation should be made in accordance with existing guidance to Reserve Bank supervisory staff on the processing of enforcement actions, which provides that recommendations concerning formal enforcement actions should be submitted to the Board's Legal Division.

of time but when the timing need not be "immediate." While issues giving rise to MRAs must be addressed to ensure the banking organization operates in a safe and sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs. Likewise, consumer compliance concerns that require less immediate resolution should be communicated as an MRA. An MRA typically will remain an open issue until resolution and confirmation by examiners that the banking organization has taken corrective action. If a banking organization does not adequately address an MRA in a timely manner, examiners may elevate an MRA to an MRIA. Similarly, a change in circumstances, environment, or strategy can also lead to an MRA becoming an MRIA. The key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action as well as the immediacy with which the banking organization must begin and complete corrective actions.

Required language. Federal Reserve examiners are expected to use the following standardized language to communicate MRAs to the board of directors (or executive-level committee of the board):

"The board of directors (or executive-level committee of the board), or banking organization *is required to*..."

Timeframe. Communications to banking organizations about MRAs must specify a timeframe within which the corrective action is expected to be completed. The timeframe, at least initially, may require estimation because the banking organization may first need to complete preliminary planning to establish the timeframe for initiating and completing the corrective action. The timeframes for MRAs are likely to become more precise over time as planning evolves and circumstances make the completion of the MRAs more urgent. Timeframes that span more than one examination cycle for safety-and-soundness issues or that exceed 12 months for consumer compliance issues should include appropriate interim progress reports.

Organization response. Following its review of the report, the banking organization's board of directors is required to provide a written response to the Reserve Bank regarding its plan, progress, and resolution of the MRA.

Supervisory follow-up. The Reserve Bank must follow-up on MRAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed. For intermediate- or long-term corrective actions for MRAs, Reserve Bank follow-up may consist of assessing the organization's progress to address the MRAs, whether satisfactory or unsatisfactory, and noting whether the initial estimated timeframe continues to be reasonable or warrants adjustment.

The means of supervisory follow-up may vary based upon the nature and severity of the matter for which corrective action is expected. Follow-up may take the form of a subsequent examination, targeted review, continuous monitoring, reliance on validation work conducted by internal audit function, reliance on the results of examinations conducted by other supervisors, or any other supervisory activity deemed suitable for evaluating the issue at hand.[5]

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In all instances, examiners are expected to exercise judgment regarding the supervisory activities best suited for evaluating a particular issue. Once follow-up is complete, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners also are expected to communicate in writing the results of their work and findings to the organization.

1070.1.2.3 Supervisory Considerations

The volume of MRIAs and MRAs should be one of the many considerations in assigning a supervisory rating to a banking organization. The presence of a large number of MRIAs or MRAs may indicate that additional formal or informal investigation may be necessary or that the initiation of a formal or informal enforcement action may be warranted.

5. Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective, as discussed in SR-13-1/CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing." (See this manual's section entitled "Internal Control and Audit Function, Oversight, and Outsourcing.") When relying on internal audit to follow up on MRAs, examiners are expected to review the relevant workpapers and, when necessary, meet with internal audit staff who documented the resolution of the issue.

Irrespective of the number of MRIAs or MRAs, in some cases, additional formal or informal investigation may be necessary or the initiation of a formal or informal enforcement action may be warranted based on the severity of the issues, the repeat nature of issues, lack of responsiveness of management, violations of law, insider abuse, fraud, or other material deficiency. In any of these cases, examiners should consult with the Board's enforcement staff.

1070.1.3 FACTORS IN ESCALATING ISSUES INTO ENFORCEMENT ACTIONS

The volume of open MRIAs and MRAs and the materiality of the issues therein to the safety and soundness of the banking organization are important overarching considerations in determining whether examiners need to consult with the Board's enforcement staff in escalating issues into enforcement actions.[6] In addition to the guidance presented in SR-13-13/CA-13-10, examiners should consider the following key factors in determining whether to recommend additional formal or informal investigation or enforcement action:

- the organization's supervisory ratings and financial condition;[7]
- whether the issues involve unsafe or unsound practices, violations of laws, noncompliance with regulations, insider abuse, fraud, or other material deficiencies;[8]
- the severity or repetitive or intentional nature of the issues;
- management's willingness and ability to correct the issues;
- management's history of instituting timely remedial or corrective actions;
- whether management already initiated corrective action or established procedures to prevent future deficiencies;
- whether criminal or other regulatory authorities are taking a formal enforcement or prosecutorial action against the same institution;
- the organization's history of violations of laws, noncompliance with regulations and unsafe and unsound unsatisfactory practices; and
- any other circumstances that warrant use of an enforcement action.

This manual's section, "Formal Corrective Actions," provides more information on formal supervisory actions, which regulators issue to correct practices that the regulators believe to be unlawful, unsafe, or unsound. See also the *Commercial Bank Examination Manual's* section entitled, "Formal and Informal Supervisory Actions," for more information.

6. Issues are considered closed if the banking organization implements and examiners verify and validate the effectiveness of the corrective action, or if the organization's practices are no longer a concern because of a change in the organization's circumstances.

7. See SR-19-3/CA-19-2, "Large Financial Institution (LFI) Rating System," and SR-19-4/CA 19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion."

8. See 12 USC 1818(b)(1).

1072.0.1 GENERAL CONSIDERATIONS IN REVISING SUPERVISORY RATINGS

Supervisory ratings can affect an institution's risk-based deposit insurance premium; statutory and regulatory requirements, including applications and the prompt-corrective-action provisions of the Federal Deposit Insurance Act; supervisory reporting and inspection or examination requirements; and other factors. Given these implications, supervisory ratings should reflect an institution's current financial condition and risk profile. As such, Federal Reserve examiners should revise supervisory ratings whenever there is strong evidence that the financial condition or risk profile of an institution has significantly changed.[1]

Supervisory ratings may be revised as a result of on-site or off-site supervisory activities. For example, a significant change in an institution's financial condition may be evident from some combination of the following: off-site information or monitoring, reports of examinations conducted by another agency, meetings or other communications with management of the institution, published financial reports or press releases, an institution's status reports in connection with an enforcement action, and information generated by ongoing surveillance activities.

When examiners change a component of one of the supervisory rating systems, they should consider whether other applicable ratings should change, based on information available at that time. The factors contributing to a change in the rating of a component rating may affect one or more of the other ratings in the rating system, such as the composite rating (if applicable).[2] Further, a rating change at the holding company may precipitate a rating change at the subsidiary depository institution or vice versa.

Any change to a component or composite rating and the rationale for that change must be communicated by Federal Reserve supervisory staff in writing via a supervisory letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies. Federal Reserve Bank examiners should follow internal procedures for reviewing, vetting, and approving interim rating changes with Reserve Bank management and Federal Reserve Board staff, as well as communicating ratings changes to supervised institutions.

1072.0.2 UPGRADES OF SUPERVISORY RATINGS AT COMMUNITY BANKING ORGANIZATIONS

In 2012, the Federal Reserve issued guidance instructing examiners to use balanced judgment and consider progress by institutions in addressing supervisory issues and in restoring an institution to satisfactory condition when assigning ratings. See SR-12-4, "Upgrades of Supervisory Ratings for Banking Organizations with $10 Billion or Less in Total Consolidated Assets." Examiners should upgrade an institution's supervisory rating when there is a demonstrated improvement in the institution's financial condition and risk-management practices, and where improvement is likely to continue. In particular, the Federal Reserve supervisory staff should evaluate the strength of an institution's core financial components, overall risk management, and board of directors' oversight in assessing whether an upgrade is warranted.

Additional specific considerations include the extent to which

- the level of capital and capital planning process are appropriate relative to risk characteristics;
- core earnings have improved, and this trend is demonstrably sustainable;
- asset quality is improving, as evidenced by a material decline of adversely classified and

1. For more information, see SR-99-17, "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System." The guidance in SR-99-17 and this manual section generally applies to the supervisory rating systems for bank holding companies and savings and loan holding companies; state member banks; U.S. branches and agencies of foreign banking organizations; and Edge and agreement corporations, overseas subsidiaries of U.S. banks, and U.S. nonbank subsidiaries of foreign banking organizations.

2. For more information on the scope and applicability of the holding company rating systems see SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less," SR-19-3/CA-19-2, "Large Financial Institution (LFI) Rating System," and attachment 1 to SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion."

nonperforming assets, and this trend is expected to continue;
- liquidity and interest rate risk positions generally are managed prudently and, in a manner, consistent with applicable supervisory guidance;
- management's projections and assumptions related to core financial factors referred to above are reasonable and subject to regular board review and oversight;
- risk-management capabilities have improved to address principal weaknesses that contributed to prior ratings, and policies and practices have been implemented that focus on sustainability commensurate with the bank's risk profile; and
- the board provides strategic review and oversight of the institution's core financial factors and risk management and actively engages in the process of correcting deficiencies.

The Federal Reserve supervisory staff also should consider whether the institution has made demonstrable and sustained improvement in particular areas relevant to the institution's operation and financial condition as noted in reports of examination and condition.

1072.0.3 LARGE FINANCIAL INSTITUTIONS AND THE LFI RATING SYSTEM

While smaller banks and holding companies generally are examined at a specific point in time, larger holding companies are subject to continuous monitoring and ongoing supervision, which includes several supervisory events or assessments over the course of the supervisory cycle. Federal Reserve policy guidelines state that Federal Reserve supervisory staff should assign larger holding companies the appropriate holding company ratings on an annual basis and more frequently as warranted. (See SR-19-4/CA-19-3.) The Federal Reserve has internal processes and procedures for initiating and appropriately vetting ratings changes. This process involves a coordinated vetting of assigning and revising ratings for large holding companies subject to the LFI rating system.

For larger holding companies, rating changes typically are precipitated by the completion of significant supervisory assessments completed throughout the supervisory cycle. For instance, horizontal supervisory events and supervisory events assessing a firm's ability to address material findings identified in previous supervisory events are common instances when Federal Reserve examiners should consider the need to adjust an institution's ratings. In all cases, examiners should revise the supervisory ratings when an institution's financial or operational strength and resilience change and no longer meet the criteria for the existing rating.

The importance of examiners providing timely and accurate assessments of a larger holding company's financial and operational condition is reflected in the LFI rating system. As described in this manual's section entitled, "Large Financial Institution Rating System," each LFI component rating is assigned along a four-level scale. A firm is rated "Conditionally Meets Expectations" when it has certain material financial or operational weaknesses in its practices or capabilities, which may place the institution's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business. Firms assigned a "Conditionally Meets Expectations" rating should not be rated as such for a prolonged period. The LFI ratings framework does not have a fixed timeline for how long a firm can be rated "Conditionally Meets Expectations." Instead, the LFI ratings framework reflects an understanding that timelines depend on the particular issue(s), noting that the Federal Reserve will work with the institution to develop appropriate timeframes for resolving the supervisory issues leading to the "Conditionally Meets Expectations" rating.

1075.0.1 STATUTORY TOOLS FOR FORMAL SUPERVISORY ACTION

The Federal Reserve supervises the following entities and has the statutory authority to take formal enforcement actions against them:
- state member banks
- bank holding companies (BHCs)
- savings and loan holding companies (SLHCs)
- nonbank subsidiaries of BHCs and of SLHCs
- Edge Act and agreement corporations
- branches and agencies of foreign banking organizations operating in the United States and their parent banks
- systemically important nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve
- officers, directors, employees, and certain other categories of individuals or entities associated with the above banks, companies, and organizations (referred to as "institution-affiliated parties")

The initial consideration and determination of whether formal action is required usually results from an examination or inspection. As such, Federal Reserve supervisory staff must include comments and conclusions in an examination report or other supervisory communications that are well supported, factually accurate, consistent, and void of editorial or inflammatory statements.

Statutory tools are available to the Federal Reserve Board if formal enforcement action is warranted against a BHC or SLHC (collectively, "holding company"), nonbank subsidiaries, or institution-affiliated parties. The primary objectives of formal actions include
- correcting practices that the regulators believe to be unlawful, unsafe, or unsound;[1]
- ensuring that appropriate corrective action programs are developed and used by financial institutions subject to formal actions;
- minimizing losses to financial institutions and the Federal Deposit Insurance Fund;
- ensuring that Federal Reserve requirements are complied with to the fullest extent possible by financial institutions and individuals; and
- ensuring that institution-affiliated parties who engage in an unsafe or unsound practice or violate the law are permanently barred from the banking industry, fined, or both, for their malfeasance.

In addition to an institution's supervisory ratings, compliance with statutes and regulations, and financial and managerial condition, Federal Reserve supervisory and legal staff consider numerous factors in determining whether to recommend additional formal or informal investigation or enforcement action. See the "Communication of Supervisory Findings" section in this manual to review factors in escalating issues into enforcement actions.

The Board does not issue an enforcement action on the basis of a "violation" of or "noncompliance" with supervisory guidance. This includes various types of Board or interagency supervisory guidance, interagency statements, advisories, letters, policy statements, questions and answers, and frequently asked questions. While supervisory guidance provides examples of practices that the Board generally considers consistent with safety-and-soundness standards or other applicable laws and regulations, supervisory guidance does not have the force and effect of law. See 12 C.F.R. part 262, appendix A, "Statement Clarifying the Role of Supervisory Guidance."

This section discusses the following topics:
- Board jurisdiction under the law
- actions or practices that may trigger the statutory remedies
- Board staff procedures
- the elements of a corrective order
- temporary orders
- written agreements
- suspensions and removals
- enforcement of orders
- civil money penalties
- indemnification payments and golden parachutes
- termination of certain nonbank subsidiary activities or ownership
- coordination of formal enforcement actions among federal banking agencies

1. For more information on informal supervisory actions, see the *Commercial Bank Examination Manual* section (1050.1) entitled, "Formal and Informal Supervisory Actions."

1075.0.2 TYPES OF CORRECTIVE ACTIONS

Generally, under section 8 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1818(b), the Board may use its cease and desist authority and other enforcement tools against (1) a BHC, (2) a nonbank subsidiary of a BHC, and (3) any institution-affiliated party.[2] The term "institution-affiliated party" includes any director, officer, employee, controlling shareholder (other than a BHC), or agent, and any other person who has filed or is required to file a change in control notice. Further, institution-affiliated parties generally include

- shareholders;
- consultants;
- joint venture partners or any other person who participates in the conduct of the affairs of a BHC or nonbank subsidiary; and
- independent contractors, including attorneys, appraisers, and accountants who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, an institution.[3]

The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on the party before the end of a six-year period.

1075.0.2.1 Cease and Desist Orders

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

A cease and desist order may require the BHC or person subject to the order to (1) cease and desist from the unsafe or unsound practices or legal violations and (2) take affirmative action to correct the violations or practices. Affirmative actions are actions necessary to restore the BHC to a safe and sound condition, and include

- improving the BHC's consolidated capital by restricting dividends and new debt;
- conserving the BHC's assets so it can serve as a source of strength to the bank;
- employing qualified officers or employees; or
- taking any other action the Board determines to be appropriate.

An individual may be required to reimburse the company for unauthorized or improper payments received, or both.

Most cease and desist orders are issued by consent. When Board staff, in conjunction with the appropriate Reserve Bank, determines that a cease and desist action is necessary, the BHC or party is permitted an opportunity to consent to the issuance of the order without the need for the issuance of a notice of charges and a contested administrative hearing. Board staff drafts the proposed cease and desist order and, with Reserve Bank staff, presents it to the BHC or individual for consent. If the BHC or individual voluntarily agrees to settle the case by the issuance of a consent cease and desist order, the proposed consent order will be presented to senior Board officials for approval, at which time the order will be final and binding.

When a BHC or person fails to consent to a cease and desist order, the Board may issue a notice of charges to the entity or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges starts a formal process that includes the convening of a public administrative hearing to be conducted before an administrative law judge.[4] After the hearing, the judge makes a recommended decision to the

2. The Board's authority under 12 U.S.C. 1818 also extends to SLHCs, their nonbank subsidiaries, and their institution-affiliated parties.

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

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

Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, the Board determines whether to issue a final cease and desist order. BHCs and individuals who are subject to cease and desist orders that were issued as a result of contested proceedings may appeal the Board's issuance of the order to the appropriate federal court.

1075.0.2.2 Temporary Cease and Desist Orders

The Board may, in conjunction with issuing a notice of charges, issue a temporary cease and desist order against a BHC or an institution-affiliated party to effect immediate correction (pursuant to 12 U.S.C. 1818(c)). The Board may issue a temporary cease and desist order to a BHC when the violation or unsafe or unsound practice described in the notice of charges, or the continuation of the violation or practice is likely to

- cause insolvency of a BHC or its subsidiary bank,
- weaken the condition of the BHC,
- cause a significant dissipation in earnings, or
- prejudice the interests of the subsidiary bank's depositors before the completion of the proceedings resulting from the notice of charges.

The Board may also issue a temporary order if it determines that a BHC's or nonbank subsidiary's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the BHC's or nonbank subsidiary's financial condition or the details or purpose of any transaction that may have a material effect on the BHC's condition. The temporary order may require the BHC or nonbank subsidiary to take the same corrective actions as a cease and desist order. The advantage of issuing a temporary cease and desist order is that it is effective immediately after it is served on the BHC or individual. Within 10 days after being served with a temporary order, however, the BHC or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease and desist order or dismisses the action.

1075.0.2.3 Written Agreements

When circumstances warrant a less severe public action than a cease and desist order, it may be appropriate to execute a written agreement with a supervised institution. The provisions of a written agreement may relate to any of the problems found at the institution or involving institution-affiliated parties. Written agreements are drafted by Board staff, in consultation with Reserve Bank staff, and must be approved by the Board's Director of the Division of Supervision and Regulation. After approval by the General Counsel, the Reserve Bank may enter into the written agreement under delegated authority (12 C.F.R. 265.11(a)(15)).

1075.0.2.4 Prohibition and Removal Authority

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

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

In addition to this legal authority, the statute separately authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director who violates the prohibitions on management interlocks.[5]

Like a cease and desist order, a removal or prohibition order may be issued either by consent or after an administrative process initiated by the issuance of a notice of intent to remove and prohibit. If an institution-affiliated party's actions warrant immediate removal from the BHC, the Board is authorized to suspend the person temporarily from the BHC pending the outcome of the complete administrative process. An institution-affiliated party currently associated with a BHC may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, BHC, or business institution.

Under 12 U.S.C. 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the institution. The Board may also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the Board. The Board may also initiate a removal or prohibition action against an institution-affiliated party who has been convicted of, or has entered into a pretrial diversion or similar program for, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the institution's depositors or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, section 19 of the Federal Deposit Insurance Act (12 U.S.C. 1829) prohibits any individual who has been convicted of, or has entered into a pretrial diversion or similar program for, a crime involving dishonesty, breach of trust, or money laundering from (1) serving as an institution-affiliated party of; (2) directly or indirectly participating in the affairs of; and (3) owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval. The statute also prohibits such an individual from holding any of the above-listed positions at a holding company or an Edge Act or agreement corporation without the Board's prior approval. The penalty for a knowing violation of this law is a potential fine of up to $1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

1075.0.2.5 Termination of Nonbank Activity

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

1075.0.2.6 Violations of Final Orders and Written Agreements

When any final order or temporary cease and desist order has been violated, the Board may apply to a U.S. district court for enforcement of the action. Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending BHC or institution-affiliated parties, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the

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

"Civil Money Penalties" section below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million, imprisonment for up to five years, or both.

1075.0.2.7 Civil Money Penalties

The Board is authorized to address misconduct by any institution or institution-affiliated party through the imposition of civil money penalties under a variety of statutes, including most commonly 12 U.S.C. 1818(i)(2). The statutory maximums are adjusted annually for inflation; current maximums may be found at 12 C.F.R. 263.65. Under 12 U.S.C. 1818(i)(2), the Board may assess a first-tier civil money penalty against any institution or institution-affiliated party for a violation of (1) law or regulation; (2) a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order; (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

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

The Board may also assess civil money penalties for the submission of any late, false, or misleading reports required by the BHC Act and Regulation Y of the Board under the three-tier penalty structure of 12 U.S.C. 1847(d) or, for SLHCs, 12 U.S.C. 1467a(r). If a BHC maintains procedures that are reasonably adapted to avoid inadvertent errors and unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a first-tier civil money penalty. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent, a second-tier penalty can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a third-tier penalty can be assessed for each day of the violation. Notwithstanding the above, violations of the BHC Act (with the exception of late, false, or inaccurate report violations as described above) may be addressed by the assessment of civil money penalties under 12 U.S.C. 1847(d).

1075.0.2.8 Administration of Formal Actions

1075.0.2.8.1 Publication of Final Orders

Under 12 U.S.C. 1818(u), the Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates.[6] These orders include cease and desist, removal, prohibition, and civil money penalty assessments. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce, unless the Board determines that publication of the order or agreement would be contrary to the public interest.

1075.0.2.8.2 Public Hearings

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

6. For enforcement actions against an entity supervised by the Federal Reserve, see the Board's public website.

propriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

1075.0.2.8.3 Subpoena Power

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

1075.0.3 PROHIBITED INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

Prohibited indemnification payments and golden parachute payments are governed by section 18(k) of the FDI Act (12 U.S.C. 1828(k)) and the FDIC's accompanying regulations at 12 C.F.R. part 359.

1075.0.3.1 Prohibited Indemnification Payments

Holding companies or insured depository institutions may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some holding companies or insured depository institutions may have broadly worded indemnification provisions, or the holding company or institution may have entered into separate indemnification agreements with its institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as with safe-and-sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the FDI Act and the accompanying Federal Deposit Insurance Corporation (FDIC) regulations.[7] The law and regulations apply to indemnification agreements and payments made by a holding company or insured depository institution to any institution-affiliated party, regardless of the holding company's or institution's financial condition. The purpose of the law and regulations is to preserve the deterrent effects of administrative enforcement actions by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses and to safeguard the assets of financial institutions.

A prohibited indemnification payment includes any payment (or agreement to make a payment) by a holding company or insured depository institution to an institution-affiliated party to pay or reimburse such person for any liability or legal expense incurred in any federal banking agency administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty; is removed or prohibited from banking; or is required to cease and desist from or take any affirmative action, including making restitution, with respect to the holding company or depository institution.[8]

The FDIC's regulations provide criteria for making permissible indemnification payments. A holding company or insured depository institution may make or agree to make a reasonable indemnification payment if all of the following conditions are met:

i. the institution's board of directors determines in writing after due investigation and consideration that the institution-affiliated party acted in good faith and the best interests of the institution;
ii. the board of directors determines in writing after due investigation and consideration that the payment will not materially affect the institution's safety and soundness;
iii. the payment does not fall within the definition of a prohibited indemnification payment; and
iv. the institution-affiliated party agrees in writing to reimburse the institution, to the extent not covered by permissible insurance, for the portion of the advanced indemnification payments which subsequently become prohibited indemnification payments.[9]

The statute and FDIC regulations reinforce the Federal Reserve's long-standing policy that an institution-affiliated party who engages in misconduct should not be insulated from the

7. See 12 U.S.C. 1828(k). The prohibition begins when a proceeding is instituted, which is when a notice of charges is issued.

8. 12 C.F.R. 359.1(l).

9. 12 C.F.R. 359.5(a).

consequences of their misconduct. From a safety-and-soundness perspective, a holding company should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the holding company's policy of compliance with applicable laws, especially when the individual's misconduct has already harmed the holding company.

Holding companies should review their bylaws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a holding company fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquisition applications, Federal Reserve supervisory staff and examiners will review identified agreements having indemnification-related issues for compliance with federal laws and regulations.[10]

1075.0.3.2 Golden Parachute Payments

FDIC regulations prohibit holding companies and their insured depository institution subsidiaries from making golden parachute payments except in certain circumstances. As described in 12 C.F.R. 359.0(b), the limitations on golden parachute payments apply to

- troubled insured depository institutions which seek to enter into contracts to pay or to make golden parachute payments to their institution-affiliated parties;[11]
- depository institution holding companies which are troubled and seek to enter into contracts to pay or to make golden parachute payments to their institution-affiliated parties; and
- healthy holding companies which seek to enter into contracts to pay or to make golden parachute payments to institution-affiliated parties of a troubled insured depository institution subsidiary.

The purposes of the law and regulations include safeguarding the assets of financial institutions and limiting rewards to institution-affiliated parties who may have contributed to the institution's troubled condition. (See SR-03-6, "Guidance Regarding Restrictions on Institutions in Troubled Condition.")

A golden parachute payment is any payment (or agreement to make any payment) in the nature of compensation for the benefit of any current or former institution-affiliated party that meets three criteria.

1. The payment or agreement must be contingent on, or by its terms payable on or after, the termination of the institution-affiliated party's primary employment or affiliation.
2. The agreement is made, or the payment is to be made on or after, or made in contemplation of, among other things, a determination that the holding company or its insured depository institution subsidiary is in a troubled condition.
3. The payment is payable to an institution-affiliated party who is terminated while a holding company or its insured depository institution subsidiary meets any of the troubled condition criteria in the golden parachute regulations.

The definition of a golden parachute payment also covers a payment made by a holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled

10. For additional information, consult SR-02-17, "Guidance Regarding Indemnification Agreements and Payments." The guidance in SR-02-17 and SR-03-6 also apply to SLHCs. See SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program." For additional considerations for institutions in choosing indemnification insurance policies, see SR-19-12, "Statement Regarding Insurance Policies for Directors and Officers."

11. See 12 C.F.R. 359.1(f)(1)(ii). The Board's Regulation Y (12 C.F.R. 225.71) states that "troubled condition" for a regulated institution means an institution that (1) has a composite rating, as determined in its most recent report of examination or inspection, of 4 or 5 under the CAMELS rating system or the Federal Reserve Bank Holding Company rating system; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the financial condition of the institution, unless otherwise informed in writing by the Board or Reserve Bank; or (3) is informed in writing by the Board or Reserve Bank that it is in troubled condition for purposes of the requirements of subpart H of Regulation Y on the basis of the institution's most recent report of condition or report of examination or inspection, or other information available to the Board or Reserve Bank. Note that under the Federal Reserve's holding company rating system for large financial institutions, there is no presumption that a firm rated "Deficient-1" would be deemed to be in troubled condition. Whether a firm rated "Deficient-1" receives a troubled condition designation will be determined by the facts and circumstances of the situation. However, firms rated "Deficient-1" due to financial weaknesses in either capital or liquidity would be more likely to be deemed in troubled condition than firms rated "Deficient-1" due solely to issues of governance or controls. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019) for more information.

condition, if the other criteria in the definition are met. This circumstance may arise when a holding company, as part of an agreement to acquire a troubled holding company, bank, or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.[12]

Holding companies or insured depository institutions may request permission from the appropriate federal banking agency to make or enter into an agreement to make a golden parachute payment by filing an application in accordance with FDIC filing instructions at 12 C.F.R. 303.244. The appropriate federal banking agency may approve the application under one of the exceptions in 12 C.F.R. 359.4(a)(1)-(3). In determining the permissibility of the payment, the Federal Reserve may consider whether, and to what degree, the individual was in a position of managerial or fiduciary responsibility, the length of time the individual was affiliated with the institution and the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations. Generally, FDIC approval will also be required before a payment is permissible.

A holding company or state member bank requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and the Reserve Bank. The Reserve Bank should forward the golden parachute application to appropriate Board staff for a final determination on the permissibility of the request. Golden parachute payments or agreements may be approved by the Board's Director of the Division of Supervision and Regulation in conjunction with the General Counsel. Denials are not delegated by the Board of Governors to Board or Reserve Bank staff.

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

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

1075.0.4 ENFORCEMENT ACTIONS FOR BANK SECRECY ACT/ANTI MONEY LAUNDERING COMPLIANCE PROGRAM FAILURES

In 2020, the federal banking agencies (FBAs) issued a joint statement updating their existing enforcement guidance to enhance transparency regarding how they evaluate enforcement actions that are required by statute when financial institutions fail to meet Bank Secrecy Act/anti-money laundering (BSA/AML) obligations.[13] The statement addresses how the agencies evaluate violations of individual components (known as pillars) of the BSA/AML compliance program. The statement also clarifies that isolated or technical violations or deficiencies are generally not considered the kinds of problems that would result in a mandatory enforcement action. The statement promotes a consistent approach to the application of section 8(s) of the FDI Act. See SR-20-19, "Joint Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements."

1075.0.5 COORDINATION OF FORMAL ENFORCEMENT ACTIONS AMONG FEDERAL BANKING AGENCIES

When an FBA determines to take a formal enforcement action against any federally insured depository institution, depository institution holding company, non-bank affiliate, or institution-affiliated party, the agencies evaluate whether

13. FBA refers to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

the enforcement action involves the interests of another FBA. Examples of such interests include unsafe or unsound practices or significant violations of law by an insured depository institution, non-bank affiliate, or depository institution holding company or misconduct by an institution-affiliated party that may have significant connections with an institution regulated by another FBA. If it is determined that one or more other FBAs have an interest in the enforcement action, the FBA proposing the enforcement action notifies the other FBA(s). For more information, see SR-18-4/CA-18-5, "Policy Statement on Interagency Notification of Formal Enforcement Actions," and 83 Fed. Reg. 27,371 (June 12, 2018).

1075.0.6 APPOINTMENT OF DIRECTORS AND SENIOR EXECUTIVE OFFICERS

Under section 32 of the FDI Act (12 U.S.C. 1831i) and subpart H of Regulation Y (12 C.F.R. 225.71 et seq.), any BHC or state member bank must provide 30 days' written notice to the Board before appointing any new director or senior executive officer,[14] or changing the responsibilities of any senior executive officer so that the officer would assume a different senior officer position if

- the regulated institution is in troubled condition;
- the regulated institution does not meet minimum capital requirements applicable to the institution as determined on the basis of the institution's most recent report of condition or report of examination or inspection; or
- the Board determines, in connection with its review of a capital restoration plan required under section 38 of the Federal Deposit Insurance Act or subpart D of the Board's Regulation H (prompt corrective action requirements), or otherwise, that such notice is appropriate.

Subpart H of Regulation Y sets forth the procedures for filing and the content of the notice. If a BHC or state member bank that is in a troubled condition appoints a director or senior officer without the required 30-day prior written notice, appropriate follow-up supervisory action should be taken.

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

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

1075.0.7 DISCIPLINARY ACTIONS AGAINST ACCOUNTANTS AND ACCOUNTING FIRMS PERFORMING CERTAIN AUDIT SERVICES

Section 36 of the FDI Act authorizes the federal bank regulatory agencies to take disciplinary actions against independent public accountants and accounting firms that perform audit services covered by the act's provisions. Section 36, as implemented by part 363 of the FDIC rules (12 C.F.R. part 363), requires that each federally insured depository institution with total assets of $500 million or more obtain an audit of its financial statements and an attestation on management's assertions concerning internal controls over financial reporting performed by an independent public accountant (the accountant). The insured depository institution must include the accountant's audit and attestation reports in its annual report. See SR-94-3, "Supervisory Guidance on the Implementation of Section 112 of the FDIC Improvement Act."

The audit requirement can be fulfilled by an independent audit of a BHC where the insured subsidiary bank (1) has total assets of less than $5 billion or (2) has total assets of $5 billion or more and has a composite CAMELS rating of 1 or 2. See SR-13-11, "Filing Procedures for Annual Independent Audits and Reports Required Under Federal Deposit Insurance Corporation (FDIC) Rules," for more information.

Section 36 and the rules enacted pursuant thereto set forth the practices and procedures to remove, suspend, or debar, for good cause, an accountant or firm from performing audit and testation services for an insured state member bank, or BHC that obtains audit services for an insured subsidiary bank.[15] Immediate suspensions are permitted in limited circumstances. Also, an accountant or accounting firm is prohibited from performing audit services for the covered institution if an authorized agency has taken such a disciplinary action against the accountant or firm, or if the U.S. Securities and Exchange Commission or the Public Company Accounting Oversight Board has taken certain disciplinary action against the accountant or firm.

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

The Federal Reserve's Holding Company (HC) Surveillance Program covers top-tier bank and savings and loan holding companies. It deploys risk identification algorithms and other surveillance products to process financial and economic data and generate forward-looking, actionable intelligence on HCs. Results are used to assess exposures, outlooks, and possible compliance shortcomings, with the goal of calibrating supervisory resources to risk. (Refer to SR-15-16 and its attachment.)

The surveillance program's objectives cover these areas: (1) HC monitoring, (2) industry analysis, and (3) metric distribution. HC monitoring consists of forward-looking metrics targeting high-risk HCs and those with emerging financial difficulties for enhanced supervisory attention, while identifying low-risk HCs for more streamlined approaches. The metrics also detect possible regulatory violations or departures from supervisory guidance and feed into financial reports on individual HCs. In industry analysis, aggregate data views and accompanying financial analyses inform Federal Reserve leaders of broad financial institution conditions and trends. In metric distribution, web applications deliver surveillance results to examiners and other supervisory staff.

As fully integrated into the supervisory process, the HC Surveillance Program involves three distinct phases. First, data are processed by the risk identification algorithms, ranging from simple rules to financial models, machine learning, and signal processing. The algorithmic system's main components are the Outlier List, Watch List, HC Monitoring Screen, and Intercompany Transactions Exception List, all described below. When the algorithms detect departures from expected patterns involving HCs, the results are transmitted via Performance Report Information and Surveillance Monitoring (PRISM), a web application available to Federal Reserve examiners and other supervisory staff for interactive data analysis.

The second phase begins as supervisory staff use additional surveillance products to confirm the initial impressions presented by first-phase surveillance results. Key examples of these additional products are the Bank Holding Company Performance Report (BHCPR), a quarterly financial report on individual HCs, described below, and the Focus Report, a web application available to Federal Reserve examiners and other supervisory staff for interactive risk assessment. In addition, aggregate data views and reports of financial condition at the supervisory portfolio and industry levels can help place a particular HC's status in context.

The third phase involves the development of supervisory responses to the information generated in the first two. A primary goal is to focus supervisory resources on excessive risk-taking, the risk of emerging financial difficulties, and possible regulatory compliance shortcomings. When problems are identified, follow-up by examiners promotes correction and resolution. By also identifying low-risk situations, the HC Surveillance Program promotes the application of more streamlined supervisory approaches for such cases.

1080.0.1 OUTLIER LIST

An Outlier List highlights HCs with elevated risk-taking and identifies those with expanded or new areas of risk-taking. It is supported by "Outlier Metrics" in the form of algorithms generating risk classifications of low, moderate, or high for individual risk and performance dimensions. The Outlier List includes HCs (FR Y-9C filers only) categorized as high risk within at least one risk or performance dimension. The risk identification algorithms can be based on a broad range of approaches and may evolve over time.

Examiners and other supervisory staff use the Outlier List to monitor a HC's risk-taking and promote adequate risk management and mitigation, with the goal of bolstering HCs' capacity to prevent or buffer financial losses. The Outlier List and its metrics also assist supervisory staff in scoping HC inspections. No regular write-up or documentation requirement is tied to the Outlier List.

1080.0.2 WATCH LIST

The Watch List identifies the risk of emerging financial weaknesses among HCs. It includes FR Y-9C filers with composite safety-and-soundness ratings consistent with financial viability, but surveillance grades of 'D' or 'F,' pointing to the possibility of deterioration in inspection findings going forward.

To generate the surveillance grades, the Holding Company Statistical Assessment of Bank Risk (HC-SABR) early-warning model is applied to financial and supervisory information for each HC filing consolidated financial statements on the FR Y-9C. The HC-SABR rating consists of the composite RFI rating most recently assigned to an HC via the inspection process, coupled with a surveillance letter grade (A, B, C, D, or F) reflecting the HC's estimated financial condition relative to others in the same rating class.

HC-SABR ratings are designed for use both in monitoring and in determining the scope of an inspection. An accompanying Schedule of Risk Factors (SRF) highlights specific indicators leading the model to flag a particular HC as strong or weak. Through ongoing monitoring, examiners and other supervisory staff review each Watch List HC to assess its financial condition and discern whether substantial deterioration is evident or impending. In such cases, supervisory staff determine whether an inspection or other supervisory initiative might be needed. The Watch List, much like the Outlier List and its metrics, can also be used in scoping HC inspections to target potentially deteriorating situations for the most extensive reviews.

At times, Reserve Bank staff may need to produce supporting documentation to explain the reasons for an HC's placement on the Watch List and outline the appropriate supervisory response. For HCs other than community banking organizations (CBOs), this type of information is often already contained in quarterly supervisory write-ups outside of the Watch List process. Separate surveillance write-ups are required for CBO HCs on the Watch List when any of the following criteria are met:

1. The current HC-SABR rating is worse than the prior quarter; or
2. The HC-SABR rating is the same as the prior quarter, but the SRF identifies one or more new contributing factors; or
3. The most recent requirement for a write-up occurred four quarters earlier.

The assessments and conclusions comprising a write-up should be brief and supported by analysis. A Watch List write-up should accomplish the following:

1. summarize the factors leading to Watch List placement;
2. describe any response from the HC to those factors;
3. assess the likelihood of further financial deterioration;
4. judge whether assigned safety-and-soundness ratings are accurate; and
5. determine whether the timing of the next inspection should be accelerated.

Follow-up action associated with newly identified problems must be initiated promptly by Reserve Banks. Follow-up action may include correspondence or meetings with an HC's management or an on-site inspection. Problem situations should be closely monitored by supervisory staff until they have been corrected or otherwise resolved.

1080.0.3 HC MONITORING SCREEN

The HC Monitoring Screen includes a focus on the parent company and non-depository subsidiaries; addresses issues such as cash flow, leverage, and complexity; identifies risks to depository institution subsidiaries; and helps monitor compliance with regulations and supervisory guidance. It provides examiners and other supervisory staff with additional perspective on the risk position and financial condition of HCs by supplementing the Outlier List and Watch List. The FR Y-9SP is utilized, among other reports, allowing the HC Monitoring Screen to provide a surveillance view of smaller HCs. Those HCs that fail screening criteria are identified, with the criteria themselves updated periodically.

Examiners and other supervisory staff review HC Monitoring Screen results quarterly and follow up with supervisory initiatives when appropriate. Detailed instructions may accompany parts of the screen linked to specific supervisory programs, as for example, the guidance discussed in this manual's section 1080.1, "Surveillance Program for Small Holding Companies," and further described in SR-13-21. Unless otherwise instructed as part of a specific supervisory program, staff are not generally required to produce surveillance write-ups or maintain surveillance documentation for HCs on the HC Monitoring Screen.

1080.0.4 INTERCOMPANY TRANSACTIONS EXCEPTION LIST

The Intercompany Transactions Exception List (ITEL) helps track compliance with section 23A of the Federal Reserve Act. The ITEL is a specialized monitoring process utilizing data from the FR Y-8, together with information from the bank Call report.

For each depository institution possibly exceeding section 23A limits, supervisory staff perform the following: (1) follow up with the HC submitting the FR Y-8 to verify the data are accurate; (2) if an error caused the exception, require an amended report; and (3) if the data are correct, and a depository institution appears to have had covered transactions exceeding section 23A limits, determine the nature and extent of the apparent violation. Reserve Bank staff produce a written review of their findings for each depository institution on the list. The review addresses any apparent violations or reporting errors, along with any corrective action taken.

1080.0.5 THE SURVEILLANCE PROGRAM'S BHC PERFORMANCE REPORT

The HC Surveillance Program generates quarterly financial reports on individual HCs, including a publicly available BHCPR consisting of consolidated and parent-only financial information and peer-group percentiles for HCs filing the FR Y-9C. The information is useful in analyzing HCs on the Outlier List, Watch List, or HC Monitoring Screen. By reviewing the performance reports, examiners and other supervisory staff gain insight into potential HC weaknesses. For example, parent leverage, cash-flow, and coverage ratios can indicate problems at the parent level that could adversely affect depository institution subsidiaries. Information on the parent's income from subsidiaries can potentially indicate problems at non-depository subsidiaries that could negatively affect depository institution subsidiaries.

The financial indicators produced by the BHCPR are leveraged in surveillance models such as HC-SABR and used in the financial analysis of HCs. Some documentation is required to help support the report. Specifically, the BHCPR's peer group analysis involves the identification of HCs that for a variety of reasons could be considered atypical.

To support this process, Reserve Bank staff annually produce a list of atypical HCs. The list provides the name, location, and ID RSSD of a company; and the reason why the HC is considered atypical. HCs removed from the atypical list relative to the previous year are also identified and discussed.

1080.0.6 ROLE IN INSPECTION PROCESS

HCs identified through the surveillance process as (1) taking on positions or pursuing strategies that could lead to problem situations, (2) having a weak or declining financial condition, or (3) failing to comply with regulations should, in general, be inspected more intensely and frequently than companies without such deficiencies.

Regarding the positions and strategies of HCs, the Outlier List is designed to identify excessive risk-taking, as are parts of the HC Monitoring Screen. Similarly, the Watch List is intended to identify companies having a weak or declining financial condition, as are parts of the HC Monitoring Screen. Also, the HC Monitoring Screen and the ITEL help detect possible compliance problems among HCs and their subsidiaries.

The full array of risk identification algorithms and products deployed in the HC Surveillance Program can be used in the scheduling and scoping of HC inspections, so as to target, in a timely manner, the riskiest situations for the most extensive reviews, while conserving supervisory resources when risk is low. The examiner-in-charge should exercise prudent supervisory judgment and consider an HC's status on each surveillance list and screen, together with all other available information sources, including the BHCPR and Focus Report, when determining the scope and nature of the inspection work required.

The surveillance program for holding companies having total consolidated assets of less than $3 billion is described below. (See SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less.") The surveillance program is a primary tool for identifying potentially significant changes in the condition of these organizations between reviews and for targeting the work of any onsite reviews. Quarterly surveillance screens identify potential parent-company and nonbank issues that may adversely affect affiliated insured depository institutions. In particular, the screens address parent-company cash flow, intercompany transactions, parent-company leverage, and consolidated capital ratios, where applicable. The surveillance screens are periodically updated to reflect industry trends and issues, as well as changes in regulatory reporting requirements.

Upon receipt and finalization of FR Y-9 data, Board surveillance staff provides each Reserve Bank with the results of the small holding company surveillance screens on a quarterly basis. Reserve Banks should evaluate this information and make a determination as to any appropriate supervisory actions within 45 days of the Board staff notice. In doing so, Reserve Banks should determine whether the screen results reveal that the holding company or its affiliates could pose or exacerbate a material risk to a depository institution subsidiary. If the screen results reveal no basis for a significant concern, no further action is required. Reserve Banks should also review the quarterly FR Y-8 data on transactions between an insured depository institution and its affiliates that are subject to section 23A of the Federal Reserve Act and Regulation W. Reserve Banks should document their FR Y-8 reviews and follow up on any potential violations.

If a Reserve Bank determines that the screen results reveal the potential for material risk to a depository institution, the Reserve Bank should take appropriate follow-up action within 90 days after initially receiving the surveillance results from Board staff. Follow-up actions may include

- contacting the holding company to obtain more information,
- requesting from the holding company a corrective action plan,
- implementing heightened monitoring procedures, or
- updating the holding company's complexity designation.

If an onsite review is recommended for a complex holding company, the review should commence within 90 days of the Reserve Bank's initial notification of the surveillance results from Board staff. The ratings assigned as a result of the onsite review should be promptly entered into the National Examination Data System (NED) and communicated to the company, Board staff, and appropriate state and federal regulatory authorities within 120 days of that notification.

In addition to the above surveillance monitoring screens, Board surveillance staff also provide Reserve Banks with program support screens containing additional information to assist in the supervision of small holding companies. One set of support screens identifies companies that have been designated as noncomplex, but which exhibit characteristics of complex organizations. Reserve Banks are to evaluate any such companies to determine whether their designation as noncomplex should be changed and their supervision program modified accordingly. A second set of support screens monitors compliance of financial holding companies with the capital, managerial, and Community Reinvestment Act standards set forth in the Gramm-Leach-Bliley Act.

Surveillance information is crucial to identifying potential issues between reviews and for ensuring that onsite work is risk focused. Accordingly, Reserve Banks should continue taking steps to ensure the accuracy of the regulatory reports that provide the basis for the surveillance program. In particular, System staff is to follow up promptly on any identified inaccuracies.

Introduction To Topics For Supervisory Review

Section 2000.0

Discussed within these subsections are topics associated with regard to the overall bank holding company organization. Included is general information, inspection objectives and procedures, and in some instances references to laws, interpretations, and Board orders. The primary topics addressed are the supervision of subsidiaries, grandfather rights, commitments, extensions of credit to BHC officials, management information systems, taxes, funding, control and ownership, reporting by foreign and domestic banking organizations, formal corrective actions, sharing of criminal referral information, investment transactions, recognition and control of risk, purchase and sale of U.S. Government guaranteed loans, and venture capital.

WHAT'S NEW IN THIS REVISED SECTION

This section is revised to include a revision of the Federal Deposit Insurance Act (FDIA) that requires a BHC or SLHC to serve as a "source of strength" to its depository institution subsidiaries. See section 38A of the FDIA and section 616(d) of the Dodd-Frank Act.

The relative merit of the degree of supervision is dependent upon a number of factors, and must be analyzed in light of efficiency and operating performance. The degree and nature of control over subsidiary organizations in a holding company system usually falls between two extremes: a tightly controlled, centralized network similar to a branch system, or a loosely controlled, decentralized system with each subsidiary operating autonomously. A bank holding company might originate as a "shell" corporation organized by investors interested in purchasing a bank, or by a bank interested in reorganizing into a holding company structure in order to expand through acquisition of nonbank concerns or other banks. The management and directorate of such a holding company are often the same as that of the bank. As the holding company expands through acquisitions, the parent may continue to exercise control through the staff of the lead bank, or may form a separate staff to overview the operations of all subsidiaries. The relative merit of the degree of supervision is dependent upon a number of factors, and must be analyzed in light of efficiency and operating performance.

The level at which policies are established and supervised, the frequency of contact between the parent and subsidiaries, and the extent to which officers and directors of the parent serve also as officers and directors of the subsidiary organizations are indicative of the level of control exercised by the parent. A centralized bank holding company is characterized by the placement of directors and officers of the parent company (or those of the lead bank) in each of its subsidiaries, with frequent group meetings held between the officers of the lead bank or holding company and those of the subsidiary organizations. While this is an efficient method of operation, this type of organization builds in the potential for conflicts of interest for those individuals who serve in dual capacities. Corporate policies should recognize this potential and provide guidance for resolution. The overriding principle should be that *no* member of the bank holding company organization should be disadvantaged by a transaction with another affiliate. Management of the investment portfolio, budgets, tax planning, personnel, correspondent relationships, loans and loan participations, and liability management are usually controlled by the parent or lead bank in a centralized system.

A decentralized system is one in which the banks act independently of the parent company, with infrequent contacts with affiliates, placement of parent or lead bank directors and officers in less than a majority of the banks within the system and infrequent reporting by subsidiaries concerning investments and operating performance. The bank holding company might act only in a minor advisory capacity. In such a decentralized system each subsidiary operates as a relatively autonomous unit, with authority and responsibility for certain actions delegated by the parent to the board and/or chief executive officer of each subsidiary.

It is the responsibility of the directors and management of the parent company to establish and supervise the policies of subsidiaries, either directly or through delegation of authority. The importance of written policies in a delegated, decentralized organization cannot be overemphasized, and the selection of qualified officers to carry out policies is equally important. If written policies have not been developed by the holding company, the examiner should recommend that major policies be written and communicated to subsidiaries. Policies should ensure that subsidiaries are not managed for cross purposes and should avoid concentrations of risks on a consolidated basis.

2010.0.1 POLICY STATEMENT ON THE RESPONSIBILITY OF BANK HOLDING COMPANIES TO ACT AS SOURCES OF STRENGTH TO THEIR SUBSIDIARY BANKS

The Board is concerned about situations where a bank has been threatened with failure notwithstanding the availability of resources to its parent bank holding company. In order to assure that the Board's policy that bank holding companies serve as sources of financial strength to subsidiary banks is understood by bank holding companies, the Board has issued a general policy statement reaffirming and articulating these principles, and confirming that the policy applies to failing bank situations. This long-standing policy has been recognized by the Supreme Court in its decision in *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234 (1978), and has been incorporated explicitly in the Board's Regulation Y, 12 C.F.R. 225.4(a)(1).

A fundamental and long-standing principle underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as sources of financial and managerial strength to their subsidiary banks. The Federal Deposit Insurance Act (FDIA) requires that a bank holding company or savings and loan holding company act as a source of strength to its depository institution(s). The term "source of strength" means the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of financial stress to the insured depository institution. (See the FDIA, section 38A(a)–(c).) It is the policy of the Board that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks in a manner consistent with the provisions of this policy statement.

Since the enactment of the Bank Holding Company Act in 1956, the Board has formally stated on numerous occasions that a bank holding company should act as a source of financial and managerial strength to its subsidiary banks. As the Supreme Court recognized, in the 1978 *First Lincolnwood* decision, Congress has expressly endorsed the Board's long-standing view that holding companies must serve as a "source of strength to subsidiary financial institutions."[1] In addition to frequent pronouncements over the years and the 1978 Supreme Court decision, this principle has been incorporated explicitly in Regulation Y since 1983. In particular, Section 225.4(a)(1) of Regulation Y provides that:

1. *Board of Governors* v. *First Lincolnwood Corp.,* 439 U.S. 234, 252 (1978), citing S. Rep. No. 95–323, 95th Cong., 1st Sess. 11 (1977).

"A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."

The important public policy interest in the support provided by a bank holding company to its subsidiary banks is based upon the fact that in acquiring a commercial bank, a bank holding company derives certain benefits at the corporate level that result, in part, from the ownership of an institution that can issue federally-insured deposits and has access to Federal Reserve credit. The existence of the federal "safety net" reflects important governmental concerns regarding the critical fiduciary responsibilities of depository institutions as custodians of depositors' funds and their strategic role within our economy as operators of the payments system and impartial providers of credit. Thus, in seeking the advantages flowing from the ownership of a commercial bank, bank holding companies have an obligation to serve as a source of strength and support to their subsidiary banks.

An important determinant of a bank's financial strength is the adequacy of its capital base. Capital provides a buffer for individual banking organizations to absorb losses in times of financial strain, promotes the safety of depositors' funds, helps to maintain confidence in the banking system, and supports the reasonable expansion of banking organizations as an essential element of a strong and growing economy. A strong capital cushion also limits the exposure of the federal deposit insurance fund to losses experienced by banking institutions. For these reasons, the Board has long considered adequate capital to be critical to the soundness of individual banking organizations and to the safety and stability of the banking and financial system.

Accordingly, it is the Board's policy that a bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing condition when the holding company is in a position to provide the support. A bank holding company's failure to assist a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a violation of Regulation Y or both.

Where necessary, the Board is prepared to take supervisory action to require such assistance. Finally, the Board recognizes that there may be unusual and limited circumstances where flexible application of the principles set forth in this policy statement might be necessary, and the Board may from time to time identify situations that may justify exceptions to the policy.

This statement is not meant to establish new principles of supervision and regulation; rather, as already noted, it builds on public policy considerations as reflected in banking laws and regulations and long-standing Federal Reserve supervisory policies and practices. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe and unsound banking practice or a violation of Regulation Y, or both, particularly if appropriate resources are on hand or are available to the bank holding company on a reasonable basis. Consequently, such a failure will generally result in the issuance of a cease and desist order or other enforcement action as authorized under banking law and as deemed appropriate under the circumstances.

2010.0.2 BOARD ORDER REQUESTING A WAIVER FROM THE BOARD'S SOURCE OF STRENGTH POLICY

On December 23, 1991, the Board approved an application of a BHC to eventually acquire 100 percent of the outstanding stock of another BHC under a 5 year option. Initially, the BHC would acquire approximately 26 percent of the acquiree's total capital by purchasing a 15-year subordinated capital note agreement. It would then have the option to acquire all of the remaining stock within 5 years. The acquiring BHC requested that the Board waive any requirement of the Board that it serve as a source of financial strength to the subsidiary bank (the Board's "Source of Strength" policy) of the BHC acquired until such time that the option is exercised to acquire the actual ownership of all the shares. The Board considered the request and determined that it would not be appropriate to waive the responsibility to serve as a source of financial strength to the bank in this case. The Board noted that the option agreement and the capital note agreement together provide a mechanism for the acquiring BHC to exert control over the future ownership of the acquired BHC and many of the most important management decisions. Refer to 1992 FRB 159 and the F.R.R.S. at 4-271.3.

2010.0.3 INSPECTION OBJECTIVES

1. To determine whether the board of directors of the parent company is cognizant of and performing its duties and responsibilities.
2. To determine the adequacy of written policies and compliance with such policies by the parent and its subsidiaries.
3. To determine whether the board is properly informed as to the financial conditions, trends and policies of its subsidiaries.
4. To determine the level of supervision over subsidiaries and whether the supervision as structured has a beneficial or detrimental effect upon the subsidiaries.

2010.0.4 INSPECTION PROCEDURES

1. Determine if the holding company maintains its own staff, or whether the holding company management and directorate are the same as those of a subsidiary.
2. Determine whether the board of directors of the parent company reviews the audit reports, regulatory examination reports, and board minutes of its subsidiaries.
3. Determine the extent to which subsidiaries rely upon the parent for investment and lending guidance.
4. Determine which specific functions and decisions are performed only at the parent company level.
5. Determine the extent to which representatives of the parent company serve as officers and/or directors of subsidiaries.
6. Review minutes of the board and executive committees of the parent to determine whether the parent company reviews loan delinquency reports, comparative balance sheets and comparative income statements of the subsidiaries.
7. Review the extent of influence and control over both bank and nonbank subsidiaries.
8. Determine the degree of influence by the parent company over:
   a. Appointment of officers;
   b. Salary administration;
   c. Budget and tax planning;
   d. Capital expenditures;
   e. Dividend policy;
   f. Investment portfolio management;
   g. Loan portfolio management;
   h. Asset/liability and interest rate/risk management.

9. Determine the degree to which management of the subsidiary companies interfaces with management of the parent company to discuss policies.

The responsibility for the performance of the organization rests with the board of directors of the parent company. Parent company management should have policies in place to prevent funding practices that put at risk the welfare of the subsidiary banks or the consolidated organization.

The parent's supervision and control of subsidiary funding activities and the funding between itself and its subsidiaries should be thus evaluated. The parent should be expected to maintain policies for itself and its subsidiaries that provide guidance and controls for funding practices. The presence and wording of funding policies and the degree to which the policies are followed by the subsidiaries, and the effectiveness of the policies in reducing risk to the entire organization should also be assessed.

The importance of the parent's involvement in funding decisions and the need for monitoring and control at the parent level needs to be emphasized. As a minimum, the parent's funding policies should address the following areas:

1. *Capitalization*—The holding company's policy on capital levels should address capital for the bank subsidiaries, the nonbank subsidiaries, and the consolidated organization. The policy for bank and consolidated capital should be consistent with the Board's Capital Adequacy Guidelines and should address the asset quality of the entity in question. The policy for nonbank capital should include maintaining the capital level at industry standards and should also address the asset quality of the subsidiary, the holding company's capital for each entity should address what measures would be taken in the event capital falls below a targeted level.

Capital should also be addressed at the parent company level by specifying the degree of ***double leverage*** that the parent is willing to accept. The parent's capital policy should provide some measure of assessing each individual subsidiary's capital adequacy in the context of the double leverage within the organization.

The capital policies should include the method for calculating dividends from each entity. The amount of dividends from subsidiaries to the parent is affected by the parent's philosophy on the distribution of capital throughout the organization. Some companies tend to keep minimum capital levels in their subsidiary banks by transferring the excess capital to the parent in the form of dividends. The parent then invests these funds for its own benefit, and downstreams the funds as needed. Other companies calculate dividends based strictly on the parent's cash needs and thus keep any excess capital at the bank level.

2. *Asset/Liability Management*—The holding company's policies in the area of *asset/liability management should include interest rate sensitivity matching, maturity matching, and the use of interest rate futures and forwards.* These topics should be addressed for each entity as well as the organization as a whole. It is the parent's responsibility to see that each entity is operating consistently with the corporate goals.

The ***interest rate sensitivity policies*** should be designed to reduce the organization's vulnerability to interest rate movements. Policies concerning the asset/liability rate sensitivity match should not be limited to the subsidiary lead bank. The rate charged on parent company debt and the rate received by the parent on its advances to subsidiaries should also be addressed to monitor the parent's ability to service its debt in the face of changing interest rates. The policy should specify what degree of mismatching is considered acceptable. The interest rate sensitivity matching of the organization should be monitored on a frequent basis through the timely preparation of a matching schedule.

Maturity matching policies should be designed to provide adequate liquidity to the organization. These policies should not be limited to the subsidiary lead bank, since a parent company serving as a funding vehicle for nonbank subsidiaries can have substantial exposure through its advances to these subsidiaries. The holding company's policies should include some measure of the liquidity of the assets in the nonbank subsidiary (determined partially by the quality of these assets), for comparison against the parent's source of funding. The policies should quantify the maximum degree of exposure in the organization that is considered acceptable to management. The reporting in this area should clearly indicate the current exposure and thus the potential for liquidity problems.

The holding company's ***policies addressing interest rate futures and forwards*** should be consistent with the Board's policy in this area. Involvement in this activity should be geared towards hedging against interest rate movements rather than speculating that interest rates will either increase or decrease. The policy should specify what use of futures and forwards is considered appropriate.

3. *Funding of Nonbank Subsidiaries*—The parent company should have policies addressing how nonbank subsidiaries fund their activities. If the subsidiaries obtain their own funding, market discipline may be a factor in controlling the activities of the subsidiaries. However, the parent cannot rely solely on market discipline due to the risks from interdependence. The parent company is still responsible under the centralized accountability approach to approve and supervise the subsidiaries' funding policies.

If the subsidiaries obtain funds from the parent, the risk from interdependence is increased. The subsidiary is less able to stand alone since it is reliant on the parent for funding. If the parent capitalizes the nonbank subsidiary through borrowed funds, bank capital is put at risk due to the increased exposure of the organization. If the borrowing results in ***double-leverage***, the risk is increased since less "hard" capital is available for support. The parent's policy on advances to nonbank subsidiaries should address this additional risk by specifying the level of borrowings that is considered acceptable relative to nonbank capital and consolidated capital. The terms of the borrowings should also be specified, and should be consistent with the company's asset/liability management policies. The policy should include contingency measures to be used in the event of liquidity problems.

2010.1.1 INSPECTION OBJECTIVES

1. To determine if the parent's funding policies adequately address funding risks to the organization.
2. To determine if the implementation of the parent's policies is effective in controlling funding risks to the organization.
3. To determine if the parent is adequately informed of actual funding practices and decisions.

2010.1.2 INSPECTION PROCEDURES

1. Review the funding policies at the parent and the subsidiary levels.
2. Determine how effectively the policies are implemented throughout the organization.
3. Discuss with management the funding practices of each subsidiary and any interorganizational funding.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, section 2010.2.5 is revised to reference SR-15-17, "Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending" and its attachment. Refer to the Board's December 18, 2015, press release.

2010.2.05 LOAN ADMINISTRATION

The examiner should make a qualitative assessment of the parent's supervision and control of subsidiary lending activities. The System's ability to evaluate the effectiveness of a company's supervision and control of subsidiary lending activities can be strengthened not only by evaluating the parent's role in light of efficiency and operating performance, but also by evaluating the *quality* of control and supervision.

In order to assess quality, there must be a standard measure against which a company's policies can be evaluated. Establishing the minimum areas that a company's loan-administration policies should address will create a standard that will aid in evaluating the quality of the company's control and its supervision of that activity.

Current inspection procedures include the testing of subsidiaries' compliance with a parent company's policies. This section summarizes the parent's responsibilities with regard to supervising subsidiary lending. It defines the internal and external factors that should be considered in the formulation of loan policies and a strategic plan. It also outlines the minimum elements that the lending policies should include.

Internal and external factors that a banking organization should consider when formulating its loan policies and strategic plan are—

1. the size and financial condition of the credit-extending subsidiaries,
2. the expertise and size of the lending staff,
3. the need to avoid undue concentrations of risk,
4. compliance with all respective laws and regulations, and
5. market conditions.

Following are the components that generally form the basis for a sound loan policy:

1. *Geographic limits.* The trade area should be clearly defined and loan officers should be fully aware of specific geographic limitations for lending purposes. Such a policy avoids approval of loans to customers outside the trade area in opposition to primary objectives. The primary trade area should be distinguished from any secondary trade area so that emphasis for each trade area may be properly placed.
2. *Distribution of loans by category.* Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, and other categories are common. Such policies are beneficial; however, they should contain provisions for deviations that are approved by the directorate or a committee. This allows credit to be distributed in relation to the market conditions of the trade area. During times of heavy loan demand in one category, an inflexible loan-distribution policy would cause that category to be slighted in favor of another. Deviations from loan distributions by category may be beneficial but are appropriate only until the risk of further increasing the loan concentration outweighs the benefits to be derived from expanding the portfolio to satisfy credit demand. See component 11, "Concentrations of credit," below.
3. *Types of loans.* The lending policy should state the types of loans that will be made and the maximum amount for each type of loan. The policy should also set forth guidelines to follow in making specific loans. Decisions about the types of loans to be granted should be based on the expertise of the lending officers, the deposit structure, and anticipated creditworthy demands of the trade area. Sophisticated credits or loans secured by collateral that require more than normal supervision should be avoided unless or until there are the necessary personnel to properly administer them. Information systems and internal controls should be in place to identify, monitor, and control the types of credit that have resulted in abnormal loss. The amount of real estate and other types

of term loans should be considered in relation to the amount of stable funds.

4. *Maximum maturities.* The loan policy should call for underwriting standards that ensure realistic repayment plans. Loan maturities should be set by taking into consideration the anticipated source of repayment, the purpose of the loan, the type of property, and the useful life of the collateral. For term loans, the lending policy should state the maximum time within which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and/or modification of the original terms of the loan. If a clean-up period[1]
5. *Loan pricing.* Rates on various loan types must be sufficient to cover the cost of funds loaned and the servicing of the loan, including overhead and possible losses, while providing an acceptable margin of profit over the long run. These costs must be known and taken into consideration before rates are established. Periodic reviews should be conducted to determine whether adjustments are necessary to reflect changes in costs or competitive factors. Specific guidelines for other factors, such as compensating balances and commitment fees, are also germane to loan pricing.
6. *Loan amount to appraised value.* The policy should outline where the responsibility for appraisals rests and should define formal, standard appraisal procedures, including procedures for possible reappraisals in case of renewal or extension. Acceptable types of appraisals and limits on the dollar amount and the type of property that personnel are authorized to appraise should be outlined. Circumstances requiring appraisals by qualified independent appraisers should be described. The maximum ratio of the loan amount to appraised value,[2] the method of valuation, and differences for various types of property should be detailed. The policy should contain a schedule listing the downpayment requirements for financing consumer goods and business equipment.
7. *Loan amount to market value of pledged securities.* In addition to the legal restrictions imposed by Federal Reserve Regulation U, the lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security (for example, closely held, over-the-counter, actively traded). The policy should assign responsibility and set a frequency for the periodic pricing of the collateral.
8. *Financial information.* Extension of credit on a safe and sound basis depends on complete and accurate information regarding the borrower's credit standing. One possible exception is when the loan is predicated on readily marketable collateral, the disposition of which was originally designated as the source of repayment for the advance. Current and complete financial information is necessary, including secondary sources of repayment, not only at the inception of the loan, but also throughout the term of the advance. The lending policy should define the financial-statement requirements for businesses and individuals at various borrowing levels and should include requirements for audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements.[3] It should include external credit checks required at various intervals. The requirements for financial information should be defined in such a way that any credit-data exception would be a clear violation of the lending policy.
9. *Limits and guidelines for loan participations.* Section 2020.2 provides significant information regarding intercompany loan participations between holding company affiliates. The lending policy should place

11. A "clean-up period" is when a borrower is asked to repay the entire balance of a credit line and to refrain from further borrowing for a specified period of time.

2. This is often referred to as the loan-to-value ratio.

3. On March 30, 1993, federal bank regulators set forth an expanded interagency policy to encourage small-business lending. Under the policy, banks and thrifts that are well or adequately capitalized and that are rated CAMELS 1 or 2 may make small-business and agricultural loans, the aggregate value of which cannot exceed 20 percent of their total capital. To qualify for the exemption, each loan may not exceed the lesser of $900,000 or 3 percent of the institution's total capital. Further, the loans selected for this exemption by the institution may not be delinquent as of the selection date and may not be made to an insider. The loans must be separately listed or have an accounting segregation from other loans in the portfolio. They "will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation." The institution's records must include an evaluation of its ability to collect the loan in determining the adequacy of its allowance for loan and lease losses. If a loan becomes more than 60 days past due, it may be reviewed and classified by an examiner based on its credit quality, not the level of loan documentation.

limits on the amount of loans purchased from any one source and also place an aggregate limit on such loans. The policy should set forth credit standards for any loan purchased as well as require that complete documentation be maintained by the purchasing entities. The policy should define the extent of contingent liability, holdback and reserve requirements, and the manner in which the loan will be handled and serviced.

10. *Loans to insiders.* Lending policies should address loans to insiders. Such policies should incorporate applicable regulatory limitations (for example, Federal Reserve Regulation O) and should also address situations in which it would be prudent to exercise certain restrictions even though not explicitly required to do so by regulation (for example, loans by nonbank subsidiaries to insiders).
11. *Concentrations of credit.* Credit concentrations may be defined as loans collateralized by a common security; loans to one borrower or related group of borrowers; loans dependent upon a particular agricultural commodity; aggregate loans to major employers, their employees, and their major suppliers; loans within industry groups; out-of-territory loans; aggregate amount of paper purchased from any one source; or those loans that often have been included in other homogeneous risk groupings. Credit concentrations, by their nature, are dependent on common key factors, and when weaknesses develop, they have an adverse impact on each individual loan making up the concentration.

    In identifying asset concentrations, commercial real estate loans and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not necessarily be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take-out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

Banking organizations should establish and adhere to policies that control "concentration risk." The lending policy should address the risk involved in various concentrations and indicate those that should be avoided or limited. However, before concentrations can be limited or reviewed, accounting systems must be in place to allow for the retrieval of information necessary to determine and monitor concentrations. The lending policy should provide for frequent monitoring and reporting of all concentrations.

Banking organizations with asset concentrations are expected to put in place effective internal policies, systems, and controls to monitor and manage this risk. Concentrations that involve excessive or undue risks require close scrutiny and should be reduced over a reasonable period of time. When there is a need to reduce asset concentrations, banking organizations are normally expected to develop a plan that is realistic, prudent, and achievable in view of the particular circumstances and market conditions. In situations where concentration levels have built up over an extended period, it may take time—in some cases several years—to achieve a more balanced and diversified portfolio. What is critical is that adequate systems and controls are in place for reducing undue or excessive concentrations in accordance with a prudent plan, along with strong credit policies and loan-administration standards to control the risks associated with new loans, and adequate capital to protect the institution while its portfolio is being restructured.

Institutions that have in place effective internal controls to manage and reduce concentrations over a reasonable period of time *need not* automatically refuse credit to sound borrowers simply because of the borrower's industry or geographic location. This principle applies to prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner.

The purpose of a lending organization's policies should be to improve the overall quality of its portfolio. The replacement of unsound loans with sound loans can enhance the quality of a portfolio, even when concentration levels are not reduced.

12. *Refinancing or renewal of loans.* Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and in a manner that protects the banking organization and improves its prospects for collecting or recovering on the asset.
13. *Loan origination and loan approvals.* The policy should establish loan-origination and loan-approval procedures, both generally and by size and type of loan. The loan limitations for all lending officers should be set accordingly. Lending limits should also be set for group authority, allowing a combination of officers or a committee to approve larger loans. Reporting procedures and the frequency of committee meetings should also be defined. The loan policy should further establish identification, review, and approval procedures for exception loans, including real estate and other loans with loan-to-value percentages in excess of supervisory limits.[4]
14. *Loan-administration procedures for loans secured by real estate.* The loan policy should establish loan-administration procedures covering documentation, disbursement, collateral administration and inspection, escrow administration, collection, loan payoffs, and loan review. Documentation procedures would specify, among other things, the types and frequency of financial statements and the requirements for verifying information provided by the borrower. They would also cover the type and frequency of collateral evaluations (appraisals and other estimates of value). In addition, loan-administration policies should address procedures for servicing and participation agreements and other loan-administration procedures such as those for claims processing (for example, seeking recovery on defaulted loans that are partially or fully guaranteed by a government entity or insurance program).
15. *Collection and foreclosure and the reporting and disclosure of delinquent obligations and charge-offs.* The lending policy should define delinquent obligations, provide guidelines on when loans are to be placed on nonaccrual or to be restructured, dictate appropriate procedures for reporting to senior management and to the directorate past-due credits, and provide appropriate guidance on the extent of disclosure of such credits. The policy should establish and require a follow-up collection procedure that is systematic and progressively stronger and should set forth guidelines (where applicable) for close surveillance by a loan work-out division. It should also address extensions and other forms of forbearance, the acceptance of deeds in lieu of foreclosure, and the timing of foreclosure. The policy must be consistent with supervisory instructions in the financial statements of condition and income for financial institutions and BHCs (bank call report and the FR Y-9C and the other FR Y-series reports). Guidelines should be established to ensure that all accounts are presented to and reviewed by management for charge-off after a stated period of delinquency. See section 2065.1 for disclosure, accounting, and reporting issues related to nonaccrual loans and restructured debt.
16. *Reserve for loan losses and provisions for loan losses.* The policy should set forth the parameters that management considers in determining an appropriate level of loan-loss reserves as well as provisions necessary to attain this level.

    Because an analysis of the allowance for loan and lease losses (ALLL) requires an assessment of the relative credit risks in the portfolio, many banking organizations, for analytical purposes, attribute portions of the ALLL to loans and other assets classified "substandard" by management or a supervisory agency. Management may do this because it believes, based on past history or other factors, that there may be unidentified losses associated with loans classified substandard in the aggregate.

    Furthermore, management may use this as an analytical approach in estimating the total amount necessary for the ALLL and in comparing the ALLL to various categories of loans over time. As a general rule, an individual loan classified substandard may remain in an accrual status as long as the regulatory reporting requirements for accrual treatment are met, even when an attribution of the ALLL has been made.
17. *Other.* The policy should address the handling of exceptions to the policy as well as

4. For subsidiaries that are insured depository institutions, real estate loans that are in excess of supervisory loan-to-value limits are to be identified in the subsidiaries' records. The aggregate amount of these loans is to be reported quarterly to the depository institution's board of directors.

provide for adherence to the policy via internal audits, centralized loan review, and/or “director’s examinations.” The policy should be reviewed annually to determine if it continues to be compatible with the BHC’s objectives as well as market conditions.

2010.2.1 UNIFORM REAL ESTATE LENDING STANDARDS

On December 23, 1992, the Board announced adoption of a uniform rule and guidelines on real estate lending, along with the FDIC, OCC, and OTS, as mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The Board’s Regulation H (12 C.F.R. 208, Membership of State Banking Institutions in the Federal Reserve System) was amended to implement the uniform real estate lending standards for state member banks. Although the Board did not directly apply the regulation to bank holding companies and their nonbank subsidiaries, those entities are expected to conduct and to supervise real estate lending activities prudently, consistent with safe and sound lending standards.

The agencies’ regulations require that each insured depository institution adopt and maintain comprehensive written real estate lending policies appropriate to the institution and the nature and scope of its lending activities. Lending policies must be reviewed and approved by the institution’s board of directors at least annually. The policies are to include standards for loan diversification and prudent underwriting as well as loan-administration procedures and documentation, approval, and reporting requirements. Depository institutions’ policies are to reflect consideration of the appendix to the banking agencies’ regulations, “Interagency Guidelines for Real Estate Lending Policies.” The guidelines are designed to help an institution formulate and maintain real estate lending policy that is appropriate to its size and the nature and scope of its operations, as required by the regulations. These guidelines are generally comparable to the inspection guidance provided in this section.

2010.2.2 LENDING STANDARDS FOR COMMERCIAL LOANS

The lending decision is properly that of the senior management and boards of directors of banking institutions, and not of their supervisory agencies. However, in fulfilling their roles, directors and senior managers have the obligation to monitor lending practices and to ensure that their policies are enforced and that lending practices generally remain within the overall ability of the institution to manage. The following subsections describe certain sound practices regarding lending standards and credit-approval processes for commercial loans.[5]

Sound lending practices address formal credit policies, formal credit-staff approval of transactions, loan-approval documentation, the use of forward-looking tools in the approval process, and management and lender information systems. In addition to evaluating adherence to these sound practices during inspections, supervisory personnel and examiners may wish to discuss these standards with loan portfolio managers at institutions where a full credit review is being performed. Senior management should be made aware of the potential for deterioration in the loan portfolio if lending discipline is not maintained, whether from inadequate assessment or communication of lending risks, incomplete adherence to prudent lending standards that reflect the risk appetite of the board of directors, or both.

Examiners should evaluate whether adequate internal oversight exists and whether institution management has timely and accurate information. As always, examiners should also discuss matters of concern with the institution and include them in their reports of inspection, even if cited practices and problem loans have not yet reached harmful or criticized levels. Such cautionary remarks help to alert institution management to potential or emerging sources of concern and may help to deter future problems. Any practices that extend beyond prudent bounds should be promptly corrected. See SR-98-18.

2010.2.2.1 Sound Practices in Loan Standards and Approval

Certain sound practices in lending can help to maintain strong credit discipline and ensure that an institution’s decision to take risk in lending is

5. This guidance is derived, in part, from the June 1998 Federal Reserve supervisory staff report, “The Significance of Recent Changes in Bank Lending Standards: Evidence from the Loan Quality Assessment Project.”

well informed, balanced, and prudent. Several of these sound practices are listed and described below.

2010.2.2.1.1 *Formal Credit Policies*

The Federal Reserve and other supervisory authorities have long stressed the importance of formal written credit policies in a sound credit-risk-management process. Such policies can provide crucial discipline to an institution's lending process, especially when the institution's standards are under assault due to intense competition for loans. They can serve to communicate formally an institution's appetite for credit risk in a manner that will support sound lending decisions, while focusing appropriate attention on loans being considered that diverge from approved standards.

In developing and refining loan policies, some institutions specify "guidance minimums" for financial performance ratios that apply to certain types of loans or borrowers (for example, commercial real estate). Such guidance makes explicit that loans not meeting certain financial tests (based on current performance, projected future performance, or both) should in general not be made, or alternatively should only be made under clearly specified situations. Institutions using this approach most effectively tend to avoid specifying standards for broad ranges of lending situations and instead focus on those areas of lending most vulnerable to excessive optimism, or where the institution expects loan volume to grow most significantly.

Formal policies can also provide lending discipline by clearly stating the type of covenants to be imposed for specific loan types. When designed and enforced properly, financial covenants can help significantly to reduce credit losses by communicating clear thresholds for financial performance and potentially triggering corrective or protective action at an early stage. Often, however, loan-approval documents do not describe the key financial covenants even when discussions with institutional staff disclose that such covenants are present. The staff and/or management of many institutions acknowledge that they have a "common practice" of imposing certain types of covenants on various types of loans. They indicate that such a practice is well known to lenders and others at the institution (but not articulated in their written loan policies), so that describing the actual covenants in the loan-approval document would be redundant. However, management and other approving authorities within an institution then receive no formal positive indication that "common practice" controls have been imposed and no indication of the level of financial performance that the covenants require of the borrower. As such, management and other approving authorities may be inadequately informed as to the risks and controls associated with the loan under consideration. In contrast, loan policies can create a clear expectation that (1) all key covenants should be described in loan-approval documents, (2) certain covenant types should be applied to all loans meeting certain criteria, and (3) explicit approval of any exception to these policies is necessary if such covenant requirements are to be waived.

Internal processes and requirements for underwriting decisions should be consistent with the nature, size, and complexity of the banking organization's (BO) activities. Departures from underwriting policies and standards, however, can have serious consequences for BOs of all sizes. Internal controls and credit reviews should be established and maintained to ensure compliance with those policies and procedures. When there are continued favorable economic and financial conditions, compliance monitoring of the BO's lending policies and procedures needs to be diligent to make certain that there is no undue reliance on optimistic outlooks for borrowers. Undue reliance on continued favorable economic conditions can be demonstrated by the following characteristics:

1. dependence on very rapid growth in a borrower's revenue as the "most likely" case
2. heavy reliance on favorable collateral appraisals and valuations that may not be sustainable over the longer term
3. greater willingness to make loans without scheduled amortization prior to the loan's final maturity
4. willingness to readily waive violations of key covenants, to release collateral or guarantee requirements, or even to restructure loan agreements, without corresponding concessions on the part of the borrower, on the assumption that a favorable environment will allow the borrower to recover quickly

Among the adverse effects of undue reliance on a continued favorable economy is the possibility that problem loans will not be identified properly or in a timely manner. Timely identification of problem loans is critical for providing a full awareness of the BO's risk position, informing management and directors of that position, taking steps to mitigate risk, and providing a proper assessment of the adequacy of the allowance for credit losses and capital.[6] Similarly, an overreliance on continued ready access to financial markets on favorable terms can originate from the following situations:

1. explicit reliance on future public market debt or equity offerings, or on other sources of refinancing, as the ultimate source of principal repayment, which presumes that market liquidity and the market's appetite for such instruments will be favorable at the time that the facility is to be repaid
2. ambiguous or poorly supported analysis of the sources of repayment of the loan's principal, together with implicit reliance for repayment on some realization of the implied market valuation of the borrower (for example, through refinancing, asset sales, or some form of equity infusion), which also assumes that markets will be receptive to such transactions at the time that the facility is to be repaid
3. measuring a borrower's leverage (for example, debt-to-equity) based solely on the market capitalization of the firm without regard to "book" equity, thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed
4. more generally, extending loans with a risk profile that more closely resembles the profile of an equity investment, under circumstances that leave additional credit or default as the borrower's only resort if favorable expectations are not met

Banking organizations that become lax in adhering to established loan-underwriting policies and procedures, as a result of overreliance on favorable economic and financial market conditions, may have significant credit concentrations that are at great risk to possible economic and financial market downturns. See SR-99-23.

Some institutions have introduced credit scoring techniques into their small-business lending in an effort to improve credit discipline while allowing heavier reliance on statistical analysis rather than detailed and costly analysis of individual loans. Institutions should take care to make balanced and careful use of credit scoring technology for small-business lending and, in particular, avoid using this technology for loans or credit relationships that are large or complex enough to warrant a formal and individualized credit analysis.

In formalizing their lending standards and practices, institutions are not precluded from making loans that do not meet all written standards. Exceptions to policies, though, should be approved and monitored by management. Formal reporting that describes exceptions to loan policies, by type of exception and organizational unit, can be extremely valuable for informing management and directors of the number and nature of material deviations from the policies that they have designed and approved.

2010.2.2.1.2 Formal Credit-Staff Approval of Transactions

Credit discipline is also enhanced when experienced credit professionals are involved in the approval process and are independent of the line lending functions.[7] Such staff can play a vital role in ensuring adherence to formal policies and in ensuring that individual loan approvals are consistent with the overall risk appetite of the institution. These independent credit professionals can be most valuable if they have the authority to reject a loan that does not meet the institution's credit standards or, alternatively, if they must concur with a loan before it can be approved.

Providing credit staff with independent approval authority over lending decisions, rather than with a more traditional requirement for "consultation" between the lending function and credit staff, allows credit staff to influence outcomes on a broad and ongoing basis. This influence and indeed the ability of credit staff to reinforce lending discipline is clearly enhanced by their early involvement in negotiations with borrowers; a more traditional approach might be to only involve credit staff once the loan pro-

6. See section 2122.0 and SR-98-25, "Sound Credit-Risk Management and the Use of Internal Credit-Risk-Rating Systems at Large Banking Organizations." Federal Reserve guidance on credit-risk management and mitigation covers both loans and other forms of on- and off-balance-sheet credit exposure.

7. For example, loan officers might be compensated for bringing loan business into the institution. Independent credit professionals, however, would be another person who would not be compensated for bringing any loan business into the institution. That person would, however, serve as a quality control monitor that would have the independent authority to reject a loan(s) and to ensure that the institution's risk appetite and credit standards are not exceeded.

posal is well developed, allowing credit staff the opportunity to have only minor influence on the outcome of negotiations except in extreme cases. Maintaining a proper balance of lending and control functions calls for a degree of partnership between line lenders and credit staff, but also requires that the independence of credit staff not be compromised by conflicting compensation policies or reporting structures.

Independent credit staff can also support sound lending practice by maintaining complete and centralized credit files that contain all key documents relevant to each loan, including complete loan-approval packages. Such files ensure that decisions are well documented and avoid undue reliance on the files maintained by individual loan officers.

2010.2.2.1.3 Loan-Approval Documents

Institutions can help ensure a careful loan-approval decision by requiring thorough and standardized loan-approval documents. Thoroughness can be enhanced by requiring formal analysis of the borrower's financial condition, key characteristics and trends in the borrower's industry, information on collateral and its valuation, as well as financial analysis of the entities providing support or guarantees and formal forward-looking analyses appropriate to the size and type of loan being considered. Incorporating such elements into standardized formats and requiring that analysis and supporting commentary be complete and in adequate depth allows approving authorities access to all relevant information on the risk profile of the borrower. Loan-approval documents should also include all material details on the proposed loan agreement itself, including key financial covenants. Standardization of formats, and to some extent content, can be useful in ensuring that all relevant information is provided to management and other approving authorities in a manner that is understandable. Standard formats also draw attention to cases in which certain key information is not presented.

One area of particular interest in this regard is analysis and commentary on participations in syndicated loans. While it may be tempting to rely on the analysis and documentation provided by the agent institution to the transaction, it has been long-standing Federal Reserve policy that participating institutions should conduct their own analysis of the borrower and the transactions, particularly if the risk appetite or portfolio characteristics of the agent differs from that of the participating institution.

2010.2.2.1.4 Use of Forward-Looking Tools in the Approval Process

During continued periods of favorable economic conditions, institutions should guard against complacency and, in particular, the temptation to base expectations of a borrower's future financial performance almost exclusively on that borrower's recent performance. In making lending decisions, and in evaluating their loan portfolio, institutions should give sufficient consideration to the potential for negative events or developments that might limit the ability of borrowers to fulfill their loan obligations. Unforeseen changes in interest rates, sales revenue, and operating expenses can have material and adverse effects on the ability of many borrowers to meet their obligations. In prior decades, inadequate attention to these possibilities during the underwriting process contributed significantly to asset-quality problems in the system. Also, sudden turmoil within various countries can result in quick changes in currency valuations and economic conditions.

Examiners should evaluate the frequency and adequacy with which institutions conduct forward-looking analysis of borrower financial performance when considering an institution's credit-risk-management process. Formal use of forward-looking financial analysis in the loan-approval process, and financial projections in particular, can be important in guarding against such complacency, especially when financial institutions are competing intensely to attract borrowers. Such projections, if they include less favorable scenarios for the key determinants of the borrower's financial performance, can help to contain undue optimism and ensure that management and other approving authorities within the organization are formally presented with a robust analysis of the risks associated with each credit. They also provide credit staff and other risk-management personnel with information that is important for ensuring adherence to the institution's lending standards and overall appetite for loan risk.

The formal presentation of financial projections and/or other forms of forward-looking analyses of the borrower is important in making explicit the conditions required for a loan to perform and in communicating the vulnerabilities of the transaction to those responsible for approving loans. Analyses also provide a useful benchmark against which institutions can assess the borrower's future performance. Although it may be tempting to avoid analyzing detailed projections for smaller borrowers, such as middle-market firms, these customers may collectively represent a significant portion of the institution's loan portfolio. As such, applying formal forward-looking analysis even on a basic level assists the institution in identifying and managing the overall risk of its lending activities.

Detailed analysis of industry performance and trends can be a useful supplement to such analyses. Such projections have the most value in maintaining credit discipline when, rather than only describing the single "most likely" scenario for future events, they characterize the kind of negative events that might impair the performance of the loan in the future.

2010.2.2.1.5 Stress Testing of the Borrower's Financial Capacity

The analysis of alternative scenarios, or "stress testing," should generally focus on the key determinants of performance for the borrower and the loan, such as the level of interest rates, the rate of sales or revenue growth, or the rate at which expense reductions can be realized. Meaningful stress testing of the prospective borrower's ability to meet its obligations is a vital part of a sound credit decision. Failure to recognize the potential for adverse events—whether specific to the borrower or its industry (for example, a change in the regulatory climate or the emergence of new competitors) or, alternatively, to the economy as a whole (for example, a recession)—can prove costly to a banking organization.

Mechanical reliance on threshold financial ratios (and the "cushion" they imply) alone is generally not sufficient, particularly for complex loans and loans to leveraged borrowers or others that must perform exceptionally well to meet their financial obligations successfully. Scenario analysis specific to the borrower, its industry, and its business plan is critical to identify the key risks of a loan. Such an analysis should have a significant influence on the decision to extend credit and, if credit is extended, on the decisions as to the appropriate loan size, repayment terms, collateral or guarantee requirements, financial covenants, and other elements of the loan's structure.

When properly conducted, meaningful stress testing can include assessing the effect the following situations or events will have on the borrower:

1. unexpected reductions in revenue growth or reversals, including shocks to revenue of the type and magnitude that would normally be experienced during a recession
2. unfavorable movements in market interest rates, especially for firms with high debt burdens
3. unplanned increases in capital expenditures due to technological obsolescence or competitive factors
4. deterioration in the value of collateral, guarantees, or other potential sources of principal repayment
5. adverse developments in key product or input markets
6. reversals in, or the borrower's reduced access to, public debt and equity markets

Proper stress testing typically incorporates an evaluation of the borrower's alternatives for meeting its financial obligations under each scenario, including asset sales, access to alternative funding or refinancing, or ability to raise new equity. In particular, the evaluation should focus not only on the borrower's ability to meet near-term interest obligations, but also on its ability to repay the principal of the obligation. See SR-99-23.

2010.2.2.1.6 Management and Lender Information

Management information systems that support the loan-approval process should clearly indicate the composition of the institution's current portfolio or exposure to allow for consideration of whether a proposed new loan—regardless of its own merits—might affect this composition sufficiently to be inconsistent with the institution's risk appetite. In particular, institutions active in commercial real estate lending should know the nature and magnitude of aggregate exposure within relevant subclasses, such as by the type of property being financed (that is, office, residential, or retail).

In addition to portfolio information, institutions should be encouraged to acquire or develop information systems that provide ready access for lenders and credit analysts to information sources that can support and enhance the financial analysis of proposed loans. Depending on the nature of an institution's borrowers, appropriate information sources may include industry financial data, economic data and forecasts, and other analytical tools such as bankruptcy scoring and default-probability models.

2010.2.3 LEVERAGED LENDING

Leveraged lending has been a financing vehicle for transactions involving mergers and acquisitions, business recapitalizations, and business expansions.[8] It is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. Leveraged transactions are characterized by a degree of financial leverage that may significantly exceed industry norms as measured by ratios such as debt-to-assets, debt-to-equity, cash flow-to-total debt, or other ratios and standards that are unique to a particular industry. Leveraged borrowers, however, can have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit-risk exposure and challenges for bank risk-management systems.

Leveraged lending activities can be conducted in a safe-and-sound fashion if pursued with a risk-management structure that provides for the appropriate underwriting, pricing, monitoring, and controls. Comprehensive credit analysis processes, frequent monitoring, and detailed portfolio reports are needed to better understand and manage the inherent risk in leveraged portfolios. Sound valuation methodologies must be used in addition to ongoing stress testing and monitoring.

Financial institutions should ensure they do not unnecessarily heighten risks by originating and then distributing poorly underwritten loans.[9] For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system. The leveraged lending guidance that follows is designed to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner.

On March 21, 2013, the Federal Reserve Board, along with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), issued "Interagency Guidance on Leveraged Lending."[10] The statement provides guidance about risk rating leveraged-financed loans. See SR-13-3 and its attachment.

2010.2.3.1 Interagency Guidance on Leveraged Lending

The vast majority of community banks should not be affected by this guidance, as they have limited involvement in leveraged lending. Community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator the implementation of cost-effective controls appropriate for the complexity of their exposures and activities.[11]

2010.2.3.1.1 Risk-Management Framework

Given the high-risk profile of leveraged transactions, financial institutions engaged in leveraged lending should adopt a risk-management framework that has an intensive and frequent review and monitoring process. The framework should have as its foundation written risk objectives, risk-acceptance criteria, and risk controls. A lack of robust risk-management processes and controls at a financial institution with significant

8. For the purpose of this guidance, references to leveraged finance, or leveraged transactions encompass the entire debt structure of a leveraged obligor (including loans and letters of credit, mezzanine tranches, senior and subordinated bonds) held by both bank and nonbank investors. References to leveraged lending and leveraged loan transactions and credit agreements refer to all debt with the exception of bond and high-yield debt held by both bank and nonbank investors.

9. For purposes of this guidance, the term "financial institution" or "institution" includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor.

10. This guidance augments previously issued supervisory statements on sound credit-risk management. Refer to SR-98-18, "Lending Standards for Commercial Loans."

11. The agencies do not intend that a financial institution that originates a small number of less complex, leveraged loans should have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions should follow applicable supervisory guidance provided in "Participations Purchased" of this section.

leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe and unsound banking practices. This guidance outlines the agencies' minimum expectations on the following topics:

- Leveraged Lending Definition
- General Policy Expectations
- Participations Purchased
- Underwriting Standards
- Valuation Standards
- Pipeline Management
- Reporting and Analytics
- Risk Rating Leveraged Loans
- Credit Analysis
- Problem-Credit Management
- Deal Sponsors
- Credit Review
- Stress Testing
- Conflicts of Interest
- Reputational Risk
- Compliance

2010.2.3.1.2 Leveraged Lending Definition

The policies of financial institutions should include criteria to define leveraged lending that are appropriate to the institution.[12] For example, numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- proceeds used for buyouts, acquisitions, or capital distributions
- transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0 * EBITDA or 3.0 * EBITDA, respectively, or other defined levels appropriate to the industry or sector[13]
- a borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio
- transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels[14]

A financial institution engaging in leveraged lending should define it within the institution's policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. A financial institution's definition should describe clearly the purposes and financial characteristics common to these transactions, and should cover risk to the institution from both direct exposure and indirect exposure via limited-recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

2010.2.3.1.3 General Policy Expectations

A financial institution's credit policies and procedures for leveraged lending should address the following:

- Identification of the financial institution's risk appetite, including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The institution's designated risk appetite should be supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and should be approved by its board of directors.
- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The limit framework should identify the related management-approval authorities and exception-tracking provisions. In addition to notional pipeline limits, the agencies expect that financial institutions with significant leveraged transactions will implement underwriting-limit frame-

12. This guidance is not meant to include asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor. Asset-based lending is a distinct segment of the loan market that is tightly controlled or fully monitored, secured by specific assets, and usually governed by a borrowing formula (or "borrowing base").

13. Cash should not be netted against debt for purposes of this calculation.

14. The designation of a financing as "leveraged lending" is typically made at loan origination, modification, extension, or refinancing. "Fallen angels" or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged would not be included within the scope of this guidance, unless the credit is modified, extended, or refinanced.

works that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk.[15]

- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses.
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms.
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors.
- Expected risk-adjusted returns for leveraged transactions.
- Minimum underwriting standards (see the "Underwriting Standards" section below).
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

2010.2.3.1.4 Participations Purchased

Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds.[16] They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for

- obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- carefully monitoring the borrower's performance throughout the life of the loan; and
- establishing appropriate risk-management guidelines as described in this document.

2010.2.3.1.5 Underwriting Standards

A financial institution's underwriting standards should be clear, written, and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. A financial institution should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, an institution's underwriting standards should consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute. The entirety of a borrower's capital structure should reflect the application of sound financial analysis and underwriting principles.
- A borrower's capacity to repay and the ability to de-lever to a sustainable level over a reasonable period. As a general guide, institutions also should consider whether base-case cash-flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term.[17] Also, projections should include one or more realistic downside scenarios that reflect key risks identified in the transaction.

15. Flex terms allow the arranger to change interest-rate spreads during the syndication process to adjust pricing to current liquidity levels.

16. Refer to other joint agency guidance regarding purchased participations: OCC Loan Portfolio Management Handbook, www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf, "Loan Participations"; Board Commercial Bank Examination Manual, www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf, section 2045.1, "Loan Participations, the Agreements and Participants"; and FDIC Risk Management Manual of Examination Policies, "Section 3.2-Loans," www.fdic.gov/regulations/safety/manual/section3-2.html#otherCredit, Loan Participations (last updated Feb. 2, 2005).

17. In general, the base-case cash-flow projection is the borrower or deal sponsor's expected estimate of financial performance using the assumptions that are deemed most likely to occur. The financial results for the base case should be better than those for the conservative case but worse than those for the aggressive or upside case. A financial institution may adjust the base-case financial projections, if necessary. The most realistic financial projections should be used when measuring a borrower's capacity to repay and de-lever.

- Expectations for the depth and breadth of due diligence on leveraged transactions. This should include standards for evaluating various types of collateral, with a clear definition of credit-risk-management's role in such due diligence.
- Standards for evaluating expected risk-adjusted returns. The standards should include identification of expected distribution strategies, including alternative strategies for funding and disposing of positions during market disruptions, and the potential for losses during such periods.
- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values.
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors. Institutions looking to rely on sponsor support as a secondary source of repayment for the loan should be able to provide documentation, including, but not limited to, financial or liquidity statements, showing recently documented evidence of the sponsor's willingness and ability to support the credit extension.
- Whether credit-agreement terms allow for the material dilution, sale, or exchange of collateral or cash-flow-producing assets without lender approval.
- Credit-agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed-charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6* Total Debt/EBITDA raises concerns for most industries.
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral-valuation methodologies. Standards for asset-based loans that are part of the entire debt structure also should outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements.
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Nothing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured, standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which a financial institution should consider separate underwriting and risk-rating guidance.

2010.2.3.1.6 Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk-assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The "capitalized cash flow" method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The "discounted cash flow" method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the "discount rate") that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a lender should reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets should be tested under a range of stress scenarios, including business conditions more adverse than the base-case scenario. Stress tests of enterprise values and their underlying assumptions should be conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The institution should perform its own discounted cash-flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral should have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the institution should establish limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise value estimates should be clearly documented, well supported, and understood by the institution's appropriate decisionmakers and risk-oversight units. Further, an institution's valuation methods should be appropriate for the borrower's industry and condition.

2010.2.3.1.7 Pipeline Management

Market disruptions can substantially impede the ability of an underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses. Accordingly, financial institutions should have strong risk management and controls over transactions in the pipeline, including amounts to be held and those to be distributed. A financial institution should be able to differentiate transactions according to tenor, investor class (for example, pro-rata and institutional), structure, and key borrower characteristics (for example, industry).

In addition, an institution should develop and maintain the following:

- A clearly articulated and documented appetite for underwriting risk that considers the potential effects on earnings, capital, liquidity, and other risks that result from pipeline exposures.
- Written policies and procedures for defining and managing distribution failures and "hung" deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from transaction closing). The financial institution's board of directors and management should establish clear expectations for the disposition of pipeline transactions that are not sold according to their original distribution plan. Such transactions that are subsequently reclassified as hold-to-maturity should also be reported to management and the board of directors.
- Guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.
- Controls to monitor performance of the pipeline against original expectations, and regular reports of variances to management, including the amount and timing of syndication and distribution variances and reporting of recourse sales to achieve distribution.
- Reports that include individual and aggregate transaction information that accurately risk rates credits and portrays risk and concentrations in the pipeline.
- Limits on aggregate pipeline commitments.
- Limits on the amount of loans that an institution is willing to retain on its own books (that is, borrower, counterparty, and aggregate hold levels), and limits on the underwriting risk

that will be undertaken for amounts intended for distribution.
- Policies and procedures that identify acceptable accounting methodologies and controls in both functional as well as dysfunctional markets, and that direct prompt recognition of losses in accordance with generally accepted accounting principles.
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures, which should address acceptable types of hedges and the terms considered necessary for providing a net credit exposure after hedging.
- Plans and provisions addressing contingent liquidity and compliance with the Board's Regulation W (12 CFR part 223) when market illiquidity or credit conditions change, interrupting normal distribution channels.

2010.2.3.1.8 Reporting and Analytics

The agencies expect financial institutions to diligently monitor higher-risk credits, including leveraged loans. A financial institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the institution's board of directors. Policies and procedures should identify the fields to be populated and captured by a financial institution's Management Information Systems, which should yield accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline.
- Risk-rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile.
- Industry mix and maturity profile.
- Metrics derived from probabilities of default and loss given default.
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs.
- Amount of impaired assets and the nature of impairment (that is, permanent, or temporary), and the amount of the ALLL attributable to leveraged lending.
- The aggregate level of policy exceptions and the performance of that portfolio.
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu (in a fair way) treatment for all lenders and, thus, dilute the secondary support from the sale of collateral.
- Secondary-market-pricing data and trading volume, when available.
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures.
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions.
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Pipeline definitions should clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed.
- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative.
- Borrower and counterparty leveraged lending reporting should consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the institution should consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

2010.2.3.1.9 Risk Rating Leveraged Loans

Previously, the agencies issued guidance on rating credit exposures and credit-rating systems, which applies to all credit transactions, including those in the leveraged lending category.[18]

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five- to seven-year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, the agencies believe that it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual status.

18. Board SR-98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations"; OCC Comptroller's Handbooks "Rating Credit Risk" and "Leveraged Lending"; and FDIC Risk Management Manual of Examination Policies, "Loan Appraisal and Classification."

2010.2.3.1.10 Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. A financial institution's policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, whether

- cash-flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- liquidity analyses include performance metrics appropriate for the borrower's industry, predictability of the borrower's cash flow, measurement of the borrower's operating cash needs, and ability to meet debt maturities;
- projections exhibit an adequate margin for unanticipated merger-related integration costs;
- projections are stress tested for one or more downside scenarios, including a covenant breach;
- transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status. From inception, the credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance;
- enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- collateral liquidation and asset sale estimates are based on current market conditions and trends;
- potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity; and
- the borrower is adequately protected from interest rate and foreign exchange risk.

2010.2.3.1.11 Problem-Credit Management

A financial institution should formulate individual action plans when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem-credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

2010.2.3.1.12 Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment should develop guidelines for evaluating the qualifications of financial sponsors and should implement processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include the following:

- the sponsor's historical performance in supporting its investments, financially and otherwise
- the sponsor's economic incentive to support, including the nature and amount of capital contributed at inception
- documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance)
- consideration of the sponsor's contractual investment limitations
- to the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals
- consideration of the sponsor's dividend and capital contribution practices
- the likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio
- guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance

2010.2.3.1.13 Credit Review

A financial institution should have a strong and independent credit-review function that demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to its senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, the institution's credit-review function should assess the performance of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. Such assessments should be performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews should generally be conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate reviews that are more frequent.

A financial institution should staff its internal credit-review function appropriately and ensure that the function has sufficient resources to ensure timely, independent, and accurate assessments of leveraged lending transactions. Reviews should evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Internal credit reviews should include the review of the institution's leveraged lending practices, policies, and procedures to ensure that they are consistent with regulatory guidance.

2010.2.3.1.14 Stress Testing

A financial institution should develop and implement guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital.[19] The sophistication of stress testing practices and sensitivity analyses should be consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

2010.2.3.1.15 Conflicts of Interest

A financial institution should develop appropriate policies and procedures to address and to prevent potential conflicts of interest when it has equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential conflicts of interest arise between the financial institution and its customers. Policies and procedures should clearly define potential conflicts of interest, identify appropriate risk-management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, management should have an established training program for employees on appropriate practices to follow to avoid conflicts of interest and provide for reporting, tracking, and resolution of any conflicts of interest that occur.

2010.2.3.1.16 Reputational Risk

Leveraged lending transactions are often syndicated through the financial and institutional markets. A financial institution's apparent failure to meet its legal responsibilities in underwriting and distributing transactions can damage its market reputation and impair its ability to compete. Similarly, a financial institution that distributes transactions, which over time have significantly higher default or loss rates and performance issues, may also see its reputation damaged.

2010.2.3.1.17 Compliance

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure potential conflicts are avoided and laws and regulations are adhered to, an institution's independent compliance function should periodically review the institution's leveraged lending activity. This guidance is consistent with the principles of safety and soundness and other agency guidance related to commercial lending.

In particular, because leveraged transactions often involve a variety of types of debt and bank products, a financial institution should ensure that its policies incorporate safeguards to prevent violations of anti-tying regulations. Section 106(b) of the Bank Holding Company Act Amendments of 1970[9k] prohibits certain forms of product tying by financial institutions and their affiliates. The intent behind Section 106(b) is to prevent financial institutions from using their market power over certain products to obtain an unfair competitive advantage in other products.

In addition, equity interests and certain debt instruments used in leveraged transactions may constitute "securities" for the purposes of federal securities laws. When securities are

19. See interagency guidance "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets" (see Board SR Letter 12-7 and its attachment), 77 Fed. Reg. 29458 (May 17, 2012), at www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm, and the joint "Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks," May 14, 2012, by the OCC at www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76a.pdf; the Board at www.federal reserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf; and the FDIC at www.fdic.gov/news/news/press/2012/pr12054a.pdf. See also FDIC final rule, Annual Stress Test, 77 Fed. Reg. 62417 (Oct. 15, 2012) (to be codified at 12 CFR part 325, subpart C).

9k. 12 USC 1972.

involved, an institution should ensure compliance with applicable securities laws, including disclosure and other regulatory requirements. An institution should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.

2010.2.4 CREDIT-RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING

On May 16, 2005, the federal bank and thrift regulatory agencies collectively issued the following interagency guidance. The guidance is intended to promote sound credit-risk management practices at banking organizations[21] that have home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). Banking organizations' credit-risk management practices for home equity lending need to keep pace with the rapid growth in home equity lending and should emphasize compliance with sound underwriting standards and practices.

The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that banking organizations need to fully recognize the risk embedded in their home equity portfolios. Following are the specific product, risk-management, and underwriting risk factors and trends that deserve scrutiny:

1. interest-only features that require no amortization of principal for a protracted period
2. limited or no documentation of a borrower's assets, employment, and income (known as "low do" or "no doc" lending)
3. higher loan-to-value (LTV) and debt-to-income (DTI) ratios
4. lower credit-risk scores for underwriting home equity loans;
5. greater use of automated valuation models (AVMs) and other collateral-evaluation tools for the development of appraisals and evaluations
6. an increase in the number of transactions generated through a loan broker or other third party

Home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk-management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral-valuation management, individual-account and portfolio management, and servicing.

Banking organizations should ensure that risk-management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for banking organizations that project or have already experienced significant growth or concentrations, particularly in higher-risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party-generated loans. (See SR-05-11.)

2010.2.4.1 Credit-Risk Management Systems

2010.2.4.1.1 Product Development and Marketing

In the development of any new product offering, product change, or marketing initiative, management should have a review and approval process that is sufficiently broad to ensure compliance with the banking organization's internal policies and applicable laws and regulations[22] and to evaluate the credit, interest-rate, operational, compliance, reputation, and legal risks. In particular, risk-management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material

21. The agencies are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. The interagency guidance frequently uses the term "financial institutions." Bank holding companies have financial institutions and various credit-extending nonbanking subsidiaries. The combined entity is being referred to in this guidance as a banking organization.

22. Applicable laws include the Federal Trade Commission Act; the Equal Credit Opportunity Act (ECOA); the Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); the Fair Housing Act; the Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

changes in the targeted market, origination source, or pricing could have a significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, banking organizations should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, see section 2010.2.4.1.3, "Third-Party Originations.") Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to increase a line, extend the interest-only period, or adjust the interest rate or term.

2010.2.4.1.2 Origination and Underwriting

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the Federal Reserve's regulations on real estate lending standards, prudently underwritten home equity loans should include an evaluation of a borrower's capacity to adequately service the debt.[23] Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.[24] Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

HELOCs generally do not have interest-rate caps that limit rate increases.[25] Rising interest rates could subject a borrower to significant payment increases, particularly in a low-interest-rate environment. Therefore, underwriting standards for interest-only and variable-rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

2010.2.4.1.3 Third-Party Originations

Banking organizations often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, they should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

Brokers are firms or individuals, acting on behalf of either the banking organization or the borrower, who match the borrower's needs with institutions' mortgage-origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the banking organization and the broker. For control purposes, the banking organization should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

Correspondents are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Banking organizations commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a banking organization grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating

23. On December 23, 1992, the Federal Reserve announced the adoption of uniform rules on real estate lending standards and issued the Interagency Guidelines for Real Estate Lending Policies. See subsection 2010.2.1. See also 12 C.F.R., section 208.51 and appendix C.

24. The Interagency Guidelines Establishing Standards for Safety and Soundness also call for documenting the source of repayment and assessing the ability of the borrower to repay the debt in a timely manner. See 12 C.F.R. 208, appendix D-1.

25. While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 C.F.R. 226.30(b).

banking organization should have systems and controls to provide assurance that the correspondent is appropriately managed, is financially sound, and provides mortgages that meet the banking organization's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality-control unit or function in the delegating banking organization should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities.

Both brokers and correspondents are compensated based upon mortgage-origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, banking organizations should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the banking organization should have adequate audit procedures and controls to verify that the third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.[26] Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the banking organization should take appropriate action against the third party, which could include terminating its relationship with the third party.

2010.2.4.1.4 Collateral-Valuation Management

Competition, cost pressures, and advancements in technology have prompted banking organizations to streamline their appraisal and evaluation processes. These changes, coupled with banking organizations underwriting to higher LTVs, have heightened the importance of strong collateral-valuation management policies, procedures, and processes.

Banking organizations should have appropriate collateral-valuation policies and procedures that ensure compliance with the Federal Reserve's appraisal regulations[27] and the Interagency Appraisal and Evaluation Guidelines (the guidelines).[28] In addition, the banking organization should—

1. establish criteria for determining the appropriate valuation methodology for a particular transaction, based on the risk in the transaction and loan portfolio (For example, higher-risk transactions or nonhomogeneous property types should be supported by more-thorough valuations. The banking organization should also set criteria for determining the extent to which an inspection of the collateral is necessary.)
2. ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation
3. implement policies and controls to preclude "value shopping" (Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property, the banking organization should adhere to a policy for selecting the most reliable method, rather than the highest value.)
4. require sufficient documentation to support the collateral valuation in the appraisal or evaluation

2010.2.4.1.5 AVMs

When AVMs are used to support evaluations or appraisals, the banking organization should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. As part of the validation process, the banking organization should document the validation's

26. In addition, a banking organization that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the banking organization can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under ECOA, and for reporting responsibilities under HMDA.

27. 12 C.F.R. 208, subpart E, and 12 C.F.R. 225, subpart G.

28. See SR-94-55, dated October 27, 1994. These revised guidelines include the June 1994 amendments. See also section 2231.0.15, appendix A.

analysis, assumptions, and conclusions. The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a "confidence score," which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Banking organizations that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Confidence levels should be established by the banking organization that are appropriate for the risk in a given transaction or group of transactions.

When tax-assessment valuations are used as a basis for the collateral valuation, the banking organization should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value as part of the validation process.

2010.2.4.1.6 Account Management

Since HELOCs often have long-term, interest-only payment features, banking organizations should have risk-management techniques that identify higher-risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, a banking organization should have risk-management procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account-management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account-management practices for large portfolios or portfolios with high-risk characteristics include—

1. periodically refreshing credit-risk scores on all customers;
2. using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
3. periodically assessing utilization rates;
4. periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;
5. monitoring home values by geographic area; and
6. obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Banking organizations should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.[29]

When appropriate, banking organizations should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circumstances.[30] In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances and (2) as a result of this change, the banking organization must have a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account-management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A banking

29. Under the Federal Reserve's risk-based capital guidelines, an unused HELOC commitment with an original maturity of one year or more may be allocated a zero percent conversion factor if the banking organization conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See 12 C.F.R. 208, appendix A, III.D.4., and 12 C.F.R. 225, appendix A, III.D.4.

30. Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 C.F.R. 226.5b(f)(3)(vi)(A)–(F).

organization's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

2010.2.4.1.7 Portfolio Management

Banking organizations should implement an effective portfolio credit-risk management process for their home equity portfolios that includes the following.

2010.2.4.1.7.1 Policies

The Federal Reserve's real estate lending standards regulations require that a banking organization's real estate lending policies be consistent with safe and sound banking practices and that the banking organization's board of directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the banking organization's overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

2010.2.4.1.7.2 Portfolio Objectives and Risk Diversification

Effective portfolio management should clearly communicate portfolio objectives, such as growth targets, utilization, rate-of-return hurdles, and default and loss expectations. For banking organizations with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher-risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the banking organization should analyze the situation sufficiently to enable the banking organization's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, a banking organization should analyze the portfolio by segment, using criteria such as product type, credit-risk score, DTI, LTV, property type, geographic area, collateral-valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

2010.2.4.1.7.3 Management Information Systems

By maintaining adequate credit MIS, a banking organization can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations. Banking organizations should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For banking organizations with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

1. production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type
2. delinquency and loss-distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI)
3. vintage tracking
4. the performance of third-party originators (brokers and correspondents)
5. market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values

2010.2.4.1.7.4 Policy and Underwriting-Exception Systems

Banking organizations should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

2010.2.4.1.7.5 High-LTV Monitoring

To clarify the real estate lending standards regulations and interagency guidelines, the agencies issued Guidance on High Loan-To-Value (HLTV) Residential Real Estate Lending (the HLTV guidance) in October 1999. The HLTV guidance clarified the Interagency Real Estate Lending Guidelines and the supervisory loan-to-value limits for loans on one- to four-family residential properties. Banking organizations are expected to ensure compliance with the supervisory loan-to-value limits of the Interagency Real Estate Lending Guidelines. The HLTV guidance outlines controls that the banking organizations should have in place when engaging in HLTV lending. Banking organizations should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the banking organization's board of directors. Specifically, banking organizations are reminded that:

1. Loans in excess of the supervisory LTV limits should be identified in the banking organization's records. The aggregate of high-LTV one-to four-family residential loans should not exceed 100 percent of the banking organization's total capital.[31] Within that limit, high-LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.
2. In calculating the LTV and determining compliance with the supervisory LTVs, the banking organization should consider all senior liens. All loans secured by the property and held by the banking organization are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property equals or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.
3. For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the banking organization is legally committed to lend over the life of the loan).
4. All real–estate secured loans in excess of supervisory LTV limits should be aggregated and included in a quarterly report for the banking organization's board of directors.

Certain insurance products help banking organizations mitigate the credit risks of HLTV residential loans. Insurance policies that cover a "pool" of loans can be an efficient and effective credit-risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The Federal Reserve considers pool insurance to be a sufficient credit enhancement to remove the HLTV designation in the following circumstances: (1) the policy is issued by an acceptable mortgage insurance company, (2) it reduces the LTV for each loan to less than 90 percent, and (3) it is effective over the life of each loan in the pool.

2010.2.4.1.7.6 Stress Testing for Portfolios

Banking organizations with home equity concentrations as well as higher-risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Banking organizations should consider stress tests that incorporate interest-rate increases and declines in home values. Since these events often occur simultaneously, the agencies recommend testing for these events together. Banking organizations should also periodically analyze markets in key geographic areas, including identified "soft" markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established

31. For purposes of the Interagency Real Estate Lending Standards Guidelines, high-LTV one- to four-family residential property loans include (1) a loan for raw land zoned for one- to four-family residential use with an LTV ratio greater than 65 percent; (2) a residential land development loan or improved lot loan with an LTV greater than 75 percent; (3) a residential construction loan with an LTV ratio greater than 85 percent; (4) a loan on non-owner occupied one- to four-family residential property with an LTV greater than 85 percent; and (5) a permanent mortgage or home equity loan on an owner-occupied residential property with an LTV equal to or exceeding 90 percent without mortgage insurance, readily marketable collateral, or other acceptable collateral.

risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

2010.2.4.1.8 Operations, Servicing, and Collections

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit-risk management should oversee these support functions to ensure that operational risks are properly controlled.

2010.2.4.1.8.1 Lien Recording

Banking organizations should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

2010.2.4.1.8.2 Problem-Loan Workouts and Loss-Mitigation Strategies

Banking organizations should have established policies and procedures for problem loan workouts and loss-mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's Uniform Retail Credit Classification and Account Management Policy, issued June 2000 (see SR-00-8 and section 2241.0) and should, at a minimum, address the following:

1. circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes (Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms.)
2. circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure
3. appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of workout loans (For large portfolios, vintage delinquency and loss tracking also should be included.)

While banking organizations are encouraged to work with borrowers on a case-by-case basis, a banking organization should not use workout strategies to defer losses. Banking organizations should ensure that credits in workout programs are evaluated separately for the allowance for loan and lease losses (ALLL), because such credits tend to have higher loss rates than other portfolio segments.

2010.2.4.1.9 Secondary-Market Activities

More banking organizations are issuing HELOC mortgage-backed securities (that is, securitizing HELOCs). Although such secondary-market activities can enhance credit availability and a banking organization's profitability, they also pose certain risk-management challenges. A banking organization's risk-management systems should address the risks of HELOC securitizations.[32]

2010.2.4.1.10 Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital

The FFIEC's Uniform Retail Credit Classification and Account Management Policy governs the classification of consumer loans and establishes general classification thresholds that are based on delinquency. Banking organizations and the Federal Reserve's examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Banking organizations should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, a banking organization should consider how the interest-only and draw features of HELOCs during the

32. See the risk management and capital adequacy of exposures arising from secondary-market credit activities discussion in SR-97-21 (see also section 2129.05).

lines' revolving period could affect the loss curves for its HELOC portfolio. Those banking organizations engaging in programmatic subprime home equity lending or banking organizations that have higher-risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.[33]

2010.2.5 OVERSIGHT OF CONCENTRATIONS IN COMMERCIAL REAL ESTATE LENDING AND SOUND RISK-MANAGEMENT LENDING

As part of a bank holding company inspection, the examiner should make an assessment of the parent company's supervision and control over its subsidiary lending activities, which includes an overall assessment of the banking organization's credit-risk concentrations, including the risk concentrations in commercial real estate lending. (See also section 2010.2.) Banking organizations, including bank holding companies, are responsible for establishing the necessary and appropriate management oversight of their bank and nonbank subsidiaries by administering, monitoring, and assuring adherence to the organization's lending policies and practices for controlling "concentration risk." Banking organizations should therefore have adequate management information systems (including the appropriate accounting and internal control systems) in place to accomplish their supervisory oversight and to control such credit concentrations.

The following guidance, Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk-Management Practices (the guidance) was issued on December 6, 2006 (effective on December 12, 2006).[34] The guidance was developed to reinforce sound risk-management practices for institutions (includes banking organizations) with high and increasing concentrations of commercial real estate loans on their balance sheets. An institution's strong risk-management practices and its maintenance of appropriate levels of capital are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE or a CRE lending strategy leading to a concentration. However, institutions needing to improve their risk-management processes may have been provided the opportunity for some flexibility on the time frame for complying with the guidance. This time frame will be commensurate with the level and nature of CRE concentration risk, the quality of the institution's existing risk-management practices, and its levels of capital. (See 71 *Fed. Reg.* 74,580 [December 12, 2006], the Federal Reserve Board's press release dated December 6, 2006, and SR-07-01 and its attachments.) See also SR-15-17, "Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending" and its attachment and the Board's December 18, 2015, press release.

2010.2.5.1 Scope of the CRE Concentration Guidance

The guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. For the purposes of this guidance, CRE loans include those loans with risk profiles sensitive to the condition of the general CRE market (for example, market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans are land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third-party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to real estate investment

33. See the January 2001 Interagency Expanded Guidance for Subprime Lending Programs (section 2128.08) for supervisory expectations regarding risk-management processes, the allowance for loan and lease losses, and capital adequacy for banking organizations engaging in subprime-lending programs.

34. The guidance was jointly adopted by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation after the bank supervisory agencies' careful consideration of the comments received following the initial issuance of the January 10, 2006, proposed guidance on concentrations in commercial real estate lending. The final guidance is applicable to state member banks and broadly applicable to bank holding companies and their nonbank subsidiaries. For the purposes of this section the references to banks, institutions, and banking organizations is confined to those entities for which the Board of Governors of the Federal Reserve System has supervisory authority.

trusts and unsecured loans to developers also should be considered CRE loans for purposes of this guidance if their performance is closely linked to performance of the CRE markets. The scope of the guidance does not include loans secured by nonfarm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property. Rather than defining a CRE concentration, the guidance's "Supervisory Oversight" section describes the criteria that the Federal Reserve will use as high-level indicators to identify banks potentially exposed to CRE concentration risk.

2010.2.5.2 CRE Concentration Assessments

Banks that are actively involved in CRE lending should perform ongoing risk assessments to identify CRE concentrations. The risk assessment should identify potential concentrations by stratifying the CRE portfolio into segments that have common risk characteristics or sensitivities to economic, financial, or business developments. A bank's CRE portfolio stratification should be reasonable and supportable. The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.

The Federal Reserve recognizes that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary by bank depending on the portfolio risk characteristics, the quality of risk-management processes, and capital levels. Therefore, the guidance does not establish a CRE concentration limit that applies to all banks. Rather, banks are encouraged to identify and monitor credit concentrations and to establish internal concentration limits, and all concentrations should be reported to senior management and the board of directors on a periodic basis. Depending on the results of the risk assessment, the bank may need to enhance its risk-management systems.

2010.2.5.3 CRE Risk Management

The sophistication of a bank's CRE risk-management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the bank. Banks should address the following key elements in establishing a risk-management framework that effectively identifies, monitors, and controls CRE concentration risk:

1. board and management oversight
2. portfolio management
3. management information systems
4. market analysis
5. credit underwriting standards
6. portfolio stress testing and sensitivity analysis
7. credit-risk review function

2010.2.5.3.1 Board and Management Oversight of CRE Concentration Risk

A bank's board of directors has ultimate responsibility for the level of risk assumed by the bank. If the bank has significant CRE concentration risk, its strategic plan should address the rationale for its CRE levels in relation to its overall growth objectives, financial targets, and capital plan. In addition, the Federal Reserve's real estate lending regulations require that each bank adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, including CRE loans. Therefore, the board of directors or a designated committee thereof should—

1. establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the bank, including any specific commitments to particular borrowers or property types, such as multifamily housing;
2. ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies;
3. review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions in which the bank lends; and
4. periodically review and approve CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) to conform to any changes in the bank's strategies and to respond to changes in market conditions.

2010.2.5.3.2 CRE Portfolio Management

Banks with CRE concentrations should manage not only the risk of individual loans but also portfolio risk. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by cyclical changes in the CRE market can expose a bank to an unacceptable level of risk if not properly managed. Management regularly should evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines and concentration limits that control the bank's overall risk exposure.

Management should develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess periodically the marketability of the portfolio. This should include an evaluation of the bank's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

2010.2.5.3.3 CRE Management Information Systems

A strong management information system (MIS) is key to effective portfolio management. The sophistication of the MIS will necessarily vary with the size and complexity of the CRE portfolio and level and nature of concentration risk. The MIS should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk. This includes meaningful information on CRE portfolio characteristics that is relevant to the bank's lending strategy, underwriting standards, and risk tolerances. A bank should periodically assess the adequacy of the MIS in light of growth in CRE loans and changes in the CRE portfolio's size, risk profile, and complexity.

Banks are encouraged to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating. Other useful stratifications may include loan structure (for example, fixed-rate or adjustable), loan purpose (for example, construction, short-term, or permanent), loan-to-value (LTV) limits, debt service coverage, policy exceptions on newly underwritten credit facilities, and affiliated loans (for example, loans to tenants). A bank should also be able to identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives.

Management reporting should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations. In addition, management reporting should include a well-defined process through which management reviews and evaluates concentration and risk-management reports, as well as special ad hoc analyses in response to potential market events that could affect the CRE loan portfolio.

2010.2.5.3.4 Market Analysis

Market analysis should provide the bank's management and board of directors with information to assess whether its CRE lending strategy and policies continue to be appropriate in light of changes in CRE market conditions. A bank should perform periodic market analyses for the various property types and geographic markets represented in its portfolio.

Market analysis is particularly important as a bank considers decisions about entering new markets, pursuing new lending activities, or expanding in existing markets. Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. The sophistication of a bank's analysis will vary by its market share and exposure, as well as the availability of market data. While a bank operating in nonmetropolitan markets may have access to fewer sources of detailed market data than a bank operating in large, metropolitan markets, a bank should be able to demonstrate that it has an understanding of the economic and business factors influencing its lending markets.

2010.2.5.3.5 Credit Underwriting Standards

A bank's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. When a bank has a CRE concentration, the establishment of sound lending policies becomes even more critical. In establishing its policies, a bank should consider both internal and external factors, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. Consistent with the Federal Reserve's real estate lending guidelines, CRE lending policies should address the following underwriting standards:

1. maximum loan amount by type of property
2. loan terms
3. pricing structures
4. collateral valuation[35]
5. LTV limits by property type
6. requirements for feasibility studies and sensitivity analysis or stress testing
7. minimum requirements for initial investment and maintenance of hard equity by the borrower
8. minimum standards for borrower net worth, property cash flow, and debt service coverage for the property

A bank's lending policies should permit exceptions to underwriting standards only on a limited basis. When a bank does permit an exception, it should document how the transaction does not conform to the bank's policy or underwriting standards, obtain appropriate management approvals, and provide reports to the board of directors or designated committee detailing the number, nature, justifications, and trends for exceptions. Exceptions to both the bank's internal lending standards and the Federal Reserve's supervisory LTV limits[36] should be monitored and reported on a regular basis. Further, banks would analyze trends in exceptions to ensure that risk remains within the bank's established risk tolerance limits.

35. Refer to the Federal Reserve's appraisal regulations: 12 C.F.R. 208 subpart E and 12 C.F.R. 225, subpart G.

36. The Interagency Guidelines for Real Estate Lending state that loans exceeding the supervisory LTV guidelines should be recorded in the bank's records and reported to the board at least quarterly.

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations as appropriate. In addition, for development and construction loans, the bank should have policies and procedures governing loan disbursements to ensure that the bank's minimum borrower equity requirements are maintained throughout the development and construction periods. Prudent controls should include an inspection process, documentation on construction progress, tracking pre-sold units, pre-leasing activity, and exception monitoring and reporting.

2010.2.5.3.6 CRE Portfolio Stress Testing and Sensitivity Analysis

A bank with CRE concentrations should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Further, a bank should consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of the CRE loan portfolio. For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.

Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. The analysis should focus on the more vulnerable segments of a bank's CRE portfolio, taking into consideration the prevailing market environment and the bank's business strategy.

2010.2.5.3.7 Credit-Risk Review Function

A strong credit-risk review function is critical for a bank's self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the bank's credit-risk review function to assess credit quality and, ultimately, to identify problem loans.

Risk ratings should be risk sensitive, objective, and appropriate for the types of CRE loans underwritten by the bank. Further, risk ratings should be reviewed regularly for appropriateness.

2010.2.5.4 Supervisory Oversight Of CRE Concentration Risk

As part of its ongoing supervisory monitoring processes, the Federal Reserve will use certain criteria to identify banks that are potentially exposed to significant CRE concentration risk. A bank that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

1. total reported loans for construction, land development, and other land[37] represent 100 percent or more of the bank's total capital[38] or
2. total commercial real estate loans as defined in this guidance[39] represent 300 percent or more of the bank's total capital, and the outstanding balance of the bank's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

The Federal Reserve will use the criteria as a preliminary step to identify banks that may have CRE concentration risk. Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on a bank's lending activity but rather serve as high-level indicators to identify banks potentially exposed to CRE concentration risk. Nor do the criteria constitute a "safe harbor" for banks if other risk indicators are present, regardless of their measurements under (1) and (2).

37. For commercial banks as reported in the Call Report FFIEC 031 and 041, schedule RC-C, item 1a.

38. For purposes of this guidance, the term *total capital* means the total risk-based capital as reported for commercial banks in the Call Report FFIEC 031 and 041 schedule RC-R—Regulatory Capital, line 21.

39. For commercial banks as reported in the Call Report FFIEC 031 and 041, schedule RC-C, item 1a.

2010.2.5.4.1 Evaluation of CRE Concentrations

The effectiveness of a bank's risk-management practices will be a key component of the supervisory evaluation of the bank's CRE concentrations. Examiners will engage in a dialogue with the bank's management to assess CRE exposure levels and risk-management practices. Banks that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

In evaluating CRE concentrations, the Federal Reserve will consider the bank's own analysis of its CRE portfolio, including consideration of factors such as—

1. portfolio diversification across property types
2. geographic dispersion of CRE loans
3. underwriting standards
4. level of pre-sold units or other types of takeout commitments on construction loans
5. portfolio liquidity (ability to sell or securitize exposures on the secondary market)

While consideration of these factors should not change the method of identifying a credit concentration, these factors may mitigate the risk posed by the concentration.

2010.2.5.4.2 Assessment of Capital Adequacy for CRE Concentration Risk

The Federal Reserve's existing capital adequacy guidelines note that a bank should hold capital commensurate with the level and nature of the risks to which it is exposed. Accordingly, banks with CRE concentrations are reminded that their capital levels should be commensurate with the risk profile of their CRE portfolios. In assessing the adequacy of a bank's capital, the Federal Reserve will consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk-management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk. A bank with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate to the level and nature of its CRE concentration risk.

2010.2.6 GUIDANCE ON PRIVATE STUDENT LOANS WITH GRADUATED REPAYMENT TERMS AT ORIGINATION

On January 29, 2015, interagency[40] guidance[41] was issued to provide financial institutions with principles applicable to private student loans that have graduated repayment terms. Financial institutions that originate private student loans may offer borrowers graduated repayment terms in addition to fixed amortizing terms at the time of loan origination. Graduated repayment terms are structured to provide for lower initial monthly payments that gradually increase. Refer to SR-15-2/CA-15-1 and its attachment.

Although most student loan agreements include a grace period[42] to help with the post-education transition, the agencies and SLC recognize that students leaving higher education programs may prefer more flexibility to transition into the labor market because of a number of factors, such as competitive job markets, traditionally low entry-level salaries, and higher student debt loads. Graduated repayment terms may align borrowers' income levels with loan repayment requirements, provide flexibility to repay the debt sooner if borrowers' incomes increase more quickly than projected, and may help long-term probability of full repayment.

Financial institutions that originate private student loans with graduated repayment terms should prudently underwrite the loans in a manner consistent with safe and sound lending practices. Financial institutions should provide disclosures that clearly communicate the timing and the amount of payments to facilitate a borrower's understanding of the loan's terms and features.

2010.2.6.1 Principles for Private Student Loans with Graduated Repayment Terms at Origination

Financial institutions should consider the following principles in their policies and procedures for underwriting private student loans with graduated repayment terms at origination:[43]

- *Ensure orderly repayment.* Private student loans should have defined repayment periods and promote orderly repayment over the life of the loans. Graduated repayment terms should ensure timely loan repayment and be appropriately calibrated according to reasonable industry and market standards based on the amount of debt outstanding. Graduated repayment terms should avoid negative amortization or balloon payments.
- *Avoid payment shock.*[44] Graduated repayment terms should result in monthly payments that a borrower can meet in a sustained manner over the life of the loan. Graduated increases in a borrower's monthly payment should begin early in the repayment period and phase in the amortization of the principal balance to limit payment shock to the borrower.
- *Align payment terms with a borrower's income.* Graduated repayment terms should be based on reasonable assumptions about the ability to repay of the borrower and cosigner, if any. Lender underwriting should include an assessment of a borrower's (and, if applicable, a cosigner's) ability to repay the highest amortizing payment over the term of the loan. Graduated repayment terms should not be structured in a way that could mask delinquencies or defer losses.
- *Provide borrowers with clear disclosures.* Financial institutions that offer private student loans with graduated repayment terms should provide borrowers with disclosures in compliance with all applicable laws and regulations. For example, the Truth in Lending Act, as implemented by Regulation Z, includes specific private student loan disclosure content requirements.[45] Ensuring that disclosures clearly communicate the timing and the

40. The agencies consist of the Board of Governors of the Federal Reserve System, the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

41. In implementing this guidance, the agencies will examine financial institutions consistent with their respective authorities.

42. A grace period is the allotted amount of time during which borrowers are not expected to make payments on student loans after initially leaving higher education programs or dropping below half-time enrollment status.

43. In addition to offering graduated repayment terms at origination, financial institutions may also offer graduated repayment terms as well as other types of workout options to borrowers experiencing financial difficulties, as addressed in ″Banking Agencies Encourage Financial Institutions to Work With Student Loan Borrowers Experiencing Financial Difficulties,″ issued July 25, 2013.

44. Payment shock occurs when a borrower experiences a significant increase in the amount of the monthly payment after a reset date.

45. 12 CFR 1026.46 and 12 CFR 1026.47.

amount of payments facilitates borrowers' understanding of their loans' terms and features.

- *Comply with all applicable federal and state consumer laws and regulations and reporting standards.*[46] Private student loans with graduated repayment terms must comply with all applicable consumer protection laws. These include, but are not limited to, the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, federal and state prohibitions against unfair, deceptive, or abusive acts or practices (such as section 5 of the Federal Trade Commission Act and sections 1031 and 1036 of the Dodd-Frank Wall Street Reform and Consumer Protection Act), the Truth in Lending Act, and the regulations issued pursuant to those laws.
- *Contact borrowers before reset dates.* Before originating private students loans with graduated repayment terms, financial institutions should develop processes for contacting borrowers before the start of the repayment period and before each payment reset date. These contacts can help establish student debt as a priority in borrowers' payment hierarchies[47] and aid borrowers in responding effectively to payment increases and other potential repayment challenges.

2010.2.7 LOAN PARTICIPATIONS, THE AGREEMENTS AND PARTICIPANTS

This subsection provides supervisory and accounting guidance for examiners to use in their inspection (or examination) and review of a bank holding company's (BHC's) or bank's use, purchase, or sale of loan participation agreements.[48] BHCs should manage and control aggregate credit and other risk exposures on a consolidated basis while recognizing legal distinctions and possible obstacles to asset movements within the parent company or its subsidiaries. Additional guidance, research, and information on loan participations and loan participation agreements will be developed and considered for future issuance and implementation.

A loan participation is an agreement that transfers a stated ownership interest in a loan to one or more other BHCs or subsidiaries, or other entities. The transfer represents an ownership interest in an individual financial asset. The lead BHC (or lead subsidiary) retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. The lead BHC or lead subsidiary should ensure that comprehensive participation agreements with originating institutions are in place for each loan facility before they consider purchasing any participating interest.

Many BHCs and their subsidiaries purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with BHC affiliates, groups of BHCs or chain banks, or other subsidiaries. Alternatively, a purchasing BHC or subsidiary may also wish to supplement its loan portfolio when loan demand is weak. In still other cases, a BHC or subsidiary may purchase or participate in a loan to accommodate another unrelated bank with which it has established an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a BHC's or bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a BHC or bank diversify its risks and improve its liquidity.

2010.2.7.1 Board Policies on Loan Participations

BHCs and their subsidiaries should have sufficient board-approved policies in place that govern their loan participation activities. At a minimum, the policy should include (1) the requirements for entering into a loan participation agreement, (2) limits for the aggregate amount of loans purchased from and sold to an outside source, (3) limits of all loans purchased and sold, (4) limits for the aggregate amount of loans to particular industries, (5) comprehensive participation agreements with originating BHCs or banks, (6) complete analysis and documentation of the credit quality of obligations purchased, (7) an analysis of the value and lien status of the collateral, (8) appraisal guidelines, (9) the maintenance of full independent credit information on the borrower throughout the

46. Reporting standards include, but are not limited to, quarterly Consolidated Reports of Condition and Income.

47. Payment hierarchy refers to the prioritization of a borrower's payment obligations.

48. As determined by the Board, it is permissible for a BHC or its subsidiary to make, acquire, broker, or service loans or other extensions of credit (12 CFR 225.28(b)(1) and (2)).

term of the loan, (10) guidelines for the timely transfer of all financial and nonfinancial credit information to participant BHCs or banks, and (11) collection procedures.

2010.2.7.2 Loan Participation Agreement

A loan participation agreement may enable a smaller lead BHC or lead subsidiary, acting as transferor, to originate a large loan in excess of its legal lending limit. Participants having an ownership interest are able to offset low local loan demand or invest in large loans without the burden of servicing the loan or incurring origination costs. A loan participation agreement may also allow the originating BHC or subsidiary to facilitate and grant a larger loan without causing it to have a concentration of credit (i.e., enabling risk diversification) or an impairment of its liquidity position. The participation agreement should contain provisions that require the originator to transfer, in a timely manner, all financial and nonfinancial credit information to the participant banks upon the loan's origination and throughout the term of the loan. The agreement should specify the allocation of payments, losses, and expenses. It should also state that a participant has the right to perform its own independent review of the transaction. The agreement should contain no language indicating that the lead BHC or lead subsidiary is a "lender" or that a participating BHC or subsidiary is a "borrower." The purchase of loan participations without a comprehensive agreement could be viewed as an unsafe and unsound banking practice.

2010.2.7.3 Accounting for Loan Participations

A loan participation agreement usually is structured to allow the participation transaction to receive sale treatment of a portion of the loan by the originating BHC or its subsidiary even though the participation agreement may restrict the purchaser when reselling its interest in the loan, subject to certain conditions.[49] Sale treatment is achieved by structuring the loan participation agreement so that interests sold to a purchaser meet the definition of a "participating interest" and the transaction satisfies all conditions for transfer of control over the interests. In general, FAS 166 (paragraph 8B) briefly defines a participating interest as a portion of a financial asset that

1. conveys proportionate ownership rights with equal priority to each participating interest holder.
2. involves no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder.
3. does not entitle any participating interest holder to receive cash before any other participating interest holder.

A transfer of a participating interest in an entire financial asset in which the transferor surrenders control over those interests is to be accounted for as a sale if and only if all the following conditions are met:

1. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.[50]
2. Each purchaser has the right to pledge or exchange the interests it received, and no condition both constrains the purchaser from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
3. The transferor does not maintain effective control over the interests.[51]

49. Three sale recognition conditions denote the transferor's surrender of control under Financial Accounting Standards (FAS) 166, "Accounting for Transfers of Financial Assets" (an amendment of FAS 140). Those conditions must be met in order for the originator (transferor) to account for the transfer of the financial assets to the participating transferee as a sale. When a loan participation is accounted for as a sale, the seller (transferor) removes the participated interest in the loan from its financial statements. FAS 166 applies to both the transferor (seller) of the participated assets and the transferee (purchaser). (See the complete text of FAS 166 (paragraphs 8B and 9) that defines a "participating interest" and the conditions for sale recognition). See also the reporting instructions for the "Consolidated Financial Statements for Bank Holding Companies" (FR Y-9C), and the FFIEC "Consolidated Reports of Condition and Income" (FFIEC 031) (bank Call Report).

50. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented.

51. Examples of a transferor's effective control over the transferred financial assets include (a) an agreement that both entitles and obligates the transferor to repurchase or redeem the financial asset (or its third-party beneficial interests) before its maturity, (b) an agreement that provides the transferor with both the unilateral ability to cause the holder to return specific

2010.2.7.4 Structuring the Loan Participation Agreement

The written participation agreement should consider contingent events such as a defaulting borrower, the lead BHC or lead subsidiary becoming insolvent, or a party to the participant arrangement that is not performing as expected. The agreement should clearly state the limitations the originator or participants impose on each other and any rights that the parties retain. The participation agreement should clearly include

- the obligation of the lead BHC or lead subsidiary to furnish timely credit information and to notify the parties of significant changes in the borrower's status;
- a requirement that the lead BHC or lead subsidiary consult with the participants prior to any proposed change to the loan, guarantee, or security agreements, or taking any action when the borrower defaults;
- the lead BHC's or lead subsidiary's and participants' specific rights if the borrower defaults;
- the resolution procedures to be followed when the lead BHC or lead subsidiary or participants;
  - do not agree on the procedures to be taken when the borrower defaults and/or;
  - have potential conflicts when the borrower defaults on more than one loan
- provisions for terminating the agency relationship between the lead BHC or lead subsidiary and the participants upon events such as insolvency, breach of duty, negligence, or misappropriation by one of the parties to the agreement.

Some participation agreements may allocate payments using a method other than a pro rata sharing based on each participant's ownership interest. The first principal payment could be applied based on the participant's ownership interest while the remaining payments would be applied according to the lead BHC's or lead subsidiary's ownership interest. In this situation, the participation agreement should specify that if a borrower defaults, the participants would share subsequent payments and collections in proportion to their ownership interest at the time of default.[52]

A participation agreement may provide that the originating lender allow a participating BHC or subsidiary to resell, but the originator reserves the right to call at any time from whoever holds the ownership interest. The originator can then enforce the call option by cutting off or restricting the flow of interest at the call date.[53] In this situation, the originating lender has retained effective control over the participation; such a call option precludes sale accounting treatment by the transferor. The transaction, therefore, should be accounted for as a secured borrowing.

2010.2.7.5 Independent Credit Analysis

A BHC or subsidiary that acquires a loan participation should regularly perform a rigorous credit analysis on its loan participation as if it had originated the loan. Due to the indirect relationship that a participant has with a borrower, it may be difficult for the participant to receive timely credit information to allow it to conduct a comprehensive credit analysis of the transaction. However, the participant should not rely solely on the originator's credit analysis. It should gather all available relevant credit information, including the details on the collateral's value (for example, values determined by an independent appraisal or an evaluation), lien status, loan agreements, and the loan's other participation agreements that existed prior to making its commitment to acquire the loan participation. A participant also should reach an agreement with the loan originator (transferor) that it will provide ongoing, complete, and timely credit information about the borrower. It is important for the participants to maintain current and complete records on their loan participations. The absence of such information may indicate that the originator did not perform the necessary due diligence prior to making its decision to acquire the loan participation. During the life of the loan participation, the originator should monitor the loan's servicing and repayment status.

financial assets and a more-than-trivial benefit attributable to that ability, other than through a cleanup call, or (c) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them.

52. This is *not* a participating interest—no sale.

53. The cash flows from a loan participation agreement, except servicing fees, should be divided in proportion to the third parties' participating interests.

2010.2.7.6 Sales of Loan Participations in the Secondary Market

If a BHC or a subsidiary has a concentration in loan participations, it may be possible for it to sell its participating interests in the secondary market to reduce its dependence on an asset group. If the BHC or a subsidiary is not large enough to participate in the secondary market, an alternative might be to sell loans without recourse to another subsidiary or correspondent bank that also desires to diversify its loan portfolio.

2010.2.7.7 Sale of Loan Participations With or Without the Right of Recourse

The parties to a participation agreement (those having a participating ownership interest) generally may have *no recourse* to the transferor or to each other even though the transferor (e.g., the originating lender) continues to service the loan. No participant's interest should be subordinate to another. Some loan participation agreements, however, may give the seller a contractual right to repurchase the participated loan interest for purposes of working out or modifying the sale. When the seller has the right to repurchase the participation, it may provide the seller with a call option on a specific loan participation asset. If the seller's right to repurchase precludes the seller from recognizing the transaction as a sale, the transaction should be accounted for as a secured borrowing.

2010.2.7.8 Sales of 100 Percent Participations

Some loan participation agreements may be structured so that the transferor sells the entire underlying loan amount (100 percent) to the agreement's participants. If participation agreements are not structured properly they can pose unnecessary and increased risks (for example, legal, compliance, or reputational risks) to the originator and the participants. The originator would have no ownership in the loan. Such agreements should therefore clearly state that the loan participants are participating in the loan and that they are not investing in a business enterprise. The policies of a BHC or subsidiary engaged in such loan participation agreements should focus on safety and soundness concerns that include

- the program's objectives
- the plan of distribution
- the credit requirements that pertain to the borrower—the originator should structure 100 percent loan participation programs only for borrowers who meet its credit requirements
- the program participant's accessibility to the borrower's financial information (as authorized by the borrower)—the originator should allow potential loan participants to obtain and review appropriate credit and other information that would enable them to make an informed credit decision.

2010.2.7.9 Participation Transactions Between Affiliates

BHCs or their subsidiaries should not relax their credit standards when participation agreements involve their affiliates. Such agreements must be structured to comply with sections 23A and 23B of the Federal Reserve Act (FRA) and the Board's Regulation W. The Federal Reserve has determined that in certain very limited circumstances the purchase or sale of a participation agreement may be exempt from these provisions.

2010.2.7.9.1 Transfer of Low-Quality Assets

In general, a bank cannot purchase a low-quality asset, including a loan participation from an affiliate. Section 23A of the FRA provides a limited exception to the general rule prohibiting the purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset *before* the affiliate acquires the asset.[54] Section 223.15 of the Board's Regulation W provides an exception from the prohibition on the purchase of a low-quality asset by a member bank from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating

54. 12 U.S.C. 371c(a)(3).

member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20-day post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

2010.2.7.10 Concentrations of Credit Involving Loan Participations

BHCs or their subsidiaries should avoid purchasing loans that generate unacceptable credit concentrations. Such concentrations may arise solely from the BHC's or subsidiary's purchases, or they may arise when loans or purchased participations are aggregated with loans originated and retained by the purchaser. The extent of contingent liabilities, holdbacks, reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, loans purchased from another source should be evaluated in the same manner as originated loans. Guidelines should be established for the type and frequency of credit and other information the BHC or its subsidiary needs to obtain from the originator to keep itself continually updated on the status of the credit. Guidelines should also be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the BHC or its subsidiary.

2010.2.7.11 Loan Participations and Environmental Liability

Environmental risk represents the adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination. BHCs or their subsidiaries may be indirectly liable via their lending activities for the costs resulting from cleaning up hazardous substance contamination. BHCs and their subsidiaries need to be careful that their actions making, administering, and collecting loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of a borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). BHCs or their subsidiaries that originate loans to borrowers through loan participation agreements could be transferring environmental risk and liability to the holders of participations, thus making them susceptible to such losses. The originator should establish and follow policies and procedures designed to control environmental risks. See the *Commercial Bank Examination Manual*, section 2140.1 (the "Environmental Liability" subsection) for a more detailed discussion on ways banks can protect themselves as lenders, and their loan participation agreement holders, from environmental liability.

2010.2.7.12 Red Flag Warning Signals

The following conditions may indicate that there are significant problems with the management of the BHC's or a subsidiary's loan participation portfolio:

1. the absence of formal loan participation policies.
2. the absence of any formal participation agreement.
3. the absence of credit evaluations and independent credit analysis.
4. the absence of complete loan documentation.
5. a higher volume of loan participations when compared to the volume of other loans in the loan portfolio.
6. missing loan participation agreements and documentation which should denote the rights and responsibilities of all participants.
7. the existence of numerous disputes or disagreements among the participants regarding the receipt of payment(s) in accordance with the participation agreements, documentation requirements, or any other significant aspects of the entity's loan participation transactions.
8. the originator is making loan payments to loan participation acquirers without receiving reimbursement by the original borrower.

2010.2.8 INSPECTION OBJECTIVES

Loan Administration

1. To determine if the parent's loan policies are adequate in relation to the responsibilities it has for the supervision of its credit-extending subsidiaries and whether those policies are consistent with safe and sound lending practices.
2. To determine if internal and external factors (for example, the size and financial condition of the credit-extending subsidiary, the size and expertise of its staff, avoidance of or control over credit concentrations, market conditions, and statutory and regulatory compliance) are considered in formulating and monitoring the organization's loan policies and strategic plan.
3. To determine if the loan policy is being monitored and complied with.
4. To establish whether the loan policy ensures sound assessments of the value of real estate and other collateral.

Lending Standards for Commercial Loans

1. To focus on and evaluate the strength of the credit-risk management process.
2. To determine whether the bank holding company has formal credit policies that (1) provide clear guidance on its appetite for credit risk and (2) support sound lending decisions.
3. To determine whether experienced credit professionals who are independent of line lending functions provide adequate internal control in the loan-approval process.
4. To evaluate whether loan-approval documents provide internal approving authorities and management with sufficient information on the risks of loans being considered, and that the information is in a clear and understandable format.
5. To evaluate whether forward-looking analysis tools are being adequately and appropriately used as part of the loan-approval process.
6. To determine whether credit-risk management information systems provide adequate information to management and lenders.
7. To incorporate the examiner's evaluation of the bank holding company's adherence to sound practices into the overall assessment of credit-risk management.
8. To be alert to indications of insufficiently rigorous risk assessment at banking organizations, particularly inadequate stress testing and excessive reliance on strong economic conditions and robust financial markets to support a borrower's capacity to service its debts.
9. To be attentive in reviewing a banking organization's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead to delayed recognition of emerging weaknesses in some loans.
10. To ascertain whether the banking organization has relied, to a significant and undue extent, on favorable assumptions about borrowers or the economy and financial markets. If so, to carefully consider downgrading, under the applicable supervisory rating framework, a banking organization's risk-management, management, and/or asset-quality ratings and, if deemed sufficiently significant to the banking organization, its capital adequacy rating.
11. To determine if the banking organization's loan-review activities or other internal control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, inadequate training, and reduced scope or by less-thorough internal loan reviews. To incorporate such findings into the determination of supervisory ratings.

Leveraged Lending

1. *Risk-Management Framework, Definition, and Policy Expectations.* To determine
   a. whether the institution has established a sound definition of leveraged lending that is appropriate for the types of leveraged loans that are underwritten and if it can be applied across all business lines;
   b. whether it has adjusted (if necessary) its risk appetite and limit structure (including pipeline limits and overall portfolio limits) to conform with the institution's definition of leveraged lending and whether it has the necessary reporting in place to assess conformance with limits.
   c. if there are appropriate policies and procedures limits in place and if the institution maintains sound leveraged lending standards both for transactions that it intends to hold as well as transactions that are underwritten to distribute.
   d. if the institution's risk-management structure has strong and effective pro-

cesses and controls and if they are appropriate based on its leveraged lending activity.

2. *Participations Purchased.* To ensure that the institution applies the same standards of prudence and credit assessment techniques and in-house limits that would apply as if it had originated the loan(s).
3. *Underwriting Standards.* To assess the effectiveness of the institution's underwriting policy standards for leveraged lending to determine whether they
   a. are clear, written, and measurable;
   b. contain underwriting limits that reflect the institution's definition and risk appetite for leveraged lending;
   c. are applied equally to loans that are originated to be held and to loans that are originated to distribute; and
   d. fully reflect the underwriting standards listed in the guidance, including:
      i. sound business premise and sustainable capital structure for each transaction
      ii. capacity to repay and ability to de-lever to a sustainable level over a reasonable period
      iii. appropriate depth and breadth of due diligence
      iv. standards for valuating expected risk-adjusted returns
      v. appropriate credit agreement covenant protections
      vi. acceptable collateral agreements.
4. *Valuation Standards.* To determine:
   a. whether enterprise valuation methodologies are appropriate to the borrower's industry and condition;
   b. whether the assumptions are clearly documented, well supported, and understood by the institution's appropriate decision makers and risk-oversight units
   c. whether enterprise valuations are performed by qualified persons independent of an institution's origination function
   d. whether an institution has policies and provides for appropriate loan to value ratios, discount rates and collateral margins for loans dependent on enterprise value or illiquid and hard-to-value collateral.
5. *Pipeline Management.* To find out if there are strong risk-management standards and controls over transactions in and to the pipeline and if those standards are applied uniformly to transactions held in the portfolio and those that are distributed.
6. *Reporting and Analytics.*
   a. To determine if individual and portfolio exposures within and across all business lines and legal vehicles are captured and reported in the appropriate amount of detail to senior management and the board.
   b. To determine if the necessary risk information (as outlined in the guidance) about leveraged lending exposures (portfolio holds and pipeline exposures) are captured in reports that are distributed timely and that adequate information is distributed to senior management and the institution's board of directors at least quarterly.
7. *Risk Rating.* To verify that leveraged loans are risk rated based on the borrower's ability to repay and de-lever to a sustainable level.
8. *Credit Analysis.*
   a. To test transactions to determine if underwriting practices are effective and comprehensive.
   b. To determine if individual leveraged lending exposures contain a comprehensive assessment of financial, business, industry, and management risks based on the elements of the guidance.
9. *Problem Credit Management.*
   a. To ascertain whether the institution formulates individual action plans and expectations
   b. To evaluate workout plans to confirm that they contain quantifiable objectives and measureable time frames
   c. To determine if problem credits are regularly reviewed for risk-rating accuracy, accrual status, impairment status, and charge off.
10. *Deal Sponsors*
    a. To determine if the institution has guidelines for evaluating deal sponsors that are based on the sponsor's ability and willingness to support the transaction where sponsors are viewed as a source of repayment.
11. *Credit Review*
    a. To ensure that the institution regularly conducts an independent credit review of the leveraged lending portfolio more frequently and in greater depth than other segments of the portfolio generally at least annually. For firms making significant changes to policies, underwriting standards, procedures etc., ensure that a

credit review is scheduled to test compliance with changes.
   b. To ensure that credit review personnel have the expertise and experience to evaluate leveraged loans.
12. *Stress Testing.*
   a. To determine if the institution is conducting periodic loan- and portfolio stress tests on leveraged loan portfolios or if the portfolio has been incorporated into enterprise-wide stress testing practices.
   b. To verify the effectiveness of the institution's periodic portfolio stress tests (in accordance with stress testing guidance) in identifying what effect economic and market events could have on the institution's financial condition and leveraged lending transactions.
13. *Conflict of Interest.* To determine
   a. if policies identify and if there are procedures to address transactions in which the institution holds both an equity and lending positions;
   b. the adequacy and effectiveness of controls and training programs that aim to curb any potential conflicts of interests that result from leveraged lending.
14. *Reputational Risk.*
   a. To determine if the institution has suffered reputational damage by failing to meet its legal responsibilities in underwriting and syndicating leveraged loan transactions into the wider financial market.

Credit-Risk Management for Home Equity Lending

1. To determine if the banking organization has an appropriate review and approval process for new product offerings, product changes, and marketing initiatives.
2. To ascertain whether the banking organization has appropriate control procedures for third parties that generate loans on its behalf and if the control procedures comply with the laws and regulations that are applicable to the organization.
3. To determine if the banking organization has given full recognition to the risks embedded in its home equity lending.
4. To determine whether the banking organization's risk-management practices have kept pace with the growth and changing risk profile of its home equity portfolios and whether underwriting standards have eased.
5. To determine whether the loan policy—
   a. ensures prudent underwriting standards for home equity lending, including standards to ensure that a thorough evaluation of a borrower's capacity to service the debt is conducted (that is, the banking organization is not relying solely on the borrower's credit score);
   b. provides risk-management safeguards for potential declines in home values;
   c. ensures that the standards for interest-only and variable-rate home equity lines of credit (HELOCs) include an assessment of a borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates; and
   d. provides appropriate collateral-valuation policies and procedures and provides for the use and validation of automated valuation models.

Loan Participations, the Agreements and Participants

1. To ascertain if the BHC engages in the purchase or sale of loans via loan participation agreements.
2. To determine if the BHC's lending policy
   a. places limits on the amount of loan participations originated, purchased, or sold based on any one source or in the aggregate;
   b. has set credit standards for the BHC's borrowers requesting loans as well as third parties acquiring loan participations from the bank as originator;
   c. requires the same credit standards for loan participations as it does for other loans;
   d. sets the amount of contingent liability, holdback (retained ownership), and the manner in which the loan should be serviced; or
   e. requires complete loan documentation for loan participations.
3. To assess the impact of any concentrations of credit to a borrower, or in the aggregate, that arise from loans involved in loan participation agreements.
4. To determine if there are any informal repurchase agreements that exist between loan participation acquirers that are designed to circumvent the originating BHC's or its subsidiary's legal lending limits, disguise delinquencies, and avoid adverse classifications.

5. To determine whether the BHC's financial condition is compromised by assessing the impact of the BHC's loan participations with its affiliates.
6. To ascertain whether loan participation transactions with affiliates are in compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
7. To determine if there are disputes between the BHC or its subsidiaries as originator of loan participations and its participants.
8. To determine if any loan participations have been adversely classified by examiners, including examiners from other supervisory agencies (includes loan participations held by the other institutions).

2010.2.9 INSPECTION PROCEDURES

Loan Administration

1. Obtain an organizational chart and determine the various levels of responsibility and job functions of individuals involved with the lending function.
2. Obtain and review the BHC's loan policy; determine if the policy contains the appropriate components, as summarized in this section. Determine how the policy is communicated to subsidiaries. Also determine whether the loan policy reflects the December 1992 uniform interagency real estate lending standards and guidelines as they apply to subsidiary depository institutions.
3. Obtain a copy of the most recent management reports concerning the quality of loans and other aspects of the loan portfolio (delinquency list, concentrations, yield analysis, loan-distribution lists, watch loan reports, charge-off reports, participation listings, internal and external audit reports, etc.). Determine the scope and sufficiency of the work performed by any committees related to the lending function. Determine if the information provided to the directorate and senior management is sufficient for them to make judgments about the quality of the portfolio and to determine appropriate corrective action.
4. Determine if an internal process has been established for the review and approval of loans that do not conform to internal lending policy. Establish whether such loans are supported by written documentation that clearly states all the relevant credit factors that culminated in the underwriting decision. Determine if exception loans of a significant size are reported to the board of directors of the subsidiary or to the holding company.
5. Review internal and external audit reports and bank examination reports for critical comments concerning loan-policy exceptions and administration. Determine whether action was taken in response to any identified exceptions. Determine who is responsible for follow-up and what the time frames are; seek rationale if no action was taken or if the action taken was half-hearted.
6. Review the organization's financial statements, the bank Call Reports, and the BHC FR Y-series reports submitted to the Federal Reserve. Determine whether reporting is accurate and disclosure is sufficient to indicate the organization's financial position and the nature of its loan portfolios, including nonaccrual loans.
7. When reviewing lending policies, ascertain whether—
   a. the loan policies facilitate extensions of credit to sound borrowers and facilitate the workout of problem loans, and
   b. the loan policies control and reduce concentration risk by placing emphasis on effective internal policies, systems, and controls to monitor the risk.
8. Through interviews with, or review of reports submitted by, the internal auditor, lending officers, loan-review personnel, and senior management, (1) evaluate the effectiveness of the BHC's self-monitoring of adherence to loan policy, (2) determine how changes to the loan policy occur, (3) determine how loans made in contradiction to the loan policy are explained, and (4) determine the various circumstances involving levels of approval and what specific consideration occurs at these levels.
9. Presuming the inspection is concurrent with a bank's primary regulator, coordinate, on a random basis, the selection of loans subject to classification. Determine whether they conform to loan policy.
10. Review management's policies and procedures for their determination of an appropriate level of loan-loss reserves.
11. On the "Policies and Supervision" or an equivalent page of the inspection report, evaluate the BHC's oversight regarding effective lending policy and procedures.

Lending Standards for Commercial Loans

1. Review formal credit policies for clear articulation of current lending standards, including—
   a. a description of the characteristics of acceptable loans and (if applicable) "guidance" minimum financial ratios,
   b. standards for the types of covenants to be imposed for specific loan types, and
   c. the treatment and reporting of policy exceptions, both for individual loans and the entire portfolio.
2. Evaluate the role played by independent credit staff in loan approvals and, in particular, whether these credit professionals are adequately experienced, are independent of line lending functions, and have authority to reject loans either because of specific exceptions to policy or because the loan does not meet the institution's credit-risk appetite.
3. Review written policies and determine operating practice in preparing loan-approval documents to evaluate whether sufficient information is provided on the characteristics and risks of loans being considered, and whether such information is provided clearly and can be easily understood.
4. Based on written policies and review of operating practice, evaluate whether loans being considered are evaluated not only on the basis of the borrower's current performance but on the basis of forward-looking analysis of the borrower.
   a. Determine whether financial projections or other forward-looking tools are an integral part of the preapproval analysis and loan-approval documents.
   b. Determine the extent to which alternative or "downside" scenarios are identified, considered, and analyzed in the loan-approval process.
5. Review credit-risk management information systems and reports to determine whether they provide adequate information to management and lenders about—
   a. the composition of the institution's current portfolio or exposure, to allow for consideration of whether proposed loans might affect this composition sufficiently to be inconsistent with the institution's risk appetite, and
   b. data sources, analytical tools, and other information to support credit analysis.
6. When appropriate, coordinate or conduct sufficient loan reviews and transaction testing in the lending function to accurately determine the quality of loan portfolios and other credit exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the preexamination risk assessment, the inspection, or bank or other examinations, arrange for the commitment of sufficient supervisory resources to conduct in-depth reviews, including transaction testing, that are adequate to ensure that the Federal Reserve achieves a full understanding of the nature, scope, and implications of the deficiencies.
7. When reviewing loans, lending policies, and lending practices—
   a. observe and analyze loan-pricing policies and practices to determine whether the institution may be unduly weighting the short-term benefit of retaining or attracting new customers through price concessions, while not giving sufficient consideration to potential longer-term consequences;
   b. be alert for indications of insufficiently rigorous risk assessment, in particular (1) excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts and (2) inadequate stress testing;
   c. be attentive in reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead that institution to delay recognition of emerging weaknesses in some loans or to lessen staff resources assigned to internal loan review;[55] and
   d. give careful consideration to downgrading, under the applicable supervisory rating framework, a banking organization's risk-management, management, and/or asset-quality ratings and its capital adequacy rating (if sufficiently significant) when there is significant and undue reliance on favorable assumptions about borrowers or the economy and financial markets, or when that reliance has slowed the recognition of loan problems.
8. Discuss matters of concern with the senior management and the board of directors of the bank holding company and report those areas

55. Examiners should recognize that an increase in classified or special-mention loans is not per se an indication of lax lending standards. Examiners should review and consider the nature of these increases and the surrounding circumstances in reaching their conclusions about the asset quality and risk management of an institution.

of concern on core page 1, “Examiner’s Comments and Matters Requiring Special Board Attention.”

Leveraged Lending

Overview

Complete or update the Leveraged Lending Internal Control Questionnaire if selected for implementation.

1. Based on an evaluation of internal controls, determine the scope of the inspection. The scope should include exposures related through common ownership, guarantors, or sponsors. Also include direct and indirect leveraged lending exposure found in financial intermediaries formed to house or distribute leveraged loans (for example CLOs, SPEs, conduits etc.).
2. Inspection procedures should include both a policy review and transaction testing approach to determine the effectiveness of the institution’s leveraged lending control process.

If the institution is found to lack robust risk-management processes and controls around leveraged lending that reinforces the institution’s risk profile, a supervisory finding of unsafe and unsound banking practices should be considered.

3. Applicability/Risk Management Framework
   a. At the start of the inspection, ascertain whether the institution has adopted an appropriate risk-management framework for leveraged lending that includes robust policies, procedures, and risk limits that have been approved by the board of directors.
   b. Implementation of this guidance should be consistent with the size and risk profile of the institution.
   c. All aspects of the guidance should be applied to institutions that originate and distribute leveraged loans.
   d. The section on Participations Purchased should be applied to banking organizations that have limited involvement in leveraged lending; community banks overall may not be materially affected by the guidance.
4. Definition of Leveraged Lending
   a. Determine if the institution has a written policy for leveraged lending and if that policy contains criteria for defining leveraged lending that are appropriate for the institution and consistent with the guidance standards.
   b. Determine if the institution’s definition includes related exposures and direct and indirect exposures.
5. General Policy Expectations
   a. Review the policy for the key risk elements referred to in the guidance (See the section on General Policy Expectations in the guidance and in the Internal Control Questionnaire). Determine if the policy includes the following elements:
      - Risk Appetite that clearly defines the amount of leveraged lending the institution is willing to underwrite and is willing to retain.
      - Limit Framework for aggregate portfolio held on balance sheet, single obligors and transactions, aggregate pipeline exposure, industry and geographic concentrations. For institutions with significant underwriting exposure, determine if limits have been established for stress losses, flex terms, economic capital, or earnings at risk associated with leveraged loans.
      - Allowance for loan and lease losses (ALLL) and capital adequacy analysis that reflect the risk of leveraged lending activities.
      - Credit approval and underwriting authorities.
      - Guidelines for senior management oversight and timely reporting to senior management and the board of directors.
      - Expected risk adjusted returns.
      - Minimum underwriting standards.
      - Underwriting practices for origination and secondary loan acquisition.
6. Participations Purchased
   a. Ascertain if the institution participating or purchasing into a leveraged loan has a clear understanding of the credit and the risks involved and also has a clear understanding of its rights and responsibilities under the participation agreement.
   b. Determine if the institution has conducted its own independent underwriting of participations and has applied the same standards of prudence, credit

assessment techniques, and in-house limits as if the institution had originated the loan(s).

c. Verify that the institution has received copies of all participation documents and any other documents relevant to the credit transaction(s).

7. Underwriting Standards
   a. Determine if the institution employs similar and consistent underwriting standards for leveraged loans it plans to hold or it plans to distribute.
      - Confirm that the institution's underwriting standards are clear, written, measurable, and reflect the institution's policy-based risk appetite for leveraged lending.
      - Evaluate the underwriting policies and standards and determine if they contain the elements found in guidance (Refer to the section on Underwriting Standards in the guidance and in the Internal Control Questionnaire):
8. Valuation Standards
   a. Confirm that the institution has policies and procedures in place for estimating enterprise value or for valuing other illiquid collateral. If enterprise value is relied on as a secondary source of repayment, determine the following:
      - If one or a combination of the three methods referred to in the guidance is used (asset, income, or market valuation).
      - If the underlying assumptions and the resulting values are well documented, supportable, and credible (Refer to the Valuations Standards section of the guidance and the Internal Control Questionnaire).
      - If enterprise value was calculated by qualified persons independent of the origination function.
      - If stress tests of key enterprise value variables and assumptions (such as cash flow earnings and sales multiples) are conducted.
      - That firms have policies that provide for appropriate loan-to-value ratios, discount rates and collateral margins.
      - If the institution has established limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value.
9. Pipeline Management
   a. Determine if the institution has strong risk management and controls that are extended to deals in the pipeline, whether those deals are intended for hold, or if they are intended for distribution.
      - Determine if the institution has policies and procedures for handling distribution failures.
      - Determine if there are procedures for stress testing pipeline deals.
      - Ascertain if management reports show that transactions can be differentiated based on their key characteristics, tenor, and investor class (pro-rata and institutional), structure, and key borrower characteristics (for example, industry).
      - Determine if there are clearly articulated rationales for the effectiveness of hedging methods and if there is appropriate measurement and monitoring.
      - Confirm that the institution has developed and maintained the pipeline procedures referred to in the guidance (see the section on Pipeline Management in the guidance and in the Internal Control Questionnaire).
10. Reporting and Analytics
    a. Ascertain if the institution's risk-management framework includes an intensive and frequent review and monitoring process.
    b. Establish whether management receives comprehensive reports about the characteristics and trends of the institution's leveraged-lending portfolio at least quarterly and if summaries are provided to the board of directors.
    c. Find out if internal reports provide a detailed and comprehensive view of global exposures, including situations when an institution has an indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative. Borrower and counterparty leveraged lending reporting should aggregate total exposure and consider exposures booked across business lines or legal entities.
    d. Verify that internal policies identify the data fields to be populated and captured by the institution's MIS and whether the reports are accurate, timely, and if the information is provided to management and the board of directors.
    e. Confirm that MIS reporting on the leveraged lending portfolio contains the appli-

cable measures listed in the guidance. (Refer to the section on Reporting and Analytics in the guidance and in the Internal Control Questionnaire.)

11. Credit Analysis
    a. Conduct transaction testing on individual leveraged lending credits to determine if the credit analysis contains a comprehensive assessment of financial, business, and industry and management risks.
    b. Evaluate individual credits to determine if they fit the institutions definition of a leveraged loan.
    c. Determine if individual credits were analyzed in conjunction with the parameters in the guidance. (Refer to the section on Credit Analysis in the guidance and in the Internal Control Questionnaire).
    d. Verify that there are guidelines for evaluating deal sponsors and their willingness and ability to support the credit.
    e. Confirm that sponsors are used as a secondary and not a primary source of repayment.
    f. Assess the credit agreement to determine if it contains language for:
        - Material dilution, sale, or exchange of collateral or cash flow producing assets without lender approval.
        - Financial performance covenants; covenant-lite, and payment-in-kind (PIK) toggle loan structures
        - Reporting requirements and compliance monitoring.
        - The distribution of reporting and other credit information to participants and investors.
        - Acceptable collateral types, loan to value guidelines and appropriate collateral valuation methodologies
12. Internal Risk Rating
    a. Determine if individual loans are risk rated based on the borrower's demonstrated ability to repay the loan and de-lever over a reasonable period of time.
        - Confirm that the institution has evidence of adequate repayment capacity, for example borrowers demonstrate the ability to fully amortize senior debt or repay at least 50 percent of total debt over a 5–7 year period. Ensure that extensions or other restructuring are not masking an inability to repay.
        - Consider adversely rating credits that do not show the capacity to pay down debt from cash flow or if refinancing is the only option for repayment.
        - Consider a substandard rating if there are no reasonable or realistic prospects for repayment or de-levering.
13. Deal Sponsors
    a. If a deal sponsor is relied on as a secondary source of repayment, determine if management has developed guidelines for evaluating the sponsor's creditworthiness.
    b. Evaluate the sponsor based on the criteria listed in the guidance (See the section on Deal Sponsors in the guidance and in the Internal Control Questionnaire).
14. Credit Review/Problem Credit Management
    a. Assess credit review staff's expertise relative to leveraged lending.
    b. Verify that the institution conducts frequent internal credit review of leveraged-lending portfolio that is done independently of the origination function. Portfolio reviews should generally be conducted no less than annually.
    c. Evaluate the institution's procedures for dealing with problem credits including if work out plans contain quantifiable objectives and measurable time frames.
15. Stress Testing
    a. Determine if the institution has developed stress tests for leveraged loans or if the loans are included in the existing stress testing protocol.
16. Conflicts of Interest/
    Reputational Risk/Compliance
    a. Confirm that the institution is meeting its legal responsibilities by underwriting and distributing transactions that do not result in undue reputational risk.
    b. Determine if potential conflicts of interest exist if the institution has both equity and lending positions in a particular transaction. Confirm that policies and procedures are in place to handle conflicts of interest.
    c. Ascertain whether the institution's compliance function periodically reviews the institution's leveraged-lending activity.
    d. Ascertain whether the institution's policies incorporate safeguards to prevent violations of anti-tying regulations.
    e. When securities are involved, determine how the institution ensures compliance with applicable securities laws, including disclosure and other regulatory requirements.

f. Ascertain what plans and provisions have been developed to ensure compliance with the Board's Regulation W (12 CFR part 223).

Credit-Risk Management for Home Equity Lending

1. Review the credit policies for home equity lending to determine if the underwriting standards address all relevant risk factors (that is, an analysis of a borrower's income and debt levels, credit score, and credit history versus the loan's size, the collateral value (including valuation methodology), the lien position, and the property type and location.
2. Determine whether the banking organization's underwriting standards include—
   a. a properly documented evaluation of the borrower's financial capacity to adequately service the debt and
   b. an adequately documented evaluation of the borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates for interest-only and variable-rate HELOCs.
3. Assess the reasonableness and adequacy of the analyses and methodologies underlying the banking organization's evaluation of borrowers.
4. If the organization uses third parties to originate home equity loans, find out—
   a. if the organization delegates the underwriting function to a broker or correspondent;
   b if the banking organization's internal controls for delegated underwriting are adequate;
   c. whether the banking organization retains appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function;
   d. if there are adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the banking organization's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations;
   e. if the banking organization has a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the quality of loans that the third party underwrites; and
   f. whether the banking organization has adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.
5. Evaluate the adequacy of the banking organization's collateral-valuation policies and procedures. Ascertain whether the organization—
   a. establishes criteria for determining the appropriate valuation methodology for a particular transaction (based on the risk in the transaction and loan portfolio);
   b. sets criteria for determining when a physical inspection of the collateral is necessary;
   c. ensures that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation;
   d. implements policies and controls to preclude "value shopping";
   e. requires sufficient documentation to support the collateral valuation in the appraisal or evaluation.
6. If the banking organization uses automated valuation models (AVMs) to support evaluations or appraisals, find out if the organization—
   a. periodically validates the models, to mitigate the potential valuation uncertainty in the model;
   b. adequately documents the validation's analysis, assumptions, and conclusions;
   c. back-tests a representative sample of evaluations and appraisals supporting loans outstanding; and
   d. evaluates the reasonableness and adequacy of its procedures for validating AVMs.
7. If tax-assessment valuations are used as a basis for collateral valuation, ascertain whether the banking organization is able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value, as part of the validation process.

8. Review the risk- and account-management procedures. Verify that the procedures are appropriate for the size of the banking organization's loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the organization.
9. If the banking organization has large home equity loan portfolios or portfolios with high-risk characteristics, determine if the organization—
   a. periodically refreshes credit-risk scores on all customers;
   b. uses behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
   c. periodically assesses utilization rates;
   d. periodically assesses payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current;
   e. monitors home values by geographic area; and
   f. obtains updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

   Determine that the frequency of these actions is commensurate with the risk in the portfolio.
10. Verify that annual credit reviews of home equity line of credit (HELOC) accounts are conducted. Verify if the reviews of HELOC accounts determine whether the line of credit should be continued, based on the borrower's current financial condition.
11. Determine that authorizations of over-limit home equity lines of credit are restricted and subject to appropriate policies and controls.
    a. Verify that the banking organization requires over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits.
    b. Evaluate the sufficiency of management information systems (MIS) that enable management to identify, measure, monitor, and control the risks associated with over-limit accounts.
12. Verify that the organization's real estate lending policies are consistent with safe and sound banking practices and that its board of directors reviews and approves the policies at least annually.
13. Determine whether the MIS—
    a. allows for the segmentation of the loan portfolios;
    b. accurately assesses key risk characteristics; and
    c. provides management with sufficient information to identify, monitor, measure, and control home equity concentrations.
14. Determine whether management periodically assesses the adequacy of its MIS, in light of growth and changes in the banking organization's risk appetite.
15. If the banking organization has significant concentrations of home equity loans (HELs) or HELOCs, determine if the MIS includes, at a minimum, reports and analysis of the following:
    a. production and portfolio trends by product, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type
    b. the delinquency and loss-distribution trends by product and originator channel, with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, or DTI)
    c. vintage tracking
    d. the performance of third-party originators (brokers and correspondents)
    e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values
16. Determine whether the banking organization accurately tracks the volume of high-LTV (HLTV) loans, including HLTV home equity and residential mortgages, and if the organization reports the aggregate of these loans to its board of directors.
17. Determine whether loans in excess of the supervisory LTV limits are identified as high-LTV loans in the banking organization's records. Determine whether the organization reports, on a quarterly basis, the dollar value of such loans to its board of directors.
18. Find out whether the organization has purchased insurance products to help mitigate the credit risks of its HLTV residential loans. If a policy has a coverage limit, determine whether the coverage may be exhausted before all loans in the pool mature or pay off.

19. Determine whether the organization's credit-risk management function oversees the support function(s). Evaluate the effectiveness of controls and procedures over staff persons responsible who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes.
20. Determine whether policies and procedures have been established for home equity problem-loan workouts and loss-mitigation strategies.

Loan Participations, the Agreements and Participants

These inspection procedures are designed to ensure that originated loans that were transferred via loan participation agreements or certificates to state member banks, bank holding companies, nonbank affiliates, or other third parties were carefully evaluated. The procedures instruct examiners to determine if the asset transfers were carried out to avoid or circumvent classification and to determine the effect of the transfers on the BHC's financial condition or that of its subsidiaries. In addition, the procedures are designed to ensure that the primary regulator of another financial institution involved in the asset transfer of any low-quality assets is notified.

1. Review the board of directors' or their designated committees' policies and procedures governing how loan participation agreements and activities are created, transacted, and administered. Refer to section 2010.2.7 for the minimum items that should be included in board-approved policies on loan participation activities.
2. Determine if managerial reports provide sufficient information relative to the size and risk profile of the loan participation portfolio and evaluate the accuracy and timeliness of reports produced for the board and senior management.
3. For loan participations held (either in whole or in part) with another lending institution, review, if applicable,
   - the participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
   - loan documentation to determine if it meets the BHC's (or its subsidiary's) underwriting procedures (that is, the documentation for loan participations should meet the same standards as the documentation for other loans the respective entity originates);
   - the transfer of loans immediately before the date of the inspection to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current inspection; and
   - losses to determine if they are shared on a pro rata or other basis according to the terms of the participation agreement.
4. Check participation certificates or agreements and records to determine whether the parties share in the risks and contractual payments on a pro rata or other basis.
5. Determine if loans are purchased on a recourse basis and that loans are sold on a nonrecourse basis.
6. Ascertain that the BHC (or its subsidiaries) do not buy back or pay interest on defaulted loans in contradiction of the underlying participation agreement.
7. Compare the volume of outstanding originated or purchased loans that were issued in the form of loan participations with the total outstanding loan portfolio.
8. Determine if the BHC (or its subsidiaries) has sufficient expertise to properly evaluate the volume of loans originated or purchased and sold as loan participations.
9. Based on the terms of the loan participation agreements, review the originator's distribution of the borrower's payments received to those entities or persons owning interests in the loan participations. Ascertain if the agreement's recourse provisions may require accounting for the transactions as a secured borrowing rather than as a sale.
10. Determine if loans are sold primarily to accommodate credit overline needs of customers or to generate fee income.
11. Determine if loans are purchased or sold to affiliates or other companies; if so, determine whether the purchasing companies request and are given sufficient information to properly evaluate the credit. (Section 23A of the Federal Reserve Act and the Board's Regulation W prohibit transfers of low-quality assets between affiliates.) See sections 2020.0, 2020.1, 2020.2.
12. Investigate any situations in which assets were transferred before the date of inspection:

a. Determine if any were transferred to avoid possible criticism during the inspection.
b. Determine whether any of the loan participations transferred were nonperforming at the time of transfer, classified during the previous examination, or transferred for any other reason that may cause the loans to be considered of questionable quality.

13. Review the BHC's policies and procedures to determine whether loan participations purchased are required to be given an independent, complete, and adequate credit evaluation. Review asset participations sold to affiliates to determine if the asset purchases were supported by an *arm's-length* and *independent* credit evaluation.
14. Determine that any assets purchased by the BHC (or its subsidiaries) were properly recorded at fair market value at the time of purchase.
15. Determine that transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
16. If poor-quality assets were transferred by the BHC to another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank's appropriate staff will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable,
    - names of originating and receiving institutions;
    - type of assets involved;
    - date (or dates) of transfer;
    - total number and dollar amount of assets transferred;
    - status of the assets when transferred (e.g., nonperforming, classified, etc.); and
    - any other information that would be helpful to the other regulator. Ascertain whether the bank manages not only the risk from individual participation loans but also portfolio risk.
17. Find out if management develops appropriate strategies for managing concentration levels, including the development of a contingency plan to reduce or mitigate concentrations during adverse market conditions (such a plan may include strategies involving not only loan participations, but also whole loan sales). Find out if the BHC's (or its subsidiaries') contingency plan includes selling loans as loan participations.
18. Ascertain if management periodically assesses the marketability of its loan participation portfolio and evaluates the BHC's (or its subsidiaries') ability to access the secondary market.
19. Verify whether the BHC (or its subsidiaries) compare its underwriting standards for loan participations with those that exist in the secondary market.

2010.2.10 INTERNAL CONTROL QUESTIONNAIRE

Applicability/Risk-Management Framework

1. Has the institution adopted a risk-management framework around leveraged lending that includes:
    a. A leveraged lending policy that is based on risk objectives, risk acceptance criteria, and risk controls?
    b. Structuring transactions that reflect a sound business premise, have an appropriate capital structure, reasonable cash flow, and balance sheet leverage?
    c. A definition of leveraged lending that can be applied across all business lines?
    d. Well-defined underwriting standards that define acceptable leverage levels and amortization expectations?
    e. A limit framework?
    f. Sound MIS?
    g. Pipeline management procedures, hold limits, and expected timing for distributions?
    h. Guidelines for stress testing?
2. Is the institution able to identify leveraged exposures to related borrowers or guarantors?
3. Is the institution able to identify leveraged loans that are managed in non-lending portfolios (for example collateralized loan obligations (CLOs), special purpose entities (SPEs), or other indirect exposures)?
4. Is the institution originating leveraged loans; participating in leveraged loans, or both?

Definition of Leveraged Lending

1. Has the institution developed an appropriate written definition for leveraged lending and incorporated it into the leveraged lending policy?
2. Is the policy definition consistent with the amounts and types of leveraged loans that the institution is engaged in?

General Policy Expectations

1. Has the institution's leveraged lending policy been approved by the board of directors?
2. Does the leveraged lending policy contain the following elements:
   a. A clear statement of the amounts of leveraged lending that it is willing to underwrite and the amount(s) it is willing to hold in its own portfolio?
   b. A limit framework that establishes limits or guidelines around the following as applicable:
      1) Single obligors and transactions?
      2) Aggregate hold portfolio?
      3) Total pipeline exposure?
      4) Industry and geographic concentration?
      5) Notional pipeline limits?
      6) Stress losses, flex terms, economic capital usage, and earnings at risk?
      7) Other parameters particular to the portfolio?
      8) The required management approval authorities and exception tracking provisions?
   c. Procedures for insuring that leveraged lending risks are appropriately reflected in the institution's level of allowance for loan and lease losses (ALLL) and capital adequacy analysis?
   d. Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms?
   e. Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors?
   f. Expected risk-adjusted returns for leveraged transactions?
   g. Minimum underwriting standards and underwriting practices for primary loan origination and secondary loan acquisition?

Participations Purchased

1. Has the institution, with respect to participations purchased, done its own independent underwriting of its portion of the transaction and has it adequately identified its risks?
2. Has the institution received copies of all documentation relevant to the transaction?
3. Is there evidence that the institution has reviewed the participation agreement and has a clear understanding of its rights and responsibilities under the agreement?

Underwriting Standards

1. Is the institution using similar underwriting standards for leveraged loans it plans to hold as well as for leveraged loans it plans to distribute?
2. Are the institution's underwriting standards clear, written, and measurable?
3. Do underwriting standards require:
   - A sound business premise for each transaction and that the borrower's capital structure is sustainable?
   - A determination and documentation of the borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period?
   - Standards for evaluating various types of collateral?
   - Standards for evaluating risk-adjusted returns?
   - The acceptable degree of reliance on enterprise value and other intangible assets for loan repayment?
   - Expectations for the degree of support expected to be provided by sponsors?
   - A prohibition on material dilution, sale, or exchange of collateral or cash flow producing assets without lender approval?
   - A credit agreement that contains financial covenants, reporting covenants, and compliance monitoring? Does the loan contain covenant-lite and PIK toggle loan structures? If so, does the borrower have the ability to repay the loan under the contractual terms?
   - Guidelines for acceptable collateral types, loan-to value-guidelines, and acceptable collateral valuation methodologies?

- Loan agreements that provide for the distribution of financial information to participants and investors?

Valuation Standards

1. Does the institution have policies for valuing illiquid, intangible, or hard to value collateral that include appropriate LTV ratios, discount rates, and collateral margins?
2. Is the institution relying on enterprise value to confirm a secondary source of repayment?
   a. Has the institution documented its valuation approach to calculating enterprise value?
   b. Has the valuation been performed by qualified persons independent of the origination function?
   c. Has one or a combination of three methods been used for determining enterprise value, asset valuation, income valuation, or market valuation?
   d. If the income method is used, is it based on capitalized cash flow or discounted cash flow?
   e. Has the institution confirmed proxy measures such as multiples of cash flow earnings or sales by performing its own discounted cash flow analysis?
   f. Are stress tests of key variables and assumptions used in determining enterprise value (such as cash flow earnings and sales multiples) conducted at origination and periodically thereafter?
   g. Does the institution have established limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value?

Pipeline Management

1. Do strong risk-management controls cover all transactions in the pipeline, including amounts planned for hold and those marked for distribution?
2. Does the institution have the capability to differentiate transactions based on their key characteristics, tenor, and investor class (pro-rata and institutional), structure, and key borrower characteristics (for example, industry)?
3. Does the institution have the following controls for pipeline exposure:
   - A documented appetite for underwriting pipeline risk that considers the potential effects on earnings, capital, and liquidity?
   - Written policies and procedures for "hung deals" or deals that are not sold down within a reasonable or 90-day period?
     – Have transactions reclassified as hold-to-maturity been reported to management and the board of directors?
   - Guidelines for conducting periodic stress tests of pipeline exposures?
   - Controls to monitor expected vs. actual performance?
   - Reports that show individual and aggregate transaction information, risk ratings and concentrations?
   - Limits on hold levels per borrower, counterparty, and aggregate hold levels?
   - Limits on the amounts intended for distribution?
   - Policies and procedures for acceptable accounting methods, including prompt recognition of losses?
   - Policies and procedures around acceptable hedging practices if applicable?
   - Plans to address contingent liabilities and compliance with Sections 23A and 23B of the Federal Reserve Act and Regulation W?

Reporting and Analytics

1. Does management receive quarterly comprehensive reports about the characteristics and trends of the institution's leveraged lending portfolio? Are summaries provided to the board of directors?
2. Do internal policies identify the data fields to be populated and captured by the institution's MIS? Are the reports accurate and timely?
3. As dictated by the size and complexity of the leveraged lending portfolio, does MIS reporting on the leveraged lending portfolio include the following:
   a. Individual and portfolio exposures within and across all business lines and legal vehicles including the pipeline?
   b. Risk-rating distribution and migration analysis?
   c. A list of borrowers who have been removed from the leveraged-lending portfolio due to improvements in their

financial characteristics and risk profile? Is the removal from the profile concurrent with a refinance, restructure or some other modification in the loan agreement?

d. Industry mix and maturity profile?
e. Metrics derived from probability of default and loss-given default?
f. Portfolio performance measures including covenant breaches, restructurings, delinquencies, nonperforming asset amounts, and charge offs?
g. Amount and nature of impaired assets and the amount of ALLL attributable to leveraged lending?
h. The level of policy exceptions in the portfolio?
i. Exposures by collateral type, including unsecured transactions when enterprise values will be the only source of repayment?
j. Defaults that trigger *pari-passu* treatment for all lenders?
k. Secondary market pricing data and trading volume (when available)?
l. An aggregation of exposures by and performance of deal sponsors?
m. An indication of gross and net exposures, hedge and counterparty concentrations; and indication of policy exceptions?
n. Actual vs. projected distribution levels of the pipeline with reports of excess levels of exposure over hold targets?
o. *Types of exposure in the pipeline:* committed exposures not accepted by the borrower; exposures committed and accepted but not closed; funded and unfunded commitments closed but not distributed?
p. *Total and segmented exposures:* subordinated debt and equity holdings (compared to limits); global exposures; indirect exposure (to an obligor or if the institution is holding a previously sold position as collateral or as a reference asset in a derivative)?
q. Exposures booked in other business units throughout the institution that are related to a leveraged loan or borrower? (For example, default swaps or total return swaps naming the distributed paper as a covered or referenced asset or as collateral exposure through repo transactions).
r. Positions held in leveraged loans in available for sale or traded portfolios or held in structured-investment vehicles owned or operated by the originating institution or its subsidiaries or affiliates?

Internal Risk Rating

1. Does the institution have evidence of adequate repayment capacity? For example, do borrowers demonstrate the ability to fully amortize senior debt or repay at least 50 percent of total debt over a five to seven-year period?
2. Are there extensions or other restructuring that are masking an inability to repay?
3. Has the primary source of repayment become inadequate? Is enterprise value being relied on as a secondary source of repayment? Is enterprise value well supported with binding purchase and sale agreements with qualified third parties? Does enterprise value consider the borrower's distressed circumstances?

Credit Analysis

1. Does transaction testing of individual leveraged lending credits contain the following elements and show that :
   a. *Cash flow analysis*—The analysis does not rely on overly optimistic or unsubstantiated projections of sales, margins, or merger and acquisition synergies?
   b. *Liquidity analysis*—There are measures to determine operating cash needs and cash needed to meet debt maturities? Analyze liquidity based on industry performance metrics?
   c. *Projections*—There is adequate margin for unanticipated merger-related integration costs?
   d. *Stress tests*—Projections are stress tested for one or more downside scenarios, including a covenant breach?
   e. *Variances from plan*—Transactions are reviewed at least quarterly to determine variance from plan; does the credit file contain a chronological rationale for and analysis of all changes to the operating plan and variances from the expected financial performance?
   f. *Enterprise Value*—Were enterprise values independently derived and validated outside of the origination function? Were

values calculated timely and did they consider value erosion?

g. *Collateral shortfalls*—Have shortfalls been identified and factored into the risk rating?
h. *Collateral liquidation and asset sales*—Are any liquidations and sales based on current market conditions and trends?
i. *Contingency plans*—Are there contingency analyses to anticipate changing conditions in debt or equity markets? Do the exposures rely on refinancing or the issuance of new equity?
j. *Interest Rate Risk and Foreign Exchange Risk*—Have these risks been addressed in the analysis? Are mitigants in place?

Problem Credit Management

1. Has the institution formulated and established procedures for dealing with problem credits?
2. Do work out plans contain quantifiable objectives and measurable time frames?
3. Are problem credits regularly reviewed for risk-rating accuracy, accrual status, recognition of impairment through specific allocations and charge-offs.

Deal Sponsors

1. Has the institution developed guidelines for evaluating the willingness and ability of sponsors to support the credit exposure and a process to regularly monitor sponsor performance?
2. Determine if the credit analysis has considered:
   a. If the sponsor is relied on as a secondary source of repayment and not a primary source of repayment?
   b. If the sponsor has a historical pattern of supporting investments, financially or otherwise?
   c. If the degree of support has been documented via a guarantee, comfort level, or verbal assurance?
   d. If there has been a periodic review of the sponsor's financial statements, an analysis of liquidity, and an analysis of the sponsor's ability to support multiple deals?
   e. If consideration has been given to the sponsor's dividend and capital contribution practices and the likelihood that the sponsor will support the borrower as compared to other deals in the sponsor's portfolio?

Credit Review

1. Does the institution conduct an internal credit review of the leveraged-lending portfolio regularly, but at least once per year?
2. Does the institution ensure that credit review personnel have the knowledge and ability to identify risks in the leveraged lending portfolio?

Stress Testing

1. Has the institution developed and implemented guidelines for conducting periodic portfolio stress tests on loans originated to hold and on loans originated to distribute?
2. Has the institution conducted periodic loan and leveraged lending portfolio level stress tests?
3. If applicable, has the leveraged-lending portfolio been included in enterprise wide stress tests?
4. Does stress testing of leveraged credits include sensitivity analyses to quantify the potential impact of changing economic and market conditions on the institution's asset quality, earnings, liquidity, and capital?

Reputational Risk

1. Does the institution have procedures, safeguards, actions, training, and staff reminders about the potential reputational risk associated with poorly underwritten originated leveraged loans?
2. Has there been any failure or apparent failure by the institution to meet its legal responsibilities in underwriting and distributing transactions that could damage its reputation or its ability to compete?

Conflicts of Interest

1. Has the institution developed appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions?
2. Do policies and procedures:

   a. Clearly define potential conflicts of interest?
   b. Identify appropriate risk-management controls and procedures?
   c. Enable employees to report potential conflicts of interest to managements without fear of retribution?
   d. Ensure compliance with applicable laws?
3. Has management:
   a. Established a training program for employees on appropriate practices to follow to avoid conflicts of interest?
   b. Provided for reporting, tracking, and resolution of any conflicts?

Compliance

1. Does the institution maintain an independent compliance review function to periodically review its leveraged-lending activity?
2. Do the institution's policies include safeguards to prevent violations of anti-tying regulations?
3. How does the institution ensure compliance with applicable securities laws, including disclosure and other regulatory requirements when equity interests and certain debt instruments have been used in leveraged transactions that may constitute "securities" under federal securities laws?
4. Have plans and provisions been developed to ensure compliance with sections 23A and 23B of the Federal Reserve Act and Regulation W?

2010.2.11 APPENDIX I - EXAMINER LOAN-SAMPLING REQUIREMENTS FOR CREDIT-EXTENDING NONBANK SUBSIDIARIES OF BHCS WITH $10-50 BILLION IN TOTAL CONSOLIDATED ASSETS

This guidance sets forth loan sampling expectations for the Federal Reserve's examination of state member bank (SMB) and the inspection of credit-extending nonbank subsidiaries of bank holding companies (BHCs) with $10-50 billion in total consolidated assets. Examiners will have the flexibility, depending upon the structure and size of subsidiary SMBs or credit-extending nonbank subsidiaries of BHCs, to utilize the guidance applicable to smaller organizations when the subsidiary's total assets are below $10 billion. This guidance clarifies expectations for the assessment of material[56] retail credit portfolios for these institutions. The guidance that follows has been solely adapted to BHC credit-extending nonbank subsidiaries.

A thorough review of a BHC's credit-extending nonbank subsidiary's loan and lease portfolio remains a fundamental element of the Federal Reserve's inspection program for these organizations. Such credit reviews are a primary means for examiners to (1) evaluate the effectiveness of a BHC's credit-extending nonbank internal loan review program and internal grading systems for determining the reliability of internal reporting of classified credits, (2) assess compliance with applicable guidance and regulations, and (3) determine the efficacy of credit-risk management and credit administration processes. Further, examiners use the findings from their credit review to identify the overall thematic credit-risk management issues, to assess asset quality, to assist in the assessment of the adequacy of the allowance for loan and lease losses (ALLL), and to inform their analysis of capital adequacy.

2010.2.11.1 Loan Sampling Methodology

Reserve Banks will establish the annual loan-sampling objective during the supervisory planning process. The annual sampling objective should provide coverage of material exposures, including those in the retail segments.[57] Reserve Banks should plan on conducting at least two loan quality reviews during the annual supervisory cycle of the BHC's credit-extending nonbank subsidiaries with $10–50 billion in total consolidated assets.

Each review should focus on one or more material commercial loan segment exposures using the comparable FR Y-9C Report loan types and, in total over the annual cycle, should cover the four highest concentrations for com-

56. A loan portfolio or portfolio segment is considered material when the portfolio or segment exceeds 25 percent of total risk-based capital (tier 1 capital plus the allowance for loan and lease losses) or contributes 25 percent or more to annual revenues.

57. Commercial loan segments include commercial and industrial (C&I) loans, 1-4 family construction, other construction loans, multifamily loans, farm loans, non-farm non-residential owner occupied, and non-farm non-residential other loans. Retail loan segments include first lien mortgages, closed-end junior liens, home equity lines of credit (HELOCs), credit cards, automobile loans, and other consumer loans.

mercial credits in terms of total risk-based capital for any FR Y-9C Report loan type from Schedule HC-C. Loan segments that generate substantial revenues are generally likely to entail higher risk. To the extent that examiners can determine that a loan category contributes 25 percent or more to annual revenues,[58] examiners should sample these segments. Examiners should also sample other loan segments that they or the bank's internal loan review have identified as exhibiting high-risk characteristics. Such risk characteristics include liberal underwriting, high levels of policy exceptions, high-delinquency trends, rapid growth, new lending products, concentrations and concentrations to industry, or significant levels of classified credits. In addition to these risk-focused samples, a sample of loans to insiders must be reviewed.[59] Annual loan sampling coverage by examiners should take into consideration the severity of the asset quality component rating, the effectiveness of the internal loan review program, the results of internal loan portfolio stress testing, and current asset quality financial trends.

During the inspection scoping phase, Reserve Bank staff should analyze the results of recent loan review reports or audits prepared for an institution's internal use and the Reserve Bank's most current assessment of credit-risk management to help establish the size and composition of loans to be selected for review. A nonbank subsidiary's internal loan review program should achieve substantial coverage beyond the examiners' annual judgmental sample of material loan portfolios. Examiners should review the findings and recommendations of the nonbank subsidiary's internal loan review program to help identify areas of risk. In selecting loans from each segment of the loan portfolio to review, examiners should include a selection of the largest loans, problem loans (past due 90 days or more, nonaccrual, restructured, or internally classified loans), and newly originated loans. Examiners should ensure the sample selection includes robust coverage of classified credits. At a minimum, loans selected for review from commercial loan segments should represent 10 percent of the committed dollar amount of credit exposure within the loan segment.

Sample sizes should be increased beyond the 10 percent minimum, based on examiner judgment, for segments when the inspection scoping process or the internal loan review program has identified

1. deficiencies with credit-risk management and administration practices,
2. unusually high loan growth,
3. credit quality or collateral values that have been adversely affected since the prior review by volatile local or national economic conditions, or
4. unreliable internal credit-risk grading.

Conversely, sample sizes should be based on the 10 percent minimum if

1. previous inspections concluded that internal loan review and credit-risk identification is effective,
2. internal loan review has reviewed a loan segment within the last 12 months and noted no material weaknesses, and
3. the inspection scoping process reveals no significant credit-risk management issues.

In general, the lower range of 10 percent sampling of each segment or the entire commercial portfolio would be acceptable when all aspects of credit risk indicate low and stable risk.

Examiners should determine classification amounts for retail credits using the Uniform Retail Classification Guidance (SR letter 00-8, "Revised Uniform Retail Credit Classification and Account Management Policy"). Annually, examiners should focus on one or more material retail loan segment exposures as divided by the comparable FR Y-9C Report loan type. Examiners should determine the appropriate sample of retail loans from material segments based on risk to be tested for compliance with internal credit administration policies and underwriting standards. While there is no minimum coverage expectation for retail portfolios or segments, the goal of sampling is to assist examiners in making an informed assessment of all aspects of retail credit-risk management. If applicable, examiners should evaluate and test secondary market origination and servicing practices and quality assurance programs. Examiners should also sample other retail loan segments, as needed, from segments the examiners or internal loan review identify as exhibiting high-risk characteristics such as liberal underwriting,

58. The 25 percent threshold should be based on internal MIS and may not be applicable or available in all instances. For the purposes of this guidance, annual revenue equals net interest income plus non interest income.

59. Federal Reserve examiners must test and evaluate Regulation O compliance annually.

high-delinquency trends, rapid growth, new lending products, or significant levels of classified credits.

2010.2.11.2 Documentation of Loan Sampling Analysis and Methodology

Examiners should discuss their analysis and objectives for achieving loan sampling coverage with Board staff during the annual supervisory planning process. Upon reaching a consensus with Board staff, the analysis and methodology should be retained in workpapers and documented in the supervisory plan. Further, examiners should document their loan sample selection methods in scoping memoranda and in the confidential section of the report of inspection. The required workpaper documentation of the commercial loan coverage calculation should be based on total loan commitments and should generally exclude loans reviewed outside of the Reserve Bank's supervisory plan when a detailed analysis of the loans by an examiner and an assessment of credit-risk management were not performed. Review of syndicated loans and participations, such as those from the Shared National Credits (SNCs) annual review, should only be included in the coverage ratio if Reserve Bank staff reviewed the credit-risk management aspects of the credit (for example, adherence to underwriting policies) and these findings are included in the examiner's assessment of overall credit-risk management practices. Examiners should continue to follow the SNC grading guidance.[60]

2010.2.11.3 Follow-Up Expectations for Inspections with Adverse Findings

Examiners should generally consider a credit-extending nonbank subsidiary's internal risk-rating system to be less reliable when examiner downgrades[61] or internal loan review downgrades equal 10 percent of the total number of loans reviewed, or 5 percent of the total dollar amount of loans and commitments reviewed. When a credit-extending nonbank subsidiary's risk-rating system is determined to be unreliable, examiners may need to expand sampling to better evaluate the effect of rating differences on the entity's ALLL and capital. In such situations, examiners should direct the BHC and its credit-extending nonbank subsidiary to take corrective action to validate its internal ratings and to evaluate whether the ALLL or capital should be increased. The Reserve Bank will follow-up with the BHC and its nonbank subsidiary to assess progress on corrective action and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed.[62] All follow-up actions on adverse findings should be discussed with Board staff.

41. Refer to SR-77-377, "Shared National Credit Program."

61. A credit-risk grading difference is considered a downgrade when (a) a risk rating is changed by the examiner from an internal Pass rating to a classified category or (b) a risk rating is changed by the examiner within the classified categories.

62. Refer to SR-13-13/CA -13-10, "Supervisory Considerations for the Communications of Supervisory Findings."

The System's ability to evaluate the effectiveness of a company's supervision and control of subsidiary investment activities can be strengthened not only by evaluating the parent's role in light of efficiency and operating performance, but also by evaluating the quality of control and supervision. In order to assess quality there must be a standard or measuring block against which a company's policies can be evaluated. By establishing the minimum areas that a company's policies should address with respect to subsidiary investments, a standard is created which can evaluate the quality of company's control and supervision of that activity. The examiner needs to make a qualitative assessment of the parent's supervision and control of subsidiary investment activities.

2010.3.1 INSPECTION OBJECTIVES

1. Determine if the parent's investment policy is adequate for the organization.
2. Determine if the investment policy is being complied with.

2010.3.2 INSPECTION PROCEDURES

1. Determine whether the management has developed a flow chart on investment authorization procedures sufficiently detailed to assure that the execution of transactions precludes the ability to circumvent policy directives.
2. Determine whether all investment policies appear to be adequately tailored to fit the business needs of each subsidiary. Review the methods and/or process through which prior approval of new activities and investments in new instruments is granted.
3. Determine whether the boards of directors and the management of subsidiaries appear to be sufficiently involved in their respective roles to assure that the performance of fiduciary responsibilities of each appears adequate.
4. Assess the adequacy of the level of management expertise in relation to its involvement in various investment activities.
5. Evaluate the reasonableness of investment activity initiated to achieve corporate objectives in light of its potential impact on the risk exposure of subsidiaries.
6. Assess the adequacy of investment policy directives in regard to the required maintenance of adequate recordkeeping systems at subsidiaries.
7. Evaluate policy directives regarding the appropriateness of accounting practices in regard to transactions involving investment participations, swaps, other transfers of investments as well as specialized investment activities.
8. Evaluate whether investment policies adequately provide for the maintenance of a stable income stream at bank subsidiaries as well as the parent company level.
9. Determine whether investment policy directives adequately address statutory limitations, particularly those involving intercompany transactions.
10. Evaluate the effectiveness of the bank holding company's audit function in assuring that investment policies and directives are adhered to at each corporate level.

This section emphasizes the importance of integrating subsidiaries into a consolidated plan, the essential elements of the planning process, and the ultimate accountability of the board of directors of the holding company. As a minimum, the parent's consolidated plan should include the following ten elements:

1. *All plans should address a long-range goal or focus, intermediate term objectives, and short-term budgets.* A long-range focus is particularly important during a changing environment and during expansions of the organization. Long-range plans generally are broad with a service or customer orientation and market share emphasis. These plans provide the entire organization with a consistent direction and facilitate changes in the organization arising from environmental changes. Intermediate goals generally are narrower in scope. Short-term budgets are generally developed at the subsidiary level; however, they are subject to review and revision by the parent in an effort to maintain consistency throughout the organization.

2. *The planning process should be formalized.* A long-range focus, intermediate term objectives, and budgets should be written and adopted by the parent's board of directors to insure centralized accountability.

3. *Plans should be consistent and interrelated over the differing time periods.* For example, budgets should be consistent with long-range goals—the implementation of a short-term, high return orientation may be inconsistent with a long-term goal of increasing market share, or short-term compensation plans may be disfunctional in the long run.

4. *A consolidated plan should increase the consistency of goals among differing subsidiaries and the parent.* The long-range goals, intermediate term objectives, and short term goals and objectives should be periodically reviewed, preferably, annually, by the BHC's board of directors. A consolidated plan should reduce unnecessary internal competition.

5. *A consolidated plan should facilitate the allocation of resources throughout the organization.* This is particularly important when the parent is providing most, or all, of the short-term funds and long-term capital. As the parent has an awareness of all subsidiaries, it can better allocate funds and personnel to areas where they will be utilized most effectively.

6. *Plans should be formulated with an awareness to possible weaknesses and recognition to areas likely to be influenced by environmental change.* For these areas, flexibility should exist for contingency plans.

7. *Methods should be determined, in the plan, to monitor and evaluate compliance with the plan.*

8. *The consolidated plan should have a measurable aspect to determine whether budgets, objectives, and goals are being met.* If they are not met, determination as to the controllability of variances should be ascertained.

9. *Plans and goals must continually be evaluated to determine whether accomplishing the goal results in the desired and expected outcome.* For example, the desired outcome may be to increase net income by granting loans with higher interest rates and above normal risk. The granting of such loans may result in a need to increase the provision for loan losses, thus causing a decrease in earnings.

10. *Plans should be flexible enough to remain effective in a volatile environment.* If plans are too rigid, they may become disfunctional if the environment changes and actually constrain an organization's ability to react. On the other hand, flexible goals and plans should enhance an organization's ability to compete by providing the entire organization with a fluid consistent direction.

2010.4.1 INSPECTION OBJECTIVES

1. To determine if the board of directors at the parent company is cognizant of and performing its duties and responsibilities.
2. To determine if the level of supervision over subsidiaries is both adequate and beneficial.
3. To evaluate the consolidated plan for consistency, controls, and effectiveness.
4. To ascertain if the board of directors of the parent company is making judgments and decisions based on adequate information flowing from the management and financial reporting systems of the organization.

2010.4.2 INSPECTION PROCEDURES

1. Evaluate the participation by the board of directors of the parent company in giving overall direction to the organization.
2. Obtain and evaluate descriptions of all im-

portant management and financial policies, procedures, and practices.

3. Determine if contradictions or ‘‘conflicts’’ between expressed and unexpressed strategies and between long-term and short-term goals exist. Also determine that goals are consistent with concern over safety and soundness.

4. Determine whether the planning process is sufficiently flexible and if contingency plans exist.

5. Spell out the lines of authority associated with the planning process.

6. Determine the degree of control exercised by the parent company over the entire organization.

7. Test compliance with policies at all levels.

2010.5.1 BACKGROUND INFORMATION ON ENVIRONMENTAL LIABILITY

Banking organizations are increasingly becoming exposed to liability associated with the clean-up of hazardous substance contamination pursuant to, the Comprehensive Environmental Response, Compensation and Liability Act (''CERCLA''), the federal superfund statute. It was enacted in response to the growing problem of improper handling and disposal of hazardous substances. CERCLA authorizes the Environmental Protection Agency (''EPA'') to clean-up hazardous waste sites and to recover costs associated with the clean-up from entities specified in the statute. The superfund statute is the primary federal law dealing with hazardous substance contamination. However, there are numerous other federal statutes, as well as state statutes, that establish environmental liability that could place banking organizations at risk. For example, underground storage tanks are also covered by separate federal legislation.[1]

While the superfund statute was enacted a decade ago, it has been only since the mid-1980s that court actions have resulted in some banking organizations being held liable for the clean-up of hazardous substance contamination. In this connection, recent court decisions have had a wide array of interpretations as to whether banking organizations are owners or operators of contaminated facilities, and thereby liable under the superfund statute for clean-up costs. This has led to uncertainty on the part of banking organizations as to how to best protect themselves from environmental liability.

The relevant provisions of CERCLA, the so-called ''superfund'' statute, as it pertains to banking organizations, indicate which persons or entities are subject to liability for clean-up costs of hazardous substance contamination. These include ''. . . the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of. . . .''[2] A person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning-up contamination under the superfund statute.

The liability imposed by the superfund statute is strict liability which means the government does not have to prove that the owners or operators had knowledge of or caused the hazardous substance contamination. Moreover, liability is joint and several, which allows the government to seek recovery of the entire cost of the clean-up from any individual party that is liable for those clean-up costs under CERCLA. In this connection, CERCLA does not limit the bringing of such actions to the EPA, but permits such actions to be brought by third parties.

CERCLA provides a secured creditor exemption in the definition of ''owner and operator'' by stating that these terms do not include ''. . . a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.''[3] However, this exception has not provided banking organizations with an effective ''safe harbor'' because recent court decisions have worked to limit the application of this exemption. Specifically, courts have held that actions by lenders to protect their security interests may result in the banking organization ''participating in the management'' of a vessel or facility, thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the banking organization, courts have held that the exemption no longer applies and that the banking organization is liable under the superfund statute as an ''owner'' of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without the knowledge of pre-existing conditions (the so-called ''innocent landowner defense''). However, the courts have applied a stringent standard to qualify for this defense. Because little guidance is provided by the statute as to what constitutes the appropriate timing and degree of ''due diligence'' to successfully employ this defense, banking organizations should exercise caution before relying on it.

2010.5.2 OVERVIEW OF ENVIRONMENTAL HAZARDS

Environmental risk can be characterized as adverse consequences resulting from having gen-

1. Resource Conservation and Recovery Act of 1986 (RCRA).
2. CERCLA, Section 107(a).
3. CERCLA, Section 101(20)(A)..

erated or handled hazardous substances, or otherwise having been associated with the aftermath of subsequent contamination. The following discussion highlights some common environmental hazards, but by no means covers all environmental hazards.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals or solvents in the manufacturing process or as waste products. For years, these types of hazardous substances were disposed of in land fills, or just dumped on industrial sites. Hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of potential hazardous substance contamination which should be of concern to banking organizations:

- Farmers and ranchers (use of fuel, fertilizers, herbicides, insecticides, and feedlot runoff).
- Dry cleaners (various cleaning solvents).
- Service station and convenience store operators (underground storage tanks).
- Fertilizer and chemical dealers and applicators (storage and transportation of chemicals).
- Lawn care businesses (application of lawn chemicals).
- Trucking firms (local and long haul transporters of hazardous substances such as fuel or chemicals).

The real estate industry has taken the brunt of the adverse affects of hazardous waste contamination. In addition to having land contaminated with toxic substances, construction methods for major construction projects, such as commercial buildings, have utilized materials that have been subsequently determined to be hazardous, resulting in significant declines in their value. For example, asbestos was commonly used in commercial construction from the 1950's to the late 1970's. Asbestos has since been found to be a health hazard and now must meet certain federal and, in many instances, state requirements for costly removal or abatement (enclosing or otherwise sealing off).

Another common source of hazardous substance contamination is underground storage tanks. Leaks in these tanks not only contaminate the surrounding ground, but often flow into ground water and travel far away from the original contamination site. As contamination spreads to other sites, clean-up costs escalate.

2010.5.3 IMPACT ON BANKING ORGANIZATIONS

Banking organizations may encounter losses arising from environmental liability in several ways. The greatest risk to banking organizations, resulting from the superfund statute and other environmental liability statutes, is the possibility of being held solely liable for costly environmental clean-ups such as hazardous substance contamination. If a banking organization is found to be a responsible party under CERCLA, the banking organization may find itself responsible for cleaning-up a contaminated site at a cost that far exceeds any outstanding loan balance. This risk of loss results from an interpretation of the superfund statute as providing for joint and several liability. Any responsible party, including the banking organization, could be forced to pay the full cost of any clean-up. Of course, the banking organization may attempt to recover such costs from the borrower, or the owner if different than the borrower, provided that the borrower or owner continues in existence and is solvent. Banking organizations may be held liable for the clean-up of hazardous substance contamination in situations where the banking organization:

- Takes title to property pursuant to foreclosure;
- Involves the banking organization's personnel or contractors engaged by the bank in day-to-day management of the facility;
- Takes actions designed to make the contaminated property salable, possibly resulting in further contamination;
- Acts in a fiduciary capacity, including management involvement in the day-to-day operations of industrial or commercial concerns, and purchasing or selling contaminated property;
- Owns existing, or acquires (by merger or acquisition), subsidiaries involved in activities that might result in a finding of environmental liability;
- Owns existing, or acquires for future expansion, premises that have been previously contaminated by hazardous substances. For example, site contamination at a branch office where a service station having underground storage tanks once operated. Also, premises or other real estate owned could be contaminated by asbestos requiring costly clean-up or abatement.

A more common situation encountered by banking organizations has been where real property collateral is found to be contaminated by hazardous substances. The value of contaminated real property collateral can decline dramatically, depending on the degree of contamination. As the projected clean-up costs increase, the borrower may not be able to provide the necessary funds to remove contaminated materials. In making its determination whether to foreclose, the banking organization must estimate the potential clean-up costs. In many cases this estimated cost has been found to be well in excess of the outstanding loan balance, and the banking organization has elected to abandon its security interest in the property and write off the loan. This situation occurs regardless of the fact that the superfund statute provides a secured creditor exemption. Some courts have not extended this exemption to situations where banking organizations have taken title to a property pursuant to foreclosure. These rulings have been based on a strict reading of the statute that provides the exemption to ‘‘security interests’’ only.

Risk of credit losses can also arise where the credit quality of individual borrowers (operators, generators, or transporters of hazardous substances) deteriorates markedly as a result of being required to clean up hazardous substance contamination. Banking organizations must be aware that significant clean-up costs borne by the borrower could threaten the borrower's solvency and jeopardize the banking organization's ultimate collection of outstanding loans to that borrower, regardless of the fact that no real property collateral is involved. Therefore, ultimate collection of loans to fund operations, or to acquire manufacturing or transportation equipment can be jeopardized by the borrower's generating or handling of hazardous substances in an improper manner. Further, some bankruptcy courts have required clean-up of hazardous substance contamination prior to distribution of a debtor's estate to secured creditors.

Borrowers may have existing subsidiaries or may be involved in merger and acquisition activity that may place the borrower at risk for the activities of others that result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court imposed clean-up costs. Additionally, borrowers can be held liable for contamination which occurred prior to their owning or using real estate.

2010.5.4 PROTECTION AGAINST ENVIRONMENTAL LIABILITY

Banking organizations have numerous ways to identify and minimize their exposure to environmental liability. Because environmental liability is relatively recent, procedures used to safeguard against such liability are evolving. The following discussion briefly describes methods currently being employed by banking organizations and others to minimize potential environmental liability.

Banking organizations should have in place adequate safeguards and controls to limit their exposure to potential environmental liability. Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests as well as existing loans. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be held to a more stringent due diligence investigation than borrowers in low-risk industries or localities. In addition to establishing procedures for granting credit, procedures should be developed and applied to portfolio analysis, credit monitoring, loan workout situations, and—prior to taking title to real property—foreclosures. Banking organizations may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess and control environmental liability.

At the same time, banking organizations must be careful that any lending policies and procedures, but especially those undertaken to assess and control environmental liability, cannot be construed as taking an active role in participating in the management or day-to-day operations of the borrower's business. Activities which could be considered active participation in the management of the borrower's business, and therefore subject the bank to potential liability, include, but are not limited to:

- having bank employees as members of the borrower's board of directors or actively participating in board decisions;
- assisting in day-to-day management and operating decisions; and
- actively determining management changes.

These considerations are especially important when the banking organization is actively involved in loan workouts or debt restructuring.

The first step in identifying and minimizing environmental risk is for banking organizations to perform environmental reviews. Such reviews may be performed by loan officers or others, and typically identify past practices and uses of the facility and property, evaluate regulatory compliance, if applicable, and identify potential future problems. This is accomplished by interviewing persons familiar with present and past uses of the facility and property, reviewing relevant records and documents, and visiting and inspecting the site.

Where the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough review and inspection of the facility and property. Environmental audits differ markedly from environmental assessments in that independent environmental engineers are employed to investigate, in greater detail, those factors listed previously, and actually test for hazardous substance contamination. Such testing might require collecting and analyzing air samples, surface soil samples, subsurface soil samples, or drilling wells to sample ground water.

Other measures used by some banking organizations to assist in identifying and minimizing environmental liability include: obtaining indemnities from borrowers for any clean-up costs incurred by the banking organization, and including affirmative covenants in loan agreements (and attendant default provisions) requiring the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, they are not a substitute for environmental reviews, assessments and audits, because their effectiveness is dependent upon the financial strength of the borrower.

2010.5.5 CONCLUSION

Potential environmental liability can touch on a great number of loans to borrowers in many industries or localities. Moreover, nonlending activities as well as corporate affiliations can lead to environmental liability depending upon the nature of the these activities and the degree of participation that the parent exercises in the operations of its subsidiaries. Such liability can result in losses arising from hazardous substance contamination because banking organizations are held directly liable for costly court ordered clean-ups. Additionally, the banking organization's ability to collect the loans it makes may be hampered by significant declines in collateral value, or the inability of a borrower to meet debt payments after paying for costly clean-ups of hazardous substance contamination.

Banking organizations must understand the nature of environmental liability arising from hazardous substance contamination. Additionally, they should take prudential steps to identify and minimize their potential environmental liability. Indeed, the common thread to environmental liability is the existence of hazardous substances, not types of borrowers, lines of business, or real property.

2010.5.6 INSPECTION OBJECTIVES

1. To determine whether adequate safeguards and controls have been established to limit exposure to potential environmental liability.
2. To determine whether the banking organization has identified specific credits and any lending and other banking and nonbanking activities that expose the organization to environmental liability.

2010.5.7 INSPECTION PROCEDURES

1. Review loan policies and procedures and establish whether these and other adequate safeguards and controls have been established to avoid or mitigate potential environmental liability.[4] In performing this task, ascertain whether:
    a. an environmental policy statement has been adopted;
    b. training programs are being conducted so that lending personnel are aware of environmental liability issues and are able to identify borrowers with potential problems;
    c. guidelines and procedures have been established for dealing with new borrowers and real property offered as collateral.
    d. the lending policies and procedures and other safeguards, including those to assess and control environmental liability, may not be construed as actively participating in the management of day-to-day operations of borrowers' businesses.

4. Refer to SR-91-20.

2. When reviewing individual credits determine whether the loan policy has been complied with in regard to a borrower's activities or industry that is associated with hazardous substances or environmental liability.

3. Ascertain whether appropriate periodic analysis of potential environmental liability is conducted.

Such analysis should be more rigorous as the risk of hazardous substance contamination increases. The following are examples of types of analyses and procedures that should be progressively considered as the risk of environmental liability increases:

- Environmental review—screening of the borrower's activities by lending personnel or real estate appraisers for potential environmental problems (using questionnaires, interviews, or observations).

  Review procedures might include a survey of past ownership and uses of the property, a property inspection, a review of adjacent or contiguous parcels of property, a review of company records for past use or disposal of hazardous materials, and a review of any relevant Environmental Protection Agency records.
- Environmental assessment—structured analysis by a *qualified* individual that identifies the borrower's past practices, regulatory compliance, and potential future problems. This analysis would include reviewing relevant documents, visiting and inspecting the site, and, in some cases, performing limited tests.
- Environmental audit—a professional environmental engineer performs a similar structured analysis as previously indicated for "environmental assessments," however, more comprehensive testing might involve collecting and analyzing air samples, surface soil samples, subsurface soil samples, or drilling wells to sample ground water.

4. Determine whether existing loans are reviewed internally to identify credits having potential environmental problems.

5. Review recordkeeping procedures and determine whether there is documentation as to the due diligence efforts taken at the time of making loans or acquiring real property.

6. Review loan agreements to determine if warranties, representations, and indemnifications have been included in loan agreements designed to protect the banking organization from losses stemming from hazardous substance contamination. (Although such provisions provide some protection for the lender, these agreements are not binding against the government or third parties. Such contractual protections are only as secure as the borrower's financial strength.)

7. For situations involving potential environmental liability arising from a banking organization's nonlending activities, verify that similar policies and procedures are in place.[5]

5. A banking organization's policies and procedures relating to environmental liability should apply to nonlending situations where appropriate. For example, banking organizations engaged in trust activities or contemplating a merger or acquisition should evaluate the possibility of existing or subsequent environmental liability arising from these activities.

2010.6.1 INTRODUCTION

Some depository institutions are active in selling uninsured nondeposit investment products, such as mutual funds or annuities, on their premises. Depository institutions provide these services at the retail level, directly or through various types of arrangements with third parties (an affiliated or non-affiliated party).[1]

Depository institutions selling nondeposit investment products should clearly inform customers of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to retail customers, depository institutions should fully inform customers and make clear that the products

- are not insured by the Federal Deposit Insurance Corporation (FDIC);
- are not deposits or other obligations of the institution and are not guaranteed by the institution; and
- are subject to investment risks, including possible loss of the principal invested.

A depository institution should design sales activities involving these investment products to minimize the possibility of customer confusion. Further, a depository institution should design sales of the investment products to safeguard the institution from liability under the applicable antifraud provisions of the federal securities laws, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of securities.

The purpose of this manual section is to provide an overview of the guidance addressing the retail sales of nondeposit investment products. For more information, see

- SR-94-11, "Interagency Statement on Retail Sales of Nondeposit Investment Products" (1994 interagency statement);
- SR-95-46, "Interpretation of Interagency Statement on Retail Sales of Nondeposit Investment Products"; and
- *Commercial Bank Examination Manual*, section 4580.1, "Retail Sales of Nondeposit Investment Products."

1. Sales arrangements involving companies affiliated with a depository institution subsidiary of a bank holding company could be subject to the provisions of section 106 of the Bank Holding Company Act amendments of 1970, as amended, 12 U.S.C. § 1871 et seq. For more information, see section 3070.0.7.4 of this manual.

2010.6.2 1994 INTERAGENCY STATEMENT SUMMARY

The Federal Reserve Board, along with the other federal banking agencies, issued an interagency statement on February 15, 1994, that provides comprehensive guidance on retail sales of nondeposit investment products occurring on or from depository institution premises. See SR-94-11.

The 1994 interagency statement was issued to address the expansion by depository institutions of activities involving the recommendation and sale to retail customers of nondeposit investment products, including mutual funds and annuities, as well as stocks and other investment products. The 1994 interagency statement focuses on issues that pertain specifically to the retail sale of investment products to customers on depository institution premises and seeks to avoid customer confusion of such products with those that are FDIC insured primarily through disclosure and separation of sales of investment products from other banking activities. In addition, the 1994 interagency statement provides guidance to depository institutions with respect to sales practices that are consistent with those applicable to registered securities brokers and dealers.

The 1994 interagency statement unifies pronouncements previously issued by the federal banking supervisory agencies that addressed various aspects of retail sales programs involving mutual funds, annuities, and other nondeposit investment products. This statement emphasizes the importance of adopting comprehensive policies and procedures governing sales programs and includes directions relating to the following matters:

- disclosure and advertising
- the use of identical and similarly named products
- the separation of sales programs
- the training and supervision of personnel
- sales practices and suitability
- third-party arrangements

The 1994 interagency statement applies to all depository institutions, including state member banks, and the U.S. branches and agencies of foreign banks, supervised by the Federal Reserve. This statement does not apply directly to bank holding companies or savings and loan holding companies (holding companies). However, the board of directors and management of holding companies should consider the provisions of the statement with regard to the holding company's oversight of its depository institution subsidiaries that offer such products to retail customers.

The 1994 interagency statement applies when retail recommendations or sales of nondeposit investment products are made by the following personnel:

- employees of the depository institution
- employees of a third party, which may or may not be affiliated with the institution,[2] occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises)
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral

For these purposes, retail sales include (but are not limited to) sales to individuals by depository institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. Sales of government and municipal securities made in a depository institution's dealer department located away from the lobby area are *not* covered by the 1994 interagency statement.

The guidelines in the 1994 interagency statement generally do not apply to the sale of nondeposit investment products to nonretail customers, such as sales to fiduciary accounts administered by an institution.[3] The disclosures provided by the interagency statement, however, should be provided to customers of fiduciary accounts where the customer directs investments, such as self-directed IRA accounts. Such disclosures need not be made to customers acting as professional money managers. Fiduciary accounts administered by an affiliated trust company on the depository institution's premises should be treated as fiduciary accounts of the institution. However, as part of its fiduciary responsibility, an institution should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to the institution's fiduciary customers.

2010.6.3 SUPERVISORY REVIEW

Reserve Bank examiners review nondeposit investment product sales activities during examinations of institutions engaging in such activities on their premises, either directly or through a third party or an affiliate. In general, examiners review nondeposit investment product sales when examining a state member bank (or a state-licensed U.S. branch or agency of a foreign bank) that engages directly in the retail sale of nondeposit investment products. The review process aims to assess the nature and sufficiency of an institution's disclosures, the separation of functions, and the training of personnel involved with the sales of mutual funds and other nondeposit products. For more information on examination procedures and objectives, see the *Commercial Bank Examination Manual*.

2. The 1994 interagency statement does not apply to the subsidiaries of insured state nonmember banks, which are subject to separate provisions relating to securities activities.

3. Restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, are set forth in 12 C.F.R. 9.12.

A banking organization should be able to readily determine for which entity within the bank holding company an individual is employed, and members of a banking organization's staff must be able to identify which subsidiary of the holding company employs them. The distinction is important because complex banking organizations must take steps to ensure that their officials and employees have both the corporate and legal authority to carry out their duties, and because the organization's personnel should only be performing activities that are permitted by law to be carried out by the holding company or its particular subsidiaries.

2010.8.1 IDENTIFICATION OF FACILITIES AND STAFF

Generally, unless there are statutory restrictions or the Federal Reserve or other regulators have issued explicit written proscriptions, such as those concerning mutual fund sales on bank premises, there is no fundamental legal prohibition on the entities of a banking organization sharing or using unmarked contiguous facilities and, in some instances, sharing officials and employees. There are, however, concerns about safety and soundness and conflicts of interest. These may arise when a banking organization does not take appropriate actions to define and differentiate the functions and responsibilities of each of its entities and staff.

Good corporate governance requires that a banking organization be able to readily identify the authority and responsibilities of its officials and employees at each of its entities, especially where the entities share facilities or use contiguous offices that are not clearly marked to indicate the identity of the different entities. This is necessary to ensure that—

1. an official or employee who makes a commitment to a counterparty on behalf of the organization has both the corporate and legal authority to do so,
2. the counterparty understands with whom it is dealing, and
3. each entity is in compliance with any legal restrictions under which it operates.

To accomplish the goal of ready identification, a banking organization should maintain well-defined job descriptions for each category of its staff at each entity. When officials and employees of one entity have responsibilities for other entities, particularly in shared facilities, the staff's responsibilities should be clearly defined and, when appropriate, disclosed or made clear to customers and the public in general. This procedure clarifies for both the public and the regulators for which entity officials or employees are carrying out their duties and responsibilities. Also, this clarifies whether an entity is operating within the scope of its charter, license, or other legal restrictions. Finally, a banking organization should establish and maintain appropriate internal controls designed to ensure the separation of the functions of the legal entities, when required, as well as have an adequate audit program to monitor such activities.

If officials and employees have responsibilities for other offices or affiliates of the banking organization, particularly those that share facilities, these responsibilities should be clearly defined and, when appropriate, disclosed or made clear to customers and the public in general. This procedure clarifies for which entity employees are carrying out their duties. Furthermore, in establishing employee responsibilities, management should ensure that they are within the scope of the entity's license or charter.

2010.8.2 EXAMINER GUIDANCE ON SHARING FACILITIES AND STAFF

Examiners should continue to be fully aware of the issues and potential problems involved in the sharing of staff and the sharing or use of unmarked contiguous facilities by the different entities of a banking organization with varied activities. At a minimum, examiners should check to see that a banking organization maintains clear records indicating the duties and responsibilities of the officials and employees at each of its entities. They should also take steps to check whether, in situations when an official or employee may perform duties for more than one entity in a shared facility, the banking organization has adequate policies and controls in place to ensure that its staff have the corporate and legal capacity to commit the organization to its counterparties and that the duties are carried out in conformance with the statutory restrictions applicable to each of the entities. See SR-95-34 (SUP).

One of the many basic tenets of internal control is that a banking organization (bank holding company, state member bank, and foreign banking organization) needs to ensure that its employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks. Such a requirement enhances the viability of a sound internal control environment because most frauds or embezzlements require the continuous presence of the wrongdoer.

In brief, this section contains a statement emphasizing the need for banking organizations to conduct an assessment of significant risk areas before developing a policy on required absences from sensitive positions. After making this assessment, the organization should require that employees in sensitive key positions, such as trading and wire transfer, not be allowed to transact or otherwise carry out, either physically or through electronic access, their assigned duties for a minimum of two consecutive weeks per year. The prescribed period of absence should, under all circumstances, be sufficient to allow all pending transactions to clear. It should also require that an individual's daily work be processed by another employee during the employee's absence. (See SR-96-37.)

2010.9.1 STATEMENT ON REQUIRED ABSENCES FROM SENSITIVE POSITIONS

A comprehensive system of internal controls is essential for a financial institution to safeguard its assets and capital, and to avoid undue reputational and legal risk. Senior management is responsible for establishing an appropriate system of internal controls and monitoring compliance with that system. Although no single control element should be relied on to prevent fraud and abuse, these acts are more easily perpetrated when proper segregation and rotation of duties do not exist. As a result, the Federal Reserve is reemphasizing the following prudent banking practices that should be incorporated into a banking organization's internal control procedures. These practices are designed to enhance the viability of a sound internal control environment, as most internal frauds or embezzlements necessitate the constant presence of the offender to prevent the detection of illegal activities.

When developing comprehensive internal control procedures, each banking organization should first make a critical assessment of its significant areas and sensitive positions. This assessment should consider all employees, but should focus more on those with authority to execute transactions, signing authority and access to the books and records of the banking organization, as well as those employees who can influence or cause such activities to occur. Particular attention should be paid to areas engaged in trading and wire-transfer operations, including personnel who may have reconciliation or other back-office responsibilities.

After producing a profile of high-risk areas and activities, it would be expected that a minimum absence of two consecutive weeks per year be required of employees in sensitive positions. The prescribed period of absence should, under all circumstances, be sufficient to allow all pending transactions to clear and to provide for an independent monitoring of the transactions that the absent employee is responsible for initiating or processing. This practice could be implemented through a requirement that affected employees take vacation or leave, the rotation of assignments in lieu of required vacation, or a combination of both so the prescribed level of absence is attained. Some banking organizations, particularly smaller ones, might consider compensating controls such as continuous rotation of assignments in lieu of required absences to avoid placing an undue burden on the banking organization or its employees.

For the policy to be effective, individuals having electronic access to systems and records from remote locations must be denied this access during their absence. Similarly, indirect access can be controlled by not allowing others to take and carry out instructions from the absent employee. Of primary importance is the requirement that an individual's daily work be processed by another employee during his or her absence; this process is essential to bring to the forefront any unusual activity of the absent employee.

Exceptions to the required-absence policy may be necessary from time to time. However, management should exercise the appropriate discretion and properly document any waivers that are granted. Internal auditing should be made aware of individuals who receive waivers and the circumstances necessitating the exceptions.

If a banking organization's internal control procedures do not now include the above practices, they should be promptly amended. After the procedures have been enhanced, they should be disseminated to all employees, and the documentation regarding their receipt and acknowledgment maintained. Additionally, adherence to the procedures should be included in the appropriate audit schedules, and the auditors should be cognizant of potential electronic access or other circumventing opportunities.

The development and implementation of procedures on required absences from sensitive positions is just one element of an adequate control environment. Each banking organization should take all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.

2010.9.2 INSPECTION OBJECTIVES

1. To determine whether a critical assessment has been performed of a banking organization's significant areas and sensitive positions.
2. To ascertain that sound internal controls exist, including policies and procedures that provide assurances that employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks per year.
3. To ascertain whether the banking organization has taken all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.
4. To establish that the appropriate audit schedules and the audits include a review of minimum absence policies and procedures, including potential electronic access or other circumventing actions by employees.

2010.9.3 INSPECTION PROCEDURES

1. Determine that a profile of high-risk areas and activities is performed on a regular periodic basis.
2. Ascertain if employees assigned to sensitive positions are required to be absent for a minimum of two weeks per year while—
   a. pending sensitive transactions are monitored while they clear, and
   b. daily work is monitored and processed by another employee during the regularly assigned employee's absence.
3. Determine if required internal control procedures for minimum absences (for example, rotation of assignments, vacation or leave, or a combination of both) are being used in sensitive operations such as trading, trust, wire transfer, reconciliation, or other sensitive back-office responsibilities.
4. Ascertain if appropriate policies, limits, and verification procedures have been established and maintained for an effective overall risk-managment system.
5. Determine whether the banking organization—
   a. prohibits others from taking and carrying out instructions from the absent employees, and
   b. prevents remote electronic access to systems and records involving sensitive transactions during the regularly assigned employee's required minimum two-week absence.
6. Ascertain that the banking organization documents waivers from the two-week minimum absence policies and procedures involving sensitive positions.
7. Determine that the appropriate audit schedules and the audits include a review of such procedures, including potential electronic access or other circumventing actions by employees.

Internal loan review is an activity which provides management with information about the quality of loans and effectiveness of a banking organization's lending policies and procedures. The objectives of loan-review procedures are to identify, in a timely manner, existing or emerging credit-quality problems and to determine whether internal lending policies are being adhered to.

The size and complexity of a bank holding company will dictate the need for and structure of internal loan review. One-bank holding companies with no significant credit-extending nonbank subsidiaries will normally establish internal loan-review procedures within the subsidiary bank. In these cases, there is no need to evaluate the loan-review procedures during the inspection.

For larger multibank companies or those with significant credit-extending nonbank subsidiaries, internal loan review is usually centralized at the parent company level. In some cases, a centralized loan-review function could operate in the lead bank and cover all affiliates within the organization. However, since parent company directors and senior management are ultimately accountable for the organization's asset quality, an evaluation of the internal loan-review function should be conducted as part of the inspection process no matter where the operations are technically located within the corporate structure. Since a subsidiary bank's primary regulator will normally want to evaluate the loan-review process as it relates to the respective bank, a coordination of efforts would be appropriate. This should be handled on an ad hoc basis, as deemed necessary by the holding company's examiner-in-charge, to avoid unnecessary duplication of efforts without compromising the independence of the appraisal process.

Internal loan-review procedures may take various forms, from senior officers' review of junior-officer loans to the formation of an independent department staffed by loan-review analysts. An effective system will identify deteriorations in credits, loans that do not comply with written loan policies, and loans with technical exceptions.

The loan-review program should be delegated to a qualified and adequate staff. The review should be systematic in scope and frequency. All related extensions of credit should be identified and analyzed together. A minimum credit size should be established that allows for an efficient review while providing adequate coverage. The process should also tie problem loans or technical exceptions to the particular loan officer to allow senior management to evaluate individual performance. Loans should be reviewed shortly after origination to determine their initial quality, technical exceptions, and compliance with written loan policies. Reasonable frequency guidelines should be set for normal reviews, with problem credits receiving special and more frequent analysis. An effective loan-review procedure will incorporate an early warning system of "red flags," such as overdrafts, adverse published reports, and deteriorating financial statements. Loan officers should also be encouraged to inform the organization's internal loan-review unit of developing loan problems, and they should be discouraged from withholding problem loans or adverse information from the review process.

The loan-review process should be independent of the loan-approval function, with written findings reported to a board or senior management committee that is not directly involved in lending. Follow-up and monitoring of problem credits should be instituted. The loan officer should be responsible for reporting on any corrective actions taken. The maintenance of adequate internal controls within the lending process, in particular for loan review or credit audit, is critical for maintaining proper incentives for banking organization staff to be rigorous and disciplined in their credit-analysis and lending decisions. A banking organization's credit analyses, loan terms and structures, credit decisions, and internal rating assignments have historically been reviewed in detail by experienced and independent loan-review staff. Such loan reviews have provided both motivation for better credit discipline within an institution and greater comfort for examiners—and management—that internal policies are being followed and that the banking organization continues to adhere to sound lending practice.

For larger multibank organizations, loan-review procedures are usually centralized and administered at the parent level, with loan-review staff employed by the parent company. In some cases, a centralized loan-review function may operate in the lead bank, covering all other affiliates in the organization. The parent company directors and senior management are ultimately accountable for supervision of the entire organization's asset quality. Therefore, it should be the System's responsibility to evaluate top management's loan-review policies and procedures as they relate to the subsidiaries, both bank and nonbank, no matter where the function is technically established within the corporate structure. The holding company examiner-in-charge should attempt to coordinate efforts and cooperate with the respective banks' primary supervisors to avoid unnecessary duplication, without compromising the independence of the appraisal process.

During favorable economic and financial markets, relatively low levels of problem loans and credit losses may increase pressure within banking organizations to reduce the resources committed to loan-review functions. These reductions may include a reduction in staff, more limited portfolio coverage, and less thorough reviews of individual loans. Undoubtedly, some useful efficiencies may be gained by reducing loan-review resources, but some banking organizations may reduce the scope and depth of loan-review activities beyond levels that are prudent over the longer horizon. If reduced too far, the integrity of the lending process and the discipline of identifying unrealistic assumptions and discerning problem loans in a timely fashion may deteriorate. This may be especially true when a large proportion of lenders may not have had direct lending experience during a credit cycle when there was an economic and financial market downturn. See SR-99-23.

If supervisors and examiners find that there are weaknesses in the internal loan-review function and in activities or other internal control and risk-management processes (for example, staff turnover, failure to commit sufficient resources, inadequate adherence to established internal controls, or inadequate training), such findings should be discussed with the senior management of the parent bank holding company or other management at a corporate-wide level and, if determined to be a major concern, presented as comments on the "Examiner's Comments and Matters Requiring Special Board Attention" core page. Findings that could adversely affect affiliated insured depository institutions should be conveyed to the primary federal or state supervisor of the insured institution. Those findings should also be considered when assigning supervisory ratings.

Shell one-bank holding companies will not have or need a loan-review program emanating from the parent company level. Loan review will normally function within the subsidiary bank and be supervised by bank directors and management.

2010.10.1 INSPECTION OBJECTIVES

1. Review the operations of the bank holding company to determine whether there is an internal loan-review program. If not, one should be implemented.
2. Determine whether the loan-review program is independent from the loan-approval function.
3. Determine if the loan-review staff is sufficiently qualified and whether its size is adequate.
4. Determine whether the scope and frequency of the loan-review procedure is adequate to ensure that problems are being identified.
5. Determine that findings from the loan-review process are being properly reported and receive adequate follow-up attention.

2010.10.2 INSPECTION PROCEDURES

1. Review the holding company's operations to determine what types of internal loan-review procedures are being performed and whether an internal loan-review program exists.
2. If no internal loan-review program exists, determine whether the size, complexity, and financial condition of the organization warrants implementation of a formal loan-review process.
3. Review the organizational structure of the loan-review function to ensure its independence from the loan-approval processes.
4. Review the reporting process for internal loan-review findings to determine whether a director committee or independent senior management committee is being appropriately advised of the findings. Determine whether adequate follow-up procedures are in place.
5. Through loan reviews, transaction testing, and discussions with loan-review management, evaluate the quality, effectiveness and adequacy of the internal loan-review staff and internal controls in relation to the organization's size and complexity.
6. Review the operation of the loan-review process to identify the method for selecting loans and the manner in which they are analyzed and graded. Determine whether these procedures are adequate.

7. Determine if loan-review activities or other internal control and risk-management processes have been weakened by turnover of internal loan-review staff; a failure to commit sufficient resources; inadequate internal controls; inadequate training; or the absence of other adequate systems, resources, or controls. If such significant findings are found, discuss those concerns with senior management and report those findings on the core page 1, "Examiner's Comments and Matters Requiring Special Board Attention."
8. Determine what type of "early warning" system is in place and whether it is adequate.
9. Determine how the scope and frequency of the review procedure is established and whether this provides adequate coverage.

Banking organizations, including trust institutions, are increasingly encountering various direct or indirect financial incentives to place trust assets with particular mutual funds. Such incentives include the payment of fees to banking organizations for using nonaffiliated fund families as well as other incentives for using those mutual funds that are managed by the institution or an affiliate. The payment of such fees, referred to variously as shareholder, subaccounting, or administrative service fees, may be structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts. Those functions may consist of maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis point amount of the dollar value of assets invested, or on transaction volume. Another form of compensation may consist of a lump-sum payment based on assets transferred into a mutual fund.

In all cases, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interests of the trust beneficiary. The primary supervisory concern is that an institution may fail to act in the best interest of beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may expose itself to an increased risk of legal action by account beneficiaries, as well as to potential violations of law or regulation.

Nearly every state legislature has modified its laws explicitly to allow fiduciaries to accept fees from mutual funds under certain conditions. As for the permissibility of other financial incentives, guidance under applicable law may be less clear. Conditions involving fee payments under state law often include compliance with standards of prudence, quality, and appropriateness for the account, and a determination of the "reasonableness" of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) has also adopted these general standards for national banks.[1] The Employee Retirement Income Security Act of 1974 (ERISA), however, generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.[2] ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

Similar conflict-of-interest concerns are raised by the investment of fiduciary-account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as "proprietary" funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments. This activity can be expected to become more prevalent as banking organizations more actively offer proprietary mutual funds.[3] See SR-99-7.

2010.12.1 DUE-DILIGENCE REVIEW NEEDED BEFORE ENTERING INTO FEE ARRANGEMENTS

Although many state laws now explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Even when the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform an appropriate level of due diligence before entering into any fee arrangements similar to those described earlier or placing fiduciary assets in proprietary mutual funds. The following measures should be included in this process:

1. *Reasoned legal opinion.* The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent

1. In general, national banks may make these investments and receive such fees if applicable law authorizes the practice and if the investment is prudent and appropriate for fiduciary accounts and consistent with established state law fiduciary requirements. This includes a "reasonableness" test for any fees received by the institution. See OCC Interpretive Letter No. 704, February 1996.

2. ERISA section 406(b)(3). See Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Federal Reserve Board interpretation of Regulation Y addresses investment of fiduciary-account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. See 12 CFR 225.125.

in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, the trust instrument, or a court order, as well as any applicable disclosure requirements or reasonableness standard for fees set forth in the law.

2. *Establishment of policies and procedures.* The institution should establish appropriate policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. Policies and procedures should generally address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable statutes, regulations, and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.
3. *Analysis and documentation of investment decisions.* When fees or other compensation are received in connection with fiduciary-account investments over which the institution has investment discretion or when such investments are made in the institution's proprietary mutual funds, the institution should fully conduct appropriate analysis supporting the investment decision. This analysis should be performed regularly and would typically include factors such as historical performance comparisons with similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should determine whether the investment is, and continues to be, (1) appropriate for the individual account, (2) in the best interest of account beneficiaries, and (3) in compliance with the provisions of the "prudent investor" or "prudent man rules," as appropriate.

On June 15, 2004, an interagency advisory concerning the embassy banking business and related banking matters was issued by the federal banking and thrift agencies[1] in coordination with the U.S. Department of the Treasury's Financial Crimes Enforcement Network. The purpose of the advisory is to provide general guidance to financial institutions regarding the treatment of accounts for foreign governments, foreign embassies, and senior foreign political figures.

The joint interagency statement advises financial institutions[2] that the decision to accept or reject an embassy or foreign government account is theirs alone to make. Financial institutions should be aware, however, that there are varying degrees of risk associated with such accounts, depending on the customer and the nature of the services provided. Financial institutions should take appropriate steps to manage such risks, consistent with sound practices and applicable anti-money-laundering laws and regulations. The advisory also encourages financial institutions to direct questions about embassy banking to their primary federal bank regulators. See SR letter 04-10, "Banking Accounts for Foreign Governments, Embassies, and Political Figures."

On March 24, 2011, another interagency advisory was issued to supplement the 2004 interagency advisory. The 2011 advisory provides information to financial institutions providing account services to foreign embassies, consulates, and missions ("foreign missions") in a manner that fulfills the needs of those foreign governments while complying with the provisions of the Bank Secrecy Act (BSA). It advises that financial institutions are expected to demonstrate the capacity to conduct appropriate risk assessments and implement the requisite controls and oversight systems to effectively manage the risk identified in these relationships with foreign missions. The 2011 advisory also confirms that it is the financial institution's decision to accept or reject a foreign mission account. See SR letter 11-6, "Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions." See also the FFIEC *Bank Secrecy Act/ Anti-Money Laundering Examination Manual* for examination and inspection procedures on embassy, foreign consulate, and foreign mission accounts.

2010.13.1 INTERAGENCY ADVISORY ON ACCEPTING ACCOUNTS FOR FOREIGN GOVERNMENTS, EMBASSIES, AND POLITICAL FIGURES

The 2004 and 2011 interagency advisories answer questions on whether financial institutions should do business with foreign embassies and whether institutions should establish account services for foreign governments, foreign embassies, and senior foreign political figures. As it would with any new account, an institution should evaluate whether or not to accept a new account for a foreign government, embassy, or political figure. That decision should be made by the institution's management, under standards and guidelines established by the board of directors, and should be based on the institution's own business objectives, its assessment of the risks associated with particular accounts or lines of business, and its capacity to manage those risks. The agencies will not, in the absence of extraordinary circumstances, direct or encourage any institution to open, close, or refuse a particular account or relationship.

Providing financial services to foreign governments and embassies and to senior foreign political figures can, depending on the nature of the customer and the services provided, involve varying degrees of risk. Such services can range from account relationships that enable an embassy to handle the payment of operational expenses—for example, payroll, rent, and utilities—to ancillary services or accounts provided to embassy staff or foreign-government officials. Each of these relationships potentially poses different levels of risk. Institutions are expected to assess the risks involved in any such relationships and to take steps to ensure both that such risks are appropriately managed and that the institution can do so in full compliance with its obligations under the BSA, as amended by the USA PATRIOT Act, and the regulations promulgated thereunder.

1. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration (the agencies).

2. The advisory is primarily directed to financial institutions located in the United States. The boards of directors of bank holding companies, however, should consider whether the advisory should be applied to their other U.S. subsidiaries' financial and other services.

When an institution elects to establish financial relationships with foreign governments, embassies, or senior foreign political figures, the agencies, consistent with their usual practice of risk-based supervision, will make their own assessment of the risks involved in such business. As is the case with all accounts, the institution should expect appropriate scrutiny by examiners that is commensurate with the level of risk presented by the account relationship. As in any case where higher risks are presented, the institution should expect an increased level of review by examiners to ensure that the institution has in place controls and compliance oversight systems that are adequate to monitor and manage such risks, as well as personnel trained in the management of such risks and in the requirements of applicable laws and regulations.

Institutions that have or are considering taking on relationships with foreign governments, embassies, or political figures should ensure that such customers are aware of the requirements of U.S. laws and regulations to which the institution is subject. Institutions should, to the maximum extent feasible, seek to structure such relationships in order to conform them to conventional U.S. domestic banking relationships so as to reduce the risks that might be presented by such relationships.

2010.13.2 RISK MITIGATION AND SUPERVISORY EXPECTATIONS FOR FOREIGN MISSIONS

A financial institution should manage the risks associated with transactions involving embassy, foreign consulate, and foreign mission accounts, and implement effective due diligence, monitoring, and reporting systems as part of its BSA/Anti-Money Laundering compliance program. The financial institution has the flexibility to manage its risk in a number of ways. A financial institution may reduce risk by ensuring customers are aware of the requirements of U.S. banking laws and regulations and monitoring those accounts for compliance. When establishing a customer relationship, a financial institution should assess the risks posed such as the volume of activity, number of accounts, and country risk.

A financial institution may also mitigate risk by entering into a written agreement with the foreign mission that clearly defines the terms of use for the account(s) setting forth available services, acceptable transactions, and access limitations. Similarly, the financial institution could offer limited purpose accounts, such as those used to facilitate operational expense payments (e.g., payroll, rent and utilities, routine maintenance), which are generally considered lower risk and allow the foreign mission to carry out its customary functions in the United States. Account monitoring to ensure compliance with account limitations and the terms of any service agreements is essential to mitigate risks associated with these accounts.

A financial institution may also provide ancillary services or accounts to foreign mission personnel and their families. As with foreign mission accounts, written agreements, which clearly define the terms of use for these types of services or accounts, may assist in mitigating the varying degrees of risk.

As with any type of accountholder, the agencies expect financial institutions to demonstrate the capacity to conduct appropriate risk assessments and implement the requisite controls and oversight systems to effectively manage varying degrees of risks in financial relationships with foreign missions. The agencies, consistent with their usual practice of risk-based supervision, will evaluate the risks associated with the account relationship and mitigating controls implemented. The agencies will not direct or require any financial institution to close or refuse a particular account or relationship, except in extraordinary circumstances (for example, when violations of law are identified that warrant an administrative enforcement action).

WHAT'S IN THIS SECTION

This section was revised as of January 2008 to incorporate references to the Federal Reserve Board's Regulation W, primarily with regard to the bank holding company (BHC) inspection process. The section includes also a discussion of the mandatory reporting of certain intercompany transactions on the FR Y-8, The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates, *and its instructions. The mandatory report is to be submitted quarterly to the Federal Reserve by (1) all top-tier BHCs, including financial holding companies, and (2) all foreign banking organizations that directly own a U.S. subsidiary bank. The examiner's inspection responsibilities are discussed.*

2020.0.1 ANALYSIS OF INTERCOMPANY TRANSACTIONS

The analysis of intercompany transactions between a parent company, its nonbank subsidiaries, and its bank subsidiaries is primarily intended to assess the nature of the relationships between these entities and the effect of the relationships on the subsidiary insured depository institutions (IDIs). IDIs include any state bank, national bank, trust company, or banking association and any institution that takes deposits that are insured by the Federal Deposit Insurance Corporation, including savings associations. Both the legal and financial ramifications of such transactions are areas of concern. Certain intercompany transactions are subject to the provisions of section 23A or 23B (or both) of the Federal Reserve Act and the Federal Reserve Board's Regulation W. Section 23A of the Federal Reserve Act is one of the most important statutes on limiting exposures to individual institutions and protecting the federal safety net. Several types of intercompany transactions and the primary regulatory concerns of each are presented below.

Dividends paid by subsidiaries to the parent. Dividends are a highly visible cash outflow by subsidiaries. If the dividend payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the subsidiary's capital ratios will deteriorate. These dividends may also have a negative effect on the subsidiary's liquidity position.

Transactions with affiliates. Transactions between subsidiary IDI affiliates is another area of potential abuse of subsidiary banks. Regulatory concern centers on the quantitative limits and collateral restrictions on certain transactions by subsidiary banks with their affiliates. These restrictions are designed to protect subsidiary IDIs from losses resulting from transactions with affiliates.

Fees paid by subsidiaries. Management or service fees are another cash outflow of bank subsidiaries. These fees may be paid to the parent, the nonbank subsidiaries, or, in some cases, to the other bank subsidiaries. Regulatory concern focuses on whether such fees are reasonable in relation to the services rendered and on the financial impact of the fees on the bank subsidiaries.

Tax allocation. How a bank holding company organization determines to allocate taxes among its component companies involves questions of both the magnitude and timing of the cash-flow effects. Unreasonable or untimely tax payments or refunds to the bank can have an adverse effect on the financial condition of the banking subsidiaries.

Purchases or swaps of assets. Asset purchases or swaps between a bank and its affiliates can create the potential for abuse of subsidiary banks. Regulatory concern focuses on the fairness of such asset transactions and their financial impact and timing. Fairness and financial considerations include the quality and collectibility and fair values of such assets and their liquidity effects. IDIs generally are prohibited from purchasing low-quality assets from affiliates. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets. Improper timing or certain structurings of asset transactions also can cause them to be regarded as extensions of credit to affiliates. As such, these types of transactions could potentially violate applicable regulations and statutes.

Compensating balances. A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Other expense allocations. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. Furthermore, a subsidiary bank should not pay for expenses for which it does not receive a benefit.

2020.0.2 ROLE OF THE EXAMINER

To properly assess intercompany transactions and relationships between affiliates, the examiner must make a thorough analysis of most intercompany transactions and must have a knowledge of applicable laws, regulations, and rulings. In particular, the examiner should be familiar with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W. The examiner should also be familiar with the FR Y-8, *The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates,* and its instructions. The mandatory report is to be submitted to the Federal Reserve by (1) all top-tier bank holding companies (BHCs), including financial holding companies, and (2) all foreign banking organizations that directly own a U.S. subsidiary bank. The completed quarterly reports are used by the Federal Reserve System to monitor bank exposures to affiliates and to ensure banks' compliance with section 23A of the Federal Reserve Act. With regard to the BHC's inspection, the examiner should review and verify, since the previous inspection, the BHC's accuracy and comprehensiveness in its reporting based on the FR Y-8 report form and instructions.

If a subsidiary IDI of a holding company is not a state member bank, the bank's primary regulator should determine the bank's compliance with pertinent banking laws. In reviewing the subsidiary bank's examination report, any violations of laws and regulations applicable to intercompany transactions should be noted. If the violation resulted from the actions of an affiliate, the affiliate's role should be identified and be subject to criticism in the inspection report.

Violations of banking laws discovered during the inspection should be brought to management's attention and referred to the bank's primary supervisor. However, any action or criticism levied directly on the bank should come from the bank's primary supervisor.

2020.1.01 *WHAT'S NEW IN THIS REVISED SECTION*

This section has been revised to discuss statutory amendments of sections 23A and 23B of the Federal Reserve Act resulting from the Dodd-Frank Act. One amendment involved the definition of an "affiliate," with regard to an investment fund when an insured depository institution (IDI) or one of its affiliates is an investment adviser. Also, the definition of "covered transactions" was revised to include the credit exposure resulting for derivative and securities lending and borrowing transactions between the IDI and its affiliates. In addition, the Dodd-Frank Act removed the quantitative 10 percent exemption limit between financial subsidiaries. The retained earnings of a financial subsidiary are to be included as part of the IDI's investment. The amendments were effective July 21, 2012. (See sections 608(a)(1)(A), 608(a)(1)(B), and 609(a) of the Dodd-Frank Act.)

Revised inspection objectives and inspection procedures also are included.

2020.1.05 SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT, AND REGULATION W

Section 23A of the Federal Reserve Act (FRA) restricts the ability of insured depository institutions (IDIs)[1] to engage in certain covered transactions with an affiliate. Transactions that are subject to section 23A also are subject to the provisions of section 23B of the FRA.[2] In addition to these statutory provisions, the Board issued Regulation W (the rule),[3] which implements sections 23A and 23B of the FRA. The rule provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous previously issued Board interpretations.

During a bank holding company inspection, transactions between an IDI and an affiliate (for example, a bank holding company parent or other nonbank subsidiary) are reviewed for compliance with sections 23A and 23B and Regulation W, as well as other banking regulations and statutes. Any violations of sections 23A and 23B of the FRA or Regulation W involving a transaction between an IDI and its affiliate that are disclosed or found during an inspection should be brought to management's attention, may be discussed in the inspection report as "Other Matters," and referred to the bank's primary supervisor. However, any action or criticism levied directly on the bank should come from the bank's primary supervisor. See also SR-03-2.

2020.1.1 SECTION 23A OF THE FEDERAL RESERVE ACT

Section 23A of the FRA (12 U.S.C. 371c) is the primary statute governing transactions between an IDI and its affiliates. Section 23A (1) designates the types of companies that are affiliates of an IDI; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on an IDI's covered transactions with any single affiliate, and with all affiliates combined; (4) sets forth collateral requirements for certain transactions with affiliates; and (5) requires all covered transactions to be conducted on terms consistent with safe and sound banking practices.

2020.1.1.1 Definition of an Affiliate

In general, companies that control or are under common control with an IDI are defined by section 23A as "affiliates" of the bank. The definition includes a bank subsidiary of a bank and any company that a bank, or its subsidiaries or affiliates, sponsors and advises on a contractual basis.[4] Affiliates, for example, may

1. By their terms, sections 23A and 23B apply to banks that are members of the Federal Reserve System ("member banks"). Other federal laws subject FDIC-insured nonmember banks and FDIC-insured thrifts to sections 23A and 23B in the same manner and to the same extent as if they were member banks. (See 12 U.S.C. 1828(j) and 12 U.S.C.1468(a)(4)). The statute also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. Because the statute and regulation apply to all insured depository institutions, this section will refer to the subject institutions as insured depository institutions (IDIs).

2. Federally insured savings associations also are subject to sections 23A and 23B as if they were banks.

3. In this section of the manual, Regulation W is referred to as "the rule" or to a specific numbered section of the rule.

4. The Board has the authority to expand the definition of affiliate to include a company that has a relationship with the bank so that covered transactions between the company and

include banks, financial holding companies, savings and loan holding companies, and their subsidiaries. Banks, savings associations, and nonbanking companies that are under common individual control or a group of individuals with the bank also are affiliates for the purposes of section 23A. Any investment fund with respect to which a member bank or affiliate thereof is an investment adviser. See section 608(a)(1)(A) of the Dodd-Frank Act. In addition, any transaction by an IDI with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are transferred to, or used for the benefit of, the affiliate. With respect to any IDI within a holding company, its affiliates include, among others, its parent, the parent's subsidiaries, and other companies directly or indirectly controlled by the bank's or holding company's shareholders. Specifically, Regulation W defines[5] an affiliate as—

1. any company that controls[6] the IDI and any other company that is controlled by the company that controls the IDI;
2. any bank subsidiary of the IDI;
3. any company—
   — that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the IDI; or
   — in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the IDI or any company that controls the IDI;
4. any company (including a real estate investment trust) that is sponsored and advised on a contractual basis by the IDI or any subsidiary or affiliate of the IDI;
5. any investment company, with respect to which an IDI or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940;
6. any investment fund for which the IDI or any affiliate of the IDI serves as an investment adviser, if the IDI and its affiliates own or control, in the aggregate, more than 5 percent of any class of voting securities or of the equity capital of the fund;
7. a depository institution that is a subsidiary of the IDI;
8. a financial subsidiary of the member bank;
9. any company in which a holding company of the IDI owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital pursuant to the merchant banking authority in section 4(k)(4)(H) or (I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H) or (I));
10. any partnership for which the IDI or any affiliate of the IDI serves as a general partner or for which the IDI or any affiliate of the IDI causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;
11. any subsidiary of an affiliate described in paragraphs (a)(1) through (10) of section 223.2 of Regulation W; and
12. any company that the Board, or the appropriate federal banking agency for the IDI, determines by regulation or order to have a relationship with the IDI or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the IDI or its subsidiary.

The following generally are not considered to be affiliates of an IDI:

1. a nonbank subsidiary of the IDI (other than a financial subsidiary), unless the Board determines not to exclude such a subsidiary;
2. a company engaged solely in holding the IDI's premises;
3. a company engaged solely in conducting a safe deposit business;
4. a company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
5. a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for the period of time specified by section 23A).

the bank may be affected by the relationship to the detriment of the bank.

5. See 12 C.F.R. 223.2.

6. By statute, "control" is defined as the power to (1) vote 25 percent or more of the voting shares of a company, excluding situations in which the stock is controlled in a fiduciary capacity; (2) elect a majority of the directors of a company; or (3) exercise a controlling influence over a company. Control is discussed in more detail at 2020.1.3.1.

2020.1.1.2 Definition of Affiliates by Type of Entity

2020.1.1.2.1 Investment Funds Advised by the Member Bank or an Affiliate of the Member Bank

Regulation W includes as an affiliate any company that is sponsored and advised on a contractual basis by the IDI or any of its affiliates as well as any investment company for which the IDI or its affiliate serves as an investment adviser, as defined in the Investment Company Act of 1940 (the 1940 Act). In Regulation W, the Board used its statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 Act—for which the IDI or an affiliate of the IDI serves as an investment adviser, if the IDI or an affiliate of the IDI owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Many investment funds that are advised by an IDI (or an affiliate of an IDI) are affiliates of the IDI under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the IDI (or an affiliate of the IDI). The IDI or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 Act.[7] The advisory relationship of an IDI or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 Act.[8] The Dodd-Frank Act treats any investment fund as an affiliate if the IDI or an affiliate of the IDI serves as an investment adviser to the fund.

2020.1.1.2.2 Financial Subsidiaries

In 1999, the Gramm-Leach-Bliley Act (the GLB Act) authorized banks to own ''financial subsidiaries'' that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected covered transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for national banks to engage in directly (other than a subsidiary that federal law specifically authorizes national banks to own or control). Specifically, a ''financial subsidiary'' is defined as ''any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.''[9] (See 12 U.S.C. 371c(e)(1).) Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more member banks, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the terms and conditions that apply to national banks) or (2) a subsidiary that national banks are specifically authorized to control by the express terms of a federal statute (other than section 5136A of the Revised Statutes), such as an Edge Act corporation or a small business investment company (SBIC).[10] (See 12 U.S.C. 24a(g)(3).) Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[11] (See 12 U.S.C. 24a(a)(2).)

The Dodd-Frank Act amended section 23A as it relates to financial subsidiaries of a bank. First, the 10 percent quantitative limit of section 23A between a bank and any individual affiliate applies to covered transactions between a bank and a financial subsidiary of the bank. In addition, for purposes of section 23A, the amount of a bank's investment in its financial subsidiary includes the retained earnings of the financial subsidiary. See section 609(a) of the Dodd-Frank Act.

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit of the transactions accrues to an

7. 12 U.S.C. 371c(b)(1)(E).
8. An investment fund typically escapes from the definition of investment company under the 1940 Act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities. An IDI may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered than an investment company under the 1940 Act because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser. (See 15 U.S.C. 80a-17).

9. 12 U.S.C. 24a(g)(3).
10. 12 U.S.C. 24a(a)(2).
11. 12 U.S.C. 371c(e)(1).

affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion provisions, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of, or investment in, the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extension of credit made by a bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

2020.1.1.2.2.1 Regulation W Provisions for Financial Subsidiaries

Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.) Regulation W also includes several special rules that apply to transactions with financial subsidiaries.

Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary. The 10 percent quantitative limit in section 23A applies with respect to covered transactions between a member bank and any individual financial subsidiary of the bank.[12]

Valuation of investments in securities issued by a financial subsidiary. Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of, and investments in, the securities of its financial subsidiary are covered transactions under the statute.[13] The Dodd-Frank Act provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall include the retained earnings of the financial subsidiary.[14] In light of this statutory provision, section 223.32(b) of the rule contains a special valuation provision for investments by a member bank in the securities of its own financial subsidiary.[15] Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with generally accepted accounting principles (GAAP) but without reflecting the bank's pro rata share of any earnings retained, or losses incurred by, the financial subsidiary after the bank's acquisition of the securities).[16]

This valuation rule differs from the general valuation rule for investments in securities issued by an affiliate in that the financial subsidiary rule permits, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the member bank's investment. As a result of this rule, the covered transaction amount for a member bank's investment in securities issued by its financial subsidiary generally would not increase after the investment was made except if the member bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The following examples were designed to assist banks in valuing investments in securities issued by a financial subsidiary of the bank. Each example involves a securities underwriter that becomes a financial subsidiary of the bank after the transactions described below.

1. *Initial valuation.*
   a. *Direct acquisition by a bank.* A bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial state-

12. A member bank's aggregate amount of covered transactions with any individual financial subsidiary of the bank may not exceed 10 percent of the bank's capital and surplus.

13. See section 609(a) of the Dodd-Frank Act. The Dodd-Frank Act eliminated the 10 percent quantitative limit exemption for certain covered transactions with financial subsidiaries and individual affiliates.

14. See section 609(a) of the Dodd-Frank Act.

15. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

16. The rule also makes clear that if a financial subsidiary is consolidated with its parent bank under GAAP, the subsidiary under the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

ments is $500. The member bank initially must value the investment at $500.

b. *Contribution of a financial subsidiary to a member bank*. The parent holding company of a bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500 and immediately contributes the shares to the member bank. The bank gives no consideration in exchange for the shares. The bank initially must value the investment at the carrying value of the shares on the bank's parent-only GAAP financial statements. Under GAAP, the bank's initial carrying value of the shares would be $500.

2. *Carrying value not adjusted for earnings and losses of the financial subsidiary*. A bank and its parent holding company engage in a transaction whereby the member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500. The bank initially values the investment at $500. In the following year, the securities underwriter earns $25 in profit, which is added to its retained earnings. The bank's investment of the shares of the underwriter is not adjusted for purposes of section 23A and Regulation W, and the bank's investment continues to be valued at $500. If, however, the member bank contributes $100 of additional capital to the securities underwriter, the bank must value the aggregate investment at $600.

Anti-evasion rules as they pertain to financial subsidiaries. Section 23A generally applies only to transactions between a bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.[17] First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the FRA or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer in which the loan is treated as capital of the subsidiary under the SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

2020.1.1.2.3 Partnerships

IDIs fund legitimate commercial transactions through partnerships. Partnerships for which an IDI or an affiliate(s) serves as a general partner are affiliates. Regulation W also defines an affiliate of an IDI as any partnership, if the IDI or an affiliate of the IDI causes any director, officer, or employee of the IDI or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank.) Also, if a company, such as a bank holding company, controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

2020.1.1.2.4 Subsidiaries of Affiliates

Regulation W deems a subsidiary of an affiliate as an affiliate of the IDI.

17. GLB Act section 121(b)(1), or 12 U.S.C. 371c(e)(3).

2020.1.1.2.5 Companies Designated by the Appropriate Federal Banking Agency

Under section 223.2(a)(12), the Board or the appropriate federal banking agency for the relevant IDI (under authority delegated by the Board) can determine that any company that has a relationship with an IDI or an affiliate of the IDI, such that covered transactions by the IDI with that company may be affected by the relationship to the detriment of the IDI, is an affiliate of the IDI. The Board and the federal banking agencies can thus protect IDIs in their transactions with associated companies. An IDI may petition the Board to review any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.[18]

2020.1.1.2.6 Merchant Banking

The GLB Act also amended the Bank Holding Company Act (BHC Act) to permit BHCs and foreign banks that qualify as financial holding companies (FHCs) to engage in merchant banking and insurance company investment activities.[19] If an FHC owns or controls more than 25 percent of a class of voting shares of a company under the merchant banking or insurance company investment authority, the company is an affiliate of any member bank controlled by the FHC by operation of the statutory definitions contained in section 23A. The GLB Act also added paragraph (b)(11) to section 23A, which creates a rebuttable presumption that a company (''portfolio companies'') is an affiliate of a member bank, for purposes of section 23A, if the bank is affiliated with an FHC and the FHC owns or controls 15 percent or more of the equity capital of the other company pursuant to the FHC's merchant banking or insurance company investment authority[20] (section 4(k)(4)(H) or (I) of the BHC Act). (See 12 U.S.C. 371c(b)(11).)

The rule also provides three specific regulatory safe harbors from the 15 percent presumption. These safe harbors apply in situations where the holding company owns or controls more than 15 percent of the total equity of the company under the merchant banking or insurance company investment authority (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the company (thereby not meeting the statutory definition of control). The three situations are substantially identical to those listed in the Board's merchant banking regulation.[21]

The first exemption applies where no director, officer, or employee of the holding company serves as a director (or individual exercising similar functions) of the company. The second exemption applies where an independent third party controls a greater percentage of the equity capital of the company than is controlled by the holding company, and no more than one officer or employee of the holding company serves as a director (or individual exercising similar functions) of the company. The third exemption applies where an independent third party controls more than 50 percent of the voting shares of the company, and officers and employees of the holding company do not constitute a majority of the directors (or individuals exercising similar functions) of the company.[22]

These safe harbors do not require Board review or approval of the exclusion from affiliate status. Moreover, the safe harbors are not intended to be a complete list of circumstances in which the 15 percent presumption may be rebutted. The rule also provides, consistent with the GLB Act, that a holding company may rebut the presumption with respect to a portfolio company by presenting information to the Board that demonstrates, to the Board's satisfaction, that the holding company does not control the portfolio company. The Board notes that a company that qualifies as an affiliate under the 15 percent presumption and under another prong of the regulation's definition of affiliate cannot avoid affiliate status through a rebuttal of the 15 percent presumption (either by qualifying for

18. See 12 C.F.R. 265.3.

19. GLB Act, section 103(a); 12 U.S.C. 1843(k)(4)(H) and (I).

20. GLB Act, section 121(b)(2). As noted above, this rebuttable presumption applies only if the affiliated FHC owns or controls 15 percent or more of the company's equity capital under the merchant banking or insurance company investment authorities. The Board noted, however, that under existing Board precedents, a BHC may not own any shares of a company in reliance on section 4(c)(6) or 4(c)(7) of the BHC Act where the holding company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

21. See 12 C.F.R. 225.176(b)(2) and (3).

22. For purposes of these safe harbors, the rule provides that the term ''holding company'' includes any subsidiary of the holding company, including any subsidiary bank of the holding company. Accordingly, if a director of a subsidiary bank or nonbank subsidiary of an FHC also serves as a director of a portfolio company, the first safe harbor, for example, would be unavailable.

one of the three regulatory safe harbors or by obtaining an ad hoc rebuttal of the presumption from the Board).

An FHC generally is considered to own or control only those shares or other ownership interests that are owned or controlled by itself or by a subsidiary of the holding company. The rule clarifies that, for purposes of applying the presumption of affiliation described above, an FHC that has an investment in a private equity fund (as defined in the Board's merchant banking rule) will not be considered indirectly to own the equity capital of a company in which the fund has invested unless the FHC controls the private equity fund (as described in the Board's merchant banking rule).

2020.1.1.2.7 Companies that are not Affiliates

Under the terms of section 23A, subsidiaries of an IDI generally are not treated as affiliates of the member bank.[23] The statute contains two specific exceptions to this general rule: financial subsidiaries of an IDI and IDI subsidiaries of an IDI are treated as affiliates of the parent IDI. The statute provides that the Board may determine that other subsidiaries of an IDI should be treated as affiliates in appropriate circumstances.[24]

Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of an IDI are treated as affiliates. A subsidiary of an IDI is treated as an affiliate if one or more affiliates of the IDI, or one or more controlling shareholders of the IDI, directly control the joint venture. For example, if an IDI controls 30 percent of company A and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This provision also covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the IDI (who, as natural persons, are not themselves section 23A affiliates of the IDI) exercise direct control over the joint venture company. The rule's treatment of certain IDI-affiliate joint ventures as affiliates does not apply to joint ventures between an IDI and any affiliated IDIs. For example, if two affiliated IDIs each own 50 percent of the voting common stock of a company, the company would continue to qualify as a subsidiary and not an affiliate of each IDI (despite the fact that an affiliate of each IDI owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

2020.1.1.2.8 Employee Benefit Plans

Regulation W clarifies, under section 223.2(b)(1)(iv), that an employee stock option plan (ESOP), of an IDI or an affiliate of the IDI cannot itself avoid classification as an affiliate of the member bank by also qualifying as a subsidiary of the member bank. Many, but not all, ESOPs, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of an IDI or its affiliates are treated as affiliates of the IDI for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated IDI (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the member bank or bank holding company, the ESOP is an affiliate.

The relationship between an IDI and its (or its) affiliate's ESOP generally warrants coverage by sections 23A and 23B. IDIs have made unsecured loans to their ESOPs or their affiliates' ESOP or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the IDI. In addition, even if the ESOP's ownership control does not warrant treatment as an affiliate, the issuance of holding company shares to an ESOP that is funded by a loan from the holding company's subsidiary IDI could be used as a vehicle by the IDI to provide funds to its parent holding company when the IDI is unable to pay dividends or is otherwise restricted in providing funds to its holding company. The attribution rule (12 C.F.R. 223.16) subjects such transactions to the restrictions of sections 23A and 23B.

23. See 12 U.S.C. 371c(b)(1)(A) and (b)(2)(A). Section 23A defines a subsidiary of a specified company as a company that is controlled by the specified company. Under the statute, a company controls another company if the first company owns or controls 25 percent or more of a class of voting securities of the other company, controls the election of a majority of the directors of the other company, or exercises a controlling influence over the policies of the other company (12 U.S.C. 371c(b)(3) and (4)).

24. 12 U.S.C. 371c(b)(2)(A).

2020.1.2 QUANTITATIVE LIMITS

Section 23A(a)(1)(A) states that an IDI may engage in a covered transaction with an affiliate only if in the case of any affiliate

1. the IDI limits the aggregate amount of covered transactions to that particular affiliate to not more than 10 percent of the IDI's capital stock and surplus and
2. the IDI limits the aggregate amount of all covered transactions with all of its affiliates to 20 percent of the IDI's capital stock and surplus.

The rule's interpretation of the 10 percent limit is consistent with the statutory language.[25] An IDI that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the IDI's capital stock and surplus. An IDI is prohibited from engaging in a new covered transaction with that affiliate if the IDI's transactions would exceed the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates exceeded the 20 percent threshold. The rule generally does not require an IDI to unwind existing covered transactions if the member bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages IDIs with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the member bank's relationships with other affiliates.

2020.1.3 CAPITAL STOCK AND SURPLUS

Under section 23A, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the IDI. An IDI's capital stock and surplus for purposes of section 23A of the FRA is—

1. the sum of tier 1 and tier 2 capital included in an institution's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the institution's most recent consolidated FFIEC Reports of Condition and Income (Call Report) filed under 12 U.S.C. 1817(a)(3);
2. the balance of an institution's allowance for loan and lease losses not included in its tier 2 capital for purposes of the calculation of risk-based capital by the appropriate federal banking agency (based on the institution's most recent consolidated Call Report of Condition and Income that is filed under 12 U.S.C. 1817(a)(3)); and
3. the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the IDI's regulatory capital.[26]

Examiners can determine the amount of the quantitative limits.[27]

2020.1.3.1 Determination of Control

The definition of "control" is similar to the definition used in the BHC Act. Under the rule, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees (or general partners or individuals exercising similar functions), of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.[28]

In addition, three additional presumptions of control are provided under the rule. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.[29] Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner,

25. Sections 223.11 and 223.12 of the rule set forth these quantitative limits.

26. See section 223.3(d) of the rule (12 C.F.R. 223.3(d)).
27. Examiners should refer to the IDI's most recent Call Report.
28. See section 223.3(g) of the rule (12 C.F.R. 223.3(g)).
29. See 12 C.F.R. 225.2(e)(2)(i).

into securities, will be deemed to control the securities.[30] Third, a rebuttable presumption provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case.[31] Such a presumption of control is particularly appropriate in the section 23A context because a BHC may have incentives to divert the resources of a subsidiary IDI to any company in which the holding company has a substantial financial interest, regardless of whether the holding company owns any voting securities of the company.

Section 23A and the rule provide that no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity except (1) when a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank, or (2) if the company owning or controlling such shares is a business trust.

2020.1.4 COVERED TRANSACTIONS

The restrictions of section 23A do not apply to every transaction between an IDI and its affiliates; section 23A only applies to seven "covered transactions" between an IDI and its affiliates.[32]

A covered transaction under section 23A of the FRA means—

1. a loan or extension of credit by an IDI to an affiliate;
2. a purchase of, or an investment in, the securities issued by an affiliate of an IDI including a purchase of assets subject to an agreement to repurchase;[33]
3. an IDI's purchase of assets from an affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation;
4. the acceptance by an IDI of securities or other debt obligations issued by an affiliate as collateral security for a loan or extension of credit by the member bank to any person or company;[34]
5. the issuance by an IDI of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.
6. a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate; or
7. a derivative transaction, as defined in 12 U.S.C. 84(b), with an affiliate, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate.

If a transaction between an IDI and an affiliate is not within one of the above categories, it is not a covered transaction for the purposes of section 23A and is not subject to its limitations. All covered transactions must be made on terms and conditions that are consistent with safe and sound banking practices.[35]

Among the transactions that generally are not subject to section 23A are dividends paid by an IDI to its holding company, sales of assets by an IDI to an affiliate for cash, an affiliate's purchase of securities issued by an IDI, and many service contracts between an IDI and an affiliate.[36] Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

2020.1.4.1 Attribution Rule

The "attribution rule," found in section 223.16, prevents an IDI from evading its restrictions of

30. See 12 C.F.R. 225.31(d)(1)(i). The rule refers more generically to convertible "instruments." It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a "security" under section 23A or the federal securities laws.

31. See, for example, 12 C.F.R. 225.143 (Board Policy Statement on Equity Investments in Banks and Bank Holding Companies).

32. 12 U.S.C. 371c(b)(7).

33. The investment by an IDI or its affiliate in a financial subsidiary of the bank excludes the retained earnings of the financial subsidiary.

34. The acceptance of an affiliate's securities for a loan when proceeds are transferred to, or used for the benefit of, an affiliate is prohibited. (See section 223.3(h)(2).)

35. Board staff has taken the position that safety and soundness requires that the transaction be conducted on market terms.

36. A transaction when an IDI receives assets from an affiliate and the IDI pays a dividend or returns capital to an affiliate may result in a purchase of assets for the purposes of section 23A. Although these transactions are not subject to section 23A, they may be subject to section 23B or other laws.

section 23A by using intermediaries, and it limits the exposure that an IDI has to customers of affiliates of the IDI. Section 223.16 provides that any covered transaction by an IDI or its subsidiary with any person is deemed to be a transaction with an affiliate of the IDI if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, an IDI's loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the member bank would be a covered transaction under section 23A.

2020.1.4.2 Credit Transactions with an Affiliate

2020.1.4.2.1 Extension of Credit to an Affiliate or Other Credit Transaction with an Affiliate

Section 23A includes a ‘‘loan or extension of credit’’ to an affiliate as a covered transaction, but does not define these terms. Section 223.3(o) of the rule defines ‘‘extension of credit’’ to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. Transactions that are defined as extensions of credit include but are not limited to the following:

1. an advance to an affiliate by means of an overdraft, cash item, or otherwise;
2. a sale of federal funds to an affiliate;
3. a lease that is the functional equivalent of an extension of credit to an affiliate;[37]
4. an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate;
5. any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate term or other material term of, an extension of credit to an affiliate;[38] and
6. any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent) to an IDI.[39]

An IDI's purchase of a debt security issued by an affiliate is an extension of credit by the IDI to the affiliate for purposes of section 23A under the rule. An IDI that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which an IDI purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

2020.1.4.2.2 Valuation of Credit Transactions with an Affiliate

A credit transaction between an IDI and an affiliate initially must be valued at the amount of funds provided by the IDI to, or on behalf of, the affiliate plus any additional amount that the IDI could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between an IDI and an affiliate is the *greater of* (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) the sum of (a) the amount provided to, or on behalf of, the affiliate in the transaction and (b) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the member transaction. (See 223.21)

The first prong of the rule's valuation formula for credit transactions (‘‘the principal amount of the credit transaction’’) would likely determine the valuation of a transaction in which an IDI purchased a zero-coupon note issued by an affiliate. An IDI should value such an extension of credit at the principal, or face amount of the note (that is, at the amount that the affiliate ultimately must pay to the IDI) rather than at the amount of funds initially advanced by the IDI. For example, assume an IDI purchased from an

37. The Board would consider a full-payout, net lease permissible for a national bank under 12 U.S.C. 24 (seventh) and 12 C.F.R. 23 to be the functional equivalent of an extension of credit.

38. A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from ‘‘LIBOR plus 100 basis points’’ to ‘‘LIBOR plus 150 basis points,’’ the parties have engaged in a new covered transaction.

39. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the IDI or the affiliate fails to pay a tax refund to the IDI.

affiliate for $50 a 10-year zero-coupon note issued by the affiliate with a face amount of $100. The rule's valuation formula requires the IDI to value this transaction at $100.

The second prong of the rule's valuation formula for credit transactions ("the amount owed by the affiliate") likely would determine the valuation of a transaction in which an affiliate fails to pay an IDI when due a fee for services rendered by the IDI to the affiliate. This prong of the valuation formula does not include (within section 23A's quantitative limits) items such as accrued interest not yet due on an IDI's loan to an affiliate.

IDIs will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a $100 term loan is a $100 covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the IDI purchases from a third party a loan previously made to an affiliate of the IDI. A different valuation formula is provided for these indirect credit transactions: The IDI must value the transaction at the price paid by the IDI for the loan plus any additional amount that the IDI could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if an IDI pays a third party $90 for a $100 term loan that the third party previously made to an affiliate of the IDI (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered-transaction amount is $90 rather than $100. The lower covered-transaction amount reflects the fact that the IDI's maximum loss on the transaction is $90 rather than the original principal amount of the loan. For another example, if an IDI pays a third party $70 for a $100 line of credit to an affiliate, of which $70 had been drawn down by the affiliate, the covered-transaction amount would be $100 (the $70 purchase price paid by the IDI for the credit plus the remaining $30 that the IDI could be required to lend under the credit line).

In another example, an IDI makes a term loan to an affiliate that has a principal amount of $100. The affiliate pays $2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of $98. The IDI must initially value the covered transaction at $100.

Although the rule considers an IDI's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

2020.1.4.2.3 Timing of a Credit Transaction with an Affiliate

An IDI has entered into a credit transaction with an affiliate at the time during the day that the IDI becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the IDI executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when an IDI funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires an IDI to compute compliance with its quantitative limits when the IDI is about to engage in a new covered transaction. The rule does not require an IDI to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is mitigated significantly by the exemption for intraday extensions of credit found in section 223.42(l). The intraday credit exemption generally applies only to extensions of credit that an IDI expects to be repaid, sold, or terminated by the end of its U.S. business day. The IDI must have policies and procedures to manage and minimize the credit exposure. Any such extension of credit that is outstanding at the end of the IDI's business day must be treated as an extension of credit and must meet the regulatory quantitative and collateral requirements.

2020.1.4.2.4 Leases

Lease transactions that constitute the functional equivalent of a loan or an extension of credit may be subject to section 23A. Such lease arrangements, in effect, are equivalent to a loan by the IDI and are essentially financing arrangements. Some of the characteristics that would normally cause a lease to be construed as a loan equivalent include the lessee's having responsibility for the servicing, maintenance, insurance, licensing, or risk of loss or damage, and the lessee's having the option to purchase the equipment.

2020.1.4.2.5 Extensions of Credit Secured by Affiliate Securities—General Valuation Rule (Section 223.24(a) and (b))

Section 23A defines as a covered transaction an IDI's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.[40] This type of covered transaction has two classes: one in which the only collateral for the loan is solely affiliate securities and another in which the loan is secured by a combination of affiliate securities and other collateral.[40a]

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.[41]

Covered transactions of the second class, in which the credit extension is secured by affiliate securities and other collateral, are valued at the lesser of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.[42]

2020.1.4.2.6 Extensions of Credit Secured by Affiliate Securities—Mutual Fund Shares

Section 23A(b)(7)(D) of the FRA defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company.

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 Act. Second, to ensure that the IDI can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the IDI's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the IDI and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the IDI's extension of credit would be covered by section 23A's attribution rule. For example, an IDI proposes to lend $100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The IDI knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule

40. See 12 U.S.C. 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. (See 12 U.S.C. 371(c)(4)) If the proceeds of a loan that is secured by an affiliate's securities are transferred to an affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate and the affiliates securities cannot be used to meet the collateral requirements of sections 23A. The loan must then be secured with other collateral in an amount and of a type that meets the requirements of section 23A for loans by an IDI to an affiliate.

40a. The securities issued by an affiliate cannot be used as collateral for a loan to any affiliate (12 U.S.C. 371c (c)(4)).

41. In either case, the transaction must comply with section 23B; that is, the IDI must obtain the same amount of affiliate securities as collateral on the credit extension that the IDI would obtain if the collateral were not affiliate securities.

42. Under the rule, an IDI may use the higher of the two valuation options for these transactions if, for example, the IDI does not have the procedures and systems in place to verify the fair market value of affiliate securities.

in section 223.16, the IDI must treat the loan to the nonaffiliate as a loan to an affiliate, and because securities issued by an affiliate are ineligible collateral under section 223.14, the loan would not be in compliance with section 223.14.

2020.1.4.3 Asset Purchases

2020.1.4.3.1 Purchase of Assets under Regulation W

Regulation W provides that a purchase of assets by an IDI from an affiliate initially must be valued at the total amount of consideration given by the IDI in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the IDI. An assumption of liabilities can include a mortgage, other debt obligations, or the cost associated with the transfer of employees, such as pension obligations, bonuses, or accrued vacation.

Asset purchases are a covered transaction for an IDI for as long as the IDI holds the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP and are reflected on the IDI's financial statements.

Certain asset purchases by an IDI from an affiliate are *not* valued in accordance with the general asset-purchase valuation formula. First, if the IDI buys from one affiliate a loan made to a second affiliate, the IDI must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the IDI buys from one affiliate a security issued by a second affiliate, the IDI must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the IDI acquires the shares of an affiliate that becomes an operating subsidiary of the IDI after the acquisition, the IDI must value the transaction under section 223.31.

A special valuation rule applies to an IDI's purchase of a line of credit or loan commitment from an affiliate. An IDI initially must value such asset purchases at the purchase price paid by the IDI for the asset plus any additional amounts that the IDI is obligated to provide under the credit facility.[43] This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated IDI.

Section 23A(d)(6) provides an exemption for purchasing assets having a readily identifiable and publically available market quotation. Section 224.42(e) of the rule codified this exemption. Section 223.42(f) expands the statutory (d)(6) exemption to allow an IDI to purchase securities from an affiliate based on price quotes obtained from certain electronic screens so long as, among other things, (1) the selling affiliate is a broker-dealer registered with the SEC, (2) the securities are traded in a ready market and eligible for purchase by state IDIs, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the IDI is an underwriter of the securities), and (4) the securities are not issued by an affiliate. See section 2020.1.10.2 for a further discussion of this exemption.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing IDI. However, if an IDI purchases assets from a nonaffiliate in contemplation that the nonaffiliate will become an affiliate of the IDI, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the IDI must ensure that the aggregate amount of the IDI's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist IDIs in valuing purchases of assets from an affiliate. An IDI's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the IDI sells the asset.

- *Cash purchase of assets.* An IDI purchases a pool of loans from an affiliate for $10 million. The IDI initially must value the covered transaction at $10 million. Going forward, if the borrowers repay $6 million of the principal amount of the loans, the IDI may value the covered transaction at $4 million.
- *Purchase of assets through an assumption of liabilities.* An affiliate of an IDI contributes

43. A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the IDI and (2) the IDI makes a separate credit decision before each drawing under the facility (see 12 C.F.R. 223.22).

real property with a fair market value of $200,000 to the IDI. The IDI pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The IDI has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the IDI retains the real property but pays off the mortgage, the IDI must continue to value the covered transaction at $50,000. If the IDI, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

2020.1.4.3.2 IDI's Purchase of Securities Issued by an Affiliate

Section 23A includes as a covered transaction an IDI's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires an IDI to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the IDI) at the *greater* of the IDI's purchase price or carrying value of the securities. An IDI that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the IDI's carrying value of the securities. In addition, if the IDI's carrying value of the affiliate securities increased or decreased after the IDI's initial investment (due to profits or losses at the affiliate), the amount of the IDI's covered transaction would increase or decrease to reflect the IDI's changing financial exposure to the affiliate. However, the amount of the IDI's covered transaction cannot decline below the amount paid by the IDI for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach would require an IDI to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the IDI paid no consideration for the securities. Second, the approach is supported by the terms of the statute, which defines both a "purchase of" *and* an "investment in" securities issued by an affiliate as a covered transaction. The statute's "investment in" language indicates that Congress was concerned with an IDI's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

Third, GLB Act amendments to section 23A supported the approach. The GLB Act defined a financial subsidiary of an IDI as an affiliate of the IDI, but specifically provides that the section 23A value of an IDI's investment in securities issued by a financial subsidiary did *not* include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of an IDI's investment in *other* affiliates *includes* the affiliates' retained earnings, which would be reflected in the IDI's carrying value of the investment under the rule.

Finally, the carrying-value approach is consistent with the purposes of section 23A—imiting the financial exposure of IDIs to their affiliates and promoting safety and soundness. The valuation rule requires an IDI to revalue upwards the amount of an investment in affiliate securities only when the IDI's exposure to the affiliate increases (as reflected on the IDI's financial statements) and the IDI's capital increases to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the IDI's greater financial exposure to the affiliate and enhances safety and soundness by reducing the IDI's ability to engage in additional transactions with an affiliate as the IDI's exposure to that affiliate increases.

The valuation rule also provides that the covered-transaction amount of an IDI's investment in affiliate securities can be no less than the purchase price paid by the IDI for the securities, even if the carrying value of the securities declines below the purchase price. This aspect of the valuation rule uses the IDI's purchase price for the securities as a floor for valuing the covered transaction. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the IDI to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of an IDI to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the IDI could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the IDI's carrying value of the affiliate's securities would decline, the section 23A value of the IDI's investment likely would decline, and, consequently, the IDI would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is what section 23A was intended to restrict.

The following examples are designed to assist IDIs in valuing purchases of, and investments in, securities issued by an affiliate:

- *Purchase of the debt securities of an affiliate.* The parent holding company of an IDI owns 100 percent of the shares of a mortgage company. The IDI purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities is $600. The IDI initially must value the investment at $600.
- *Purchase of the shares of an affiliate.* The parent holding company of an IDI owns 51 percent of the shares of a mortgage company. The IDI purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares is $100. The IDI initially must value the investment at $100. Going forward, if the IDI's carrying value of the shares declines to $40, the IDI must continue to value the investment at $100.
- *Contribution of the shares of an affiliate.* The parent holding company of an IDI owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the IDI. The IDI gives no consideration in exchange for the shares. If the initial carrying value of the shares is $300, then the IDI initially must value the investment at $300. Going forward, if the IDI's carrying value of the shares increases to $500, the IDI must value the investment at $500.

2020.1.4.5 Issuance of a Letter of Credit or Guarantee

2020.1.4.5.1 Confirmation of a Letter of Credit Issued by an Affiliate

Section 23A includes as a covered transaction the issuance by an IDI of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. (See section 223.3(h)(5).) When an IDI confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit.[44] Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

44. See UCC 5-107(2).

2020.1.4.5.2 Credit Enhancements Supporting a Securities Underwriting

The definition of guarantee in section 23A does not include an IDI's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the IDI.[45] Such a credit enhancement would not be issued "on behalf of" the affiliate. Although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.[46] Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

2020.1.4.5.3 Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements

A cross-guarantee agreement among an IDI, an affiliate, and a nonaffiliate in which the nonaffiliate may use the IDI's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among IDIs and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve an IDI, one or more affiliates of the IDI, and one or more nonaffiliates of the IDI, where a nonaffiliate is permitted to deduct obligations of an affiliate of the IDI to the nonaffiliate when settling the nonaffiliate's obligations to the IDI. These arrangements also would include agreements in which an IDI is required or permitted to add the obligations of an affiliate of the IDI to a nonaffiliate when determining the IDI's obligations to the nonaffiliate. These types of CANAs expose an IDI to the credit risk of its affiliates because the IDI may become liable for the obligations of its affiliates. Because the exposure of an IDI to an affiliate in such an arrangement resembles closely the exposure of an IDI when it issues a guarantee on behalf of

45. See 62 *Fed. Reg.* 45295, August 27, 1997.
46. See 12 U.S.C. 371c(a)(2).

an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit an IDI from entering into such a CANA to the extent that the netting arrangement does not cap the potential exposure of the IDI to the participating affiliate (or affiliates).

2020.1.4.5.4 Keepwell Agreements

In a keepwell agreement between an IDI and an affiliate, the IDI typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the IDI in entering into such a keepwell agreement is similar to the credit risk incurred by an IDI in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

2020.1.4.5.5 Prohibition on the Purchase of Low-Quality Assets

Section 23A generally prohibits the purchase by an IDI of a low-quality asset from an affiliate.[47] In addition, an IDI and its subsidiaries cannot purchase or accept as collateral a low-quality asset from an affiliate. Section 23A defines a low-quality asset to include (1) an asset classified as ''substandard,'' ''doubtful,'' or ''loss,'' or treated as ''other loans specially mentioned,'' in the most recent report of examination or inspection by a federal or state supervisory agency (a ''classified asset''), (2) an asset in nonaccrual status, (3) an asset on which payments are more than 30 days past due in the payment of principal or interest, or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor. Any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.

Regulation W expands the definition of low-quality assets in several respects. (See 12 C.F.R. 223.3(v).) First an asset may be identified by examiners as a low-quality asset if they represent credits to countries that are not complying with their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund Program. Although such assets may not be considered classified assets, examiners are to consider these assets in their assessment of an IDI's asset quality and capital adequacy.

Second, the rule considers a financial institution's use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution's internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by an IDI from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company's deferral or alteration of an asset's rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated ''other real estate owned'' (OREO), until it is reviewed by an examiner and receives a favorable classification. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the IDI performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[48] Section 223.15 of the rule also provides an exception from the prohibition on the purchase by an IDI of a low-quality asset from an affiliate for certain loan renewals. The rule allows an IDI that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying

47. 12 U.S.C. 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset and no liabilities are associated with the asset.

48. 12 U.S.C. 371c(a)(3).

loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating IDI to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the IDI purchased its participation and (2) the proposed transaction would not increase the IDI's proportional share of the credit facility. The IDI must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20 days' post-consummation notice to its appropriate federal banking agency. An IDI is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the IDI's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the IDI (not just affiliated IDIs).

2020.1.5 COLLATERAL FOR CERTAIN TRANSACTIONS WITH AFFILIATES

Section 23A requires a member bank's use of collateral for certain transactions between an IDI and its affiliates.[49] Each loan or extension of credit to an affiliate,[50] or guarantee, acceptance, or letter of credit issued on behalf of an affiliate by an IDI or its subsidiary, and any credit exposure of an IDI or a subsidiary to an affiliate resulting from a securities borrowing or lending transaction, or a derivative transaction, shall be secured at all times by collateral ("credit exposure") at the amounts required by the statute. The required collateral varies,[51] depending on the type of collateral used to secure the transaction.[52] The specific collateral requirements are—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, letter of credit or credit exposure, if the collateral is composed of—
   a. obligations of the United States or its agencies;
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
   c. notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;[53] or
   d. a segregated, earmarked deposit account with the member bank that is for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such.
2. 110 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of stock, leases, or other real or personal property.

For example, an IDI makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate. The loan satisfies the collateral requirements of section 23A because $500 of the loan is 100 percent secured by obligations of the United States, $400 of the loan is 120 percent secured by debt instruments, and $100 of the loan is 130 percent secured by real estate. The statute prohibits an IDI from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.[54] An IDI must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

Each loan or extension of credit to an affiliate or guarantee, acceptance, credit exposure or letter of credit issued on behalf of an affiliate (herein referred to as credit transactions) by an IDI or its subsidiary must be secured at the time of the transaction by collateral.

49. The IDI must perfect the security interest in the collateral (*Fitzpatrick v. FDIC*, 765 F.2d 569 (6th Cir. 1985). A purchase of assets from an affiliate does not require collateral.
50. 12 U.S.C. 371c(b)(7).
51. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.
52. 12 U.S.C. 371c(c)(1).
53. Regulation A includes a representative list of acceptable government obligations (12 C.F.R. 201.108).
54. 12 U.S.C. 371c(c)(3).

2020.1.5.1 Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 23A (c) of the statute. Section 23A (c)(1) requires that an IDI meet the collateral requirements of the statute at all times. A low-quality asset cannot be used to satisfy the statute's or regulation's collateral requirements, but can be taken as additional collateral.

2020.1.5.1.1 Deposit Account Collateral

Under section 23A, an IDI may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a ''segregated, earmarked deposit account'' maintained with the IDI in an amount equal to 100 percent of the credit extended.[55] IDIs may secure covered transactions with omnibus deposit accounts so long as the IDI takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, IDIs must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

2020.1.5.1.2 Ineligible Collateral

The purpose of section 23A's collateral requirements is to ensure that IDIs that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended.

The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.

Under section 223.14(c) of the rule, intangible assets also are not deemed acceptable to meet the collateral requirements imposed by section 23A.[56] Intangible assets, including servicing assets, are particularly hard to value, and an IDI may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be ''secured'' by collateral. A credit transaction between an IDI and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute ''real or personal property'' under section 23A. There is a particularly significant risk that an IDI may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the IDI. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.

As noted above, section 23A prohibits an IDI from accepting securities issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the IDI itself also are not eligible collateral to secure a credit transaction with an affiliate. Equity securities issued by a lending IDI, and debt securities issued by a lending IDI that count as regulatory capital of the IDI, are not eligible collateral under section 23A. If an IDI was forced to foreclose on a credit transaction with an affiliate secured by such securities, the IDI may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the IDI's outstanding securities or result in a change in control of the IDI. In addition, to the extent that an IDI is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the IDI's capital, thereby offsetting any potential benefit provided by the collateral.

2020.1.5.1.3 Perfection and Priority

Under section 223.14(d) of the rule, an IDI's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that an IDI has

55. 12 U.S.C. 371c(c)(1)(A)(iv).

56. The rule does not confine the definition of intangible assets by reference to GAAP.

good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the IDI has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. An IDI also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the IDI the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the IDI or (2) the amount of any credits secured by the collateral that are senior to that of the IDI. For example, if an IDI lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: An IDI makes a $2,000 loan to an affiliate. The affiliate grants the IDI a second-priority security interest in a piece of real estate valued at $3,000. Another institution that previously lent $1,000 to the affiliate has a first-priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Because of the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the IDI for purposes of this section is only $2,000—$600 less than the amount of real estate collateral required by this section for the transaction ($2,000 × 130 percent = $2,600).

2020.1.5.1.4 Unused Portion of an Extension of Credit

Section 23A requires that the "amount" of an extension of credit be secured by the statutorily prescribed levels of collateral. Under the statute, an IDI provides a line of credit to an affiliate, it must secure the full amount of the line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule, however, provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the IDI does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.[57] In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the IDI to advance additional funds without posting the additional collateral required by section 23A. If an IDI voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. The entire amount of the line counts against the IDI's quantitative limit, even if the line of credit does not need to be secured.

2020.1.5.1.5 Purchasing Affiliate Debt Securities in the Secondary Market

An IDI's investment in the debt securities issued by an affiliate is an extension of credit by the IDI to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits IDIs in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where an IDI purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When an IDI buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced. Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing an IDI's good faith under this exemption transaction, examiners should look at (1) the time elapsed between the original issuance of the affiliate's debt securities and the IDI's purchase, (2) the existence of any relevant agreements or relationships between the IDI and the third-party seller of the affiliate's debt securities, (3) any history of IDI

57. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. Moreover, these transactions are still subject to the 10 and 20 percent limits of the statute.

financing of the affiliate, and (4) any other relevant information.

2020.1.5.1.6 Credit Transactions with Nonaffiliates that Become Affiliates

IDIs sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the IDI. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the IDI entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the IDI. For example, an IDI with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. The IDI does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the bank holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the IDI. The IDI is not in violation of the quantitative limits of the rule's section 223.11 or 223.12 at the time of the stock acquisition. The IDI is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the IDI's capital stock and surplus, and the transaction counts toward the 20 percent limit for transactions with all affiliates. In addition, the IDI must bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition. Transactions with nonaffiliates in contemplation of the nonaffiliate becoming an affiliate must meet the quantitative and collateral requirements of the rule at the time of the inception of the credit transaction and of the affiliation.

2020.1.6 LIMITATIONS ON COLLATERAL

IDIs may accept as collateral for covered transactions receivables, leases, or other real or personal property.[58] The following are limitations and collateral restrictions:

58. As noted above, letters of credit and mortgage-servicing rights may not be accepted as collateral for purposes of section 23A. See section 223.14(c)(4)(5) of the rule (12 C.F.R. 223.14(c)(4) and (5).

1. Any collateral that is subsequently retired or amortized must be replaced by additional eligible collateral. This is done to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit, guarantee, acceptance, or letter of credit equal to the minimum percentage that was required at the inception of the transaction.
2. A low-quality asset is not acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, an affiliate, or credit exposure to an affiliate resulting from a securities borrowing or lending transaction, or derivative transaction.
3. Securities or other debt obligations issued by an affiliate of an IDI shall not be acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, or credit exposure from a securities borrowing or lending transaction, or derivative transaction to, that affiliate or any other affiliate of the IDI.

The above collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

2020.1.7 DERIVATIVE TRANSACTIONS WITH AFFILIATES

2020.1.7.1 Derivative Transactions between Insured Depository Institutions and Their Affiliates

Derivative transactions between an IDI and its affiliates generally arise from the risk-management needs of the institution or the affiliate. Transactions arising from the institution's needs typically occur when an institution enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract, or when the institution is unable to hedge the risk directly because it is not authorized to hold the hedging asset. To manage the market risk, the institution may have an affiliate acquire the hedging asset. The institution would then do a bridging derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between an IDI and its affiliate are affiliate-driven. To accomplish its asset-liability-management goals, an institution's affiliate may enter into an interest-rate or foreign-exchange derivative with the institution. For example, an institution's holding company may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The holding company may then enter into a fixed-to-floating interest-rate swap with its subsidiary member bank to reduce the holding company's interest-rate risk.

IDIs and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. IDIs and their affiliates often choose to use each other as their derivative counterparties, however, to maximize the profits of, and manage risks within, the consolidated financial group.

2020.1.7.1.1 Section 23A on Derivatives Transactions

The Dodd-Frank Act amended section 23A as it relates to derivatives and now provides that a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes (12 U.S.C. 84(b)) with an affiliate, is a covered transaction to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate. The Dodd-Frank Act also requires that any credit exposure must be secured consistent with the collateral requirements of section 23A. This is a significant change and requires that all IDIs calculate the relevant credit exposure and count that amount towards the institution's quantitative limits. The Dodd-Frank Act requires the IDI to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the institution monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements. Regulation W provides that credit derivatives between an institution and an unaffiliated third party that reference the obligations of an affiliate of the institution and that are the functional equivalent of a guarantee by the institution on behalf of an affiliate should be treated as a guarantee by the institution on behalf of an affiliate for the purposes of section 23A. (The novation of a derivative between an IDI and its affiliate is treated as a purchase under the statute.)

2020.1.7.1.2 Section 23B and Regulation W Regarding Derivative Transactions

Derivative transactions between an IDI and an affiliate also are subject to section 23B of the FRA under the express terms of the statute.[59]

Regulation W clarifies further that the transactions are subject to the market-terms requirement of section 23B of the FRA (see section 223.51). The rule requires IDIs to comply strictly with section 23B in their derivative transactions with affiliates. Section 23B requires an institution to treat an affiliate no better than a *similarly situated* nonaffiliate. To comply with section 23B of the FRA, each institution should have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the institution imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality. Similarly, each institution should monitor derivatives exposure to affiliates at least as rigorously as it monitors derivatives exposure to comparable unaffiliated companies. In addition, each institution should price and require collateral in its derivative transactions with affiliates in a way that is at least as favorable to the institution as the way in which it would price or require collateral in a derivative transaction with comparable unaffiliated counterparties.

Section 23B generally does not allow an IDI to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer unless the institution can demonstrate that the affiliate is of comparable creditworthiness as its most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because an IDI generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and

59. In addition to applying to covered transactions, as defined in section 23A of the FRA, the market-terms requirement of section 23B of the FRA applies broadly to, among other things, "[t]he payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise" (12 U.S.C. 371c-1(a)(2)(C)). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk-management services to the affiliate.

conditions from an IDI than the institution receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

2020.1.7.1.3 Covering Derivatives That Are the Functional Equivalent of a Guarantee

Although most derivatives are not treated as covered transactions, section 223.33 of the rule provides that credit derivatives between an IDI and a nonaffiliate in which the IDI protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the IDI are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.[60] An IDI is not allowed to reduce its covered transaction amount for these derivatives to reflect hedging positions established by the IDI with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the IDI.

2020.1.8 INTRADAY EXTENSIONS OF CREDIT

An extension of credit under section 23A of the FRA includes the credit exposure arising from intraday extensions of credit by IDIs to their affiliates. IDIs regularly provide transaction accounts to their affiliates in conjunction with providing payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are occasionally subject to overdrafts during the day that are repaid in the ordinary course of business.

Intraday extensions of credit by an IDI to an affiliate are subject to the market-terms requirement of section 23B under the rule. The rule also requires that, under section 23A, institutions establish and maintain policies and procedures that are reasonably designed to manage the credit exposure arising from an institution's intraday extensions of credit to affiliates. The policies and procedures must, at a minimum, provide for monitoring and controlling the institution's intraday credit exposure to each affiliate, and to all affiliates in the aggregate, and ensure that the institution's intraday credit extensions to affiliates comply with section 23B.

Section 223.42(l) of the rule provides that intraday credit extensions by an IDI to an affiliate are section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the IDI (1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The policies and procedures are to be established and maintained for—

1. monitoring and controlling the credit exposure arising at any one time from the IDI's intraday extensions of credit to each affiliate and all affiliates in the aggregate and
2. ensuring that any intraday extensions of credit by the IDI to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

2020.1.8.1 Standard under Which the Agencies May Grant Additional Exemptions

The Dodd-Frank Act amended section 23A to authorize the appropriate federal banking agency to exempt transactions or relationships by order if the exemption would be in the public interest and consistent with the purposes of section 23A. The exemption determination requires the concurrence of the Board. The FDIC has a 60-day period to determine whether the requested exemption presents an unacceptable risk to the insurance fund. The request should describe in detail the transaction or relationship for which the member bank seeks exemption. The exemption request also should explain why the Agency should exempt the transaction or relationship, and why it meets the public interest standard of the statute. The Board has approved a number of exemptions, most of

60. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

which involve corporate reorganizations. These exemptions are available on the Board's website, www.federalreserve.gov/boarddocs/legalint/FederalReserve Act.

2020.1.9 EXEMPTIONS FROM SECTION 23A

Section 23A exempts seven transactions or relations from its quantitative limits and collateral requirements.[61] Regulation W, subpart E, clarifies these exemptions and exempts a number of additional types of transactions. The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular IDI to use any such exemption if the IDI's use of the exemption is resulting in unsafe or unsound banking practices.

2020.1.9.1 Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

2020.1.9.1.1 Parent Institution/Subsidiary Institution Transactions

Transactions with an IDI are exempt from the quantitative limits and collateral requirements (section 223.14) if the member bank controls 80 percent or more of the voting securities of the IDI or the depository institution controls 80 percent or more of the voting securities of the IDI.

2020.1.9.1.2 Sister-Bank Exemption (section 223.41(b))

Regulation W exempts transactions with an IDI if the same company controls 80 percent or more of the voting securities of the member bank and the IDI.[62] In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.[63]

The sister-bank exemption generally applies only to transactions between IDIs.[64] The rule's definition of affiliate excludes uninsured depository institution subsidiaries of a member bank. Covered transactions between a member bank and a parent uninsured depository institution or a commonly controlled uninsured depository institution, under the rule, generally would be subject to section 23A, whereas covered transactions between a member bank and a subsidiary uninsured depository institution would not be subject to section 23A.[65]

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit or other covered transaction to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, an IDI purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The IDI's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under section 223.41(b), but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the IDI and Affiliate B under section 223.3(h)(1) that does not qualify for the sister-bank exemption.

61. See 12 U.S.C. 371c(d)

62. Banks that are affiliated in this manner are referred to as "sister banks." Sister banks can improve their efficiency through intercorporate transfers under this exception. Also, "company" in this context is not limited to a bank holding company. For example, if a retail corporation owns two credit card banks, the two credit card banks would be sister banks, and the sister-bank exception could be used for transactions between two credit card banks.

63. 12 U.S.C. 371c(a)(4).

64. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister-insured depository institution generally qualify for the sister-bank exemption.

65. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt corrective-action framework set forth in section 38 of the FDI Act (12 U.S.C. 1831o) and regulations adopted by the bank's appropriate federal banking agency.

2020.1.9.1.3 Purchase of Loans on a Nonrecourse Basis from an Affiliated IDI

Banks that are commonly controlled (i.e., at least 25 percent common ownership) can purchase loans on a nonrecourse basis. This allows chain banks and banks in companies that are not owned 80 percent by the same company to achieve the same efficiency as sister banks. The exemption only applies to the purchase of loans; other covered transactions, such as extensions of credit, are not exempt.

2020.1.9.1.4 Internal Corporate Reorganizations

Section 223.41(d) of the rule provides an exemption for asset purchases by an IDI from an affiliate that is part of a one-time internal corporate reorganization of a holding company.[66] The exemption includes purchases of assets in connection with a transfer of securities issued by an affiliate to an IDI, as described in section 223.31(a).

Under this exemption, an IDI would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) that are exempt from the quantitative limits of section 23A if the following conditions are met.

First, the purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate. The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to an IDI.[67] Second, the IDI's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the IDI whole, for a period of two years, for any transferred assets that become low-quality assets.[68] Third, a majority of the IDI's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the IDI's capital stock and surplus (or up to 25 percent of the IDI's capital stock and surplus with the prior approval of the appropriate federal banking agency) for the IDI. Fifth, the holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

2020.1.9.2 Other Covered Transactions Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of a low-quality asset (section 223.15) do not apply to the following exempted transactions (see section 223.42) and certain conditions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13). Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

1. Making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 U.S.C. 1813) or in an affiliated foreign bank that represents an ongoing, working balance maintained in the ordinary course of correspondent business
2. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business

66. See 1998 *Fed. Res. Bull.* 985 and 1013-14.

67. The IDI must provide the Board, as well as the appropriate federal agency, a notice that describes the primary business activities of the affiliate whose shares or assets are being transferred to the IDI and must indicate the anticipated date of the reorganization.

68. The holding company can meet these criteria by either repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank. The purchase or payment must be made within 30 days of each quarter end. In addition, if a cash payment is made, the IDI will hold an amount of risk-based capital equal to the book value of any transferred assets that become low-quality so long as the IDI retains ownership or control of the transferred asset. For example, under this dollar-for-dollar capital requirement, the risk-based capital charge for each transferred low-quality loan asset would be 100 percent (equivalent to a 1250 percent risk weight), rather than the 8 percent requirement (equivalent to a 100 percent risk weight) that would apply to a similar defaulted loan asset that is not a part of the transferred asset pool. See the Board's letter dated December 21, 2007, to Andres L. Navarette (Capital One Financial Corp.). Once the capital pool has been allocated to specific assets as described above, the capital cannot be applied to other low-quality assets if the initial low-quality asset returns to performing status. The IDI can only apply the allocated capital pool to new assets if the initial assets are fully paid or sold.

3. Transactions secured by cash or U. S. government securities
4. Purchasing securities of a servicing affiliate, as defined by section 4(c)(1) of the BHC Act
5. Purchasing certain liquid assets
6. Purchasing certain marketable securities
7. Purchasing certain municipal securities
8. Purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by an IDI and sold to the affiliate subject to a repurchase agreement or with recourse
9. Asset purchases from an affiliate by a newly formed IDI, if the appropriate federal banking agency for the IDI has approved the asset purchase in writing in connection with the review of the formation of the IDI
10. Transactions approved under the Bank Merger Act that involve affiliated IDIs or an IDI and the U.S. branches and agencies of a foreign bank
11. Purchasing, on a nonrecourse basis, an extension of credit from an affiliate under certain conditions
12. Intraday extensions of credit
13. Riskless-principal transactions

2020.1.9.2.1 Correspondent Banking

Section 23A exempts from its quantitative limits and collateral requirements a deposit by an IDI in an affiliated IDI or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.[69] Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained by the IDI in the ordinary course of conducting the correspondent business.[70] Although not specified by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

2020.1.9.2.2 Secured Credit Transactions

Section 23A and section 223.42(c) of the rule exempt any credit transaction by an IDI with an affiliate that is ''fully secured'' by obligations of the United States or its agencies, or obligations that are fully guaranteed by the United States or its agencies, as to principal and interest.[71]

A deposit account meets the ''segregated, earmarked'' requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to fully secure a credit transaction, then the transaction is completely exempt from the quantitative limits of the statute. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

The exemption provides that a credit transaction with an affiliate will be exempt ''to the extent that the transaction is and remains secured'' by appropriate (d)(4) collateral. If an IDI makes a $100 nonamortizing term loan to an affiliate that is secured by $50 of U.S. Treasury securities and $75 of real estate, the value of the covered transaction will be $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value of the covered transaction would increase to $55. The Board expects IDIs that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

2020.1.10 ASSET PURCHASES FROM AN AFFILIATE—EXEMPTIONS

2020.1.10.1 Purchase of a Security by an Insured Depository Institution from an Affiliate

Section 23A of the FRA restricts the ability of a member bank to fund its affiliates through asset purchases, loans, or certain other transactions (referred to as ''covered transactions'').

69. 12 U.S.C. 371c(d)(2).

70. Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an *uninsured* depository institution or foreign bank.

71. 12 U.S.C. 371c(d)(4). A partial list of such obligations can be found in the rules's section 201.108 (12 C.F.R. 201.108).

Paragraph (d)(6) of section 23A contains an exemption from the statute (the (d)(6) exemption) for "purchasing assets having a readily identifiable and publicly available market quotation," if the purchase is at or below such quotation.[72]

2020.1.10.2 Purchases of Assets with Readily Identifiable Market Quotes

Section 23A(d)(6) exempts the purchase of assets by an IDI from an affiliate if the assets have a "readily identifiable and publicly available market quotation" and are purchased at their current market quotation. The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true "market quotation" and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at or below the asset's current market quotation.[73]

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

If an IDI purchases from one affiliate, the securities issued by another affiliate, the IDI has engaged in two types of covered transactions: (1) the purchase of securities from an affiliate and (2) the investment in securities issued by an affiliate. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities being issued by a second affiliate.

2020.1.10.3 Purchasing Certain Marketable Securities

Regulation W provided an additional exemption from section 23A for certain purchases of securities by a member bank from an affiliate. The rule expanded the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, the selling affiliate is a broker-dealer registered with the SEC, the securities have a ready market and are eligible for purchase by state member banks, the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities), and the securities are not issued by an affiliate.

2020.1.10.3.1 Broker-Dealer Requirement and Securities Purchases from Foreign Broker-Dealers

Under the Regulation W exemption, the selling affiliate must be a broker-dealer securities affiliate that is registered with the Securities and Exchange Commission (SEC). Broker-dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker-dealer. In addition, SEC-registered broker-dealers have experience in determining whether a security has a "ready market" under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker-dealers. The rule explicitly provides, however, that an IDI may request that the Board exempt securities purchases from a particular foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.

2020.1.10.3.2 Securities Eligible for Purchase by a State Member Bank

The exemption requires that the IDI's purchase of securities be eligible for purchase by a state member bank. For example, the Board determined that a member bank may purchase equity securities from an affiliate, if the purchase is

72. 12 U.S.C. 371c(d)(6).

73. The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at a publicly available market quotation.

made to hedge the member bank's permissible customer-driven equity derivative transaction. The purchase must be treated as a purchase of a security on the Call Report.

2020.1.10.3.3 No Purchases Within 30 Days of an Underwriting

The exemption generally prohibits an IDI from using the exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an affiliate of the IDI is an underwriter of the securities. This provision applies unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

2020.1.10.3.4 No Securities Issued by an Affiliate

If an IDI purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.

2020.1.10.3.5 Price-Verification Methods

The exemption applies only in situations in which the IDI is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirmed its position that it would not be appropriate to use independent dealer quotations or economic models to establish a market price for a security under the (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing an IDI to purchase unlimited amounts of the security from an affiliate.

2020.1.10.3.6 Record Retention

The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the IDI is in compliance with the terms of the exemption.

2020.1.10.4 Purchasing Municipal Securities

Section 223.42(g) of the rule exempts an IDI's purchase of municipal securities from an affiliate if the purchase meets certain requirements.[74] First, the IDI must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the IDI must report the transaction as a securities purchase in its Call Report. Third, the municipal securities should either be rated by a nationally recognized statistical rating organization (NRSRO) or be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.[75] Under any of the three pricing options, the IDI must purchase the municipal securities at or below the quoted or verified price.

74. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. That Act defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 U.S.C. 78c(a)(29).)

75. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

2020.1.10.5 Purchase of Loans on a Nonrecourse Basis

Section 223.41(c) of the rule exempts the purchase of loans on a nonrecourse basis from an affiliated depository institution. Under sections 23A(d)(6), a member bank may purchase loans on a nonrecourse basis from an affiliated "bank" exempt from the quantitative limitations of section 23A, even if the transactions does not qualify for the sister-bank exemption.[76] The rule clarifies that the scope of the exemption parallels that of the sister-bank exemption by stating that this exemption applies only to a member bank's purchase of a loan from an affiliated IDI.

2020.1.10.6 Purchases of Assets by Newly Formed Institutions

Section 223.42(i) of the rule exempts a purchase of assets by a newly formed IDI from an affiliate if the appropriate federal banking agency for the IDI has approved the purchase. This exemption allows companies to charter a new IDI and to transfer assets to the IDI free of the quantitative limits and low-quality-asset prohibition of section 23A.

2020.1.10.7 Transactions Approved under the Bank Merger Act

The Bank Merger Act exemption applies to transactions between an IDI and a certain IDI affiliate. Section 223.42(j) exempts transactions between IDIs that are approved pursuant to the Bank Merger Act. The rule also makes the Bank Merger Act exemption available for merger and other related transactions between an IDI and a U.S. branch or agency of an affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act. There is no regulatory exemption for merger transactions between an IDI and its nonbank affiliate. Any IDI merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions contained in section 223.41(d) of the rule.

76. See 12 U.S.C. 371c(d)(6).

2020.1.11 PURCHASES OF EXTENSIONS OF CREDIT—THE PURCHASE EXEMPTION

Regulation W codified, with changes, the exemption that was previously found at section 250.250 (12 C.F.R. 250.250). In general,

1. The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
   a. the extension of credit is originated by the affiliate;
   b. the IDI makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;
   c. the IDI commits to purchase the extensions of credit before the affiliate makes or commits to the extensions of credit; and
   d. the IDI does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)
2. The rule also includes a 50 percent limit on the amount of loans an IDI may purchase from an affiliate under the purchase exemption. When an IDI purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The IDI's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the IDI to continue to support the affiliate through asset purchases, and reduces the IDI's ability to make independent credit decisions with respect to the asset purchases.
3. *"Substantial, ongoing funding" test.* The rule allows the appropriate federal banking agency for an IDI to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the IDI's asset purchases from an affiliate under the exemption may cause harm to the IDI.
4. *Independent credit review by the IDI.* To qualify for the purchase exemption under section 223.42(k), an IDI must independently review the creditworthiness of the borrower before committing to purchase each loan. Under established Federal Reserve guidance, an IDI is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the

credit and other risks inherent in a proposed transaction.[77] This function is not delegable to any third party, including affiliates of the IDI. Also, an IDI cannot rely on the standards of a government-sponsored enterprise. Accordingly, to qualify for this exemption, the IDI, independently and using its own credit policies and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.

5. *Purchase of loans from an affiliate must be without recourse*. In connection with an IDI's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the IDI. The rule also specifies that the purchase exemption only applies in situations where the IDI purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by an IDI to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate an IDI's using its affiliate as an origination agent, not to permit an IDI to take loans off an affiliate's books that the affiliate purchased from a third party.

2020.1.12 OTHER BOARD-APPROVED EXEMPTIONS FROM SECTION 23A

Section 23A gives the Board the authority to grant exemptions from the statute's restrictions if such exemptions are "in the public interest and consistent with the purposes of this section" (12 U.S.C. 371c(f)(2)). Regulation W includes several exemptions that are available to qualifying IDIs.

2020.1.12.1 Exemptions and Interpretation from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member institution with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 U.S.C. 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

2020.1.12.2 Interpretation—Loans to a Nonaffiliate that Purchases Securities or Other Assets Through a Depository Institution Affiliate Agent or Broker

In Regulation W, the Board issued an interpretation (12 C.F.R. 223.26(b)) regarding an IDI's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an IDI grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. However, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee. (See 12 C.F.R. 223.16(c)(2).)

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to "any transaction in which an affiliate acts as an agent or broker or receives a

77. See, for example, SR-97-21.

fee for its services to the institution or any other person" (12 U.S.C. 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 C.F.R. 223.16(b).)

2020.1.12.3 Exemption—Loans to a Nonaffiliate that Purchases Securities from a Depository Institution Securities Affiliate that Acts as a Riskless Principal

The Board has granted an exemption in Regulation W from section 23A of the FRA for extensions of credit by an IDI to customers who use the loan proceeds to purchase a security that is issued by a third party through a broker-dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans that a depository institution makes to borrowers to engage in riskless-principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution. This exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 C.F.R. 223.16(c)(1) and (2).)

2020.1.12.4 Exemption—Depository Institution Loan to a Nonaffiliate Pursuant to a Preexisting Line of Credit and the Proceeds Are Used to Purchase Securities from the Institution's Broker-Dealer Affiliate

The Board approved an exemption in Regulation W from section 23A for loans by an IDI to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker-dealer affiliate. In more detail, the Board exempted extensions of credit by an IDI to its customers that use the credit to purchase securities from a registered broker-dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 C.F.R. 223.16(c)(3).)

2020.1.12.5 Exemption—Credit Card Transactions

Regulation W also provides an exemption from section 23A's attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member institution that is widely accepted by merchants that are not affiliates of the institution (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the institution. Extensions of credit to unaffiliated borrowers pursuant to special-purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member institution) are subject to the rule.

The credit card exemption includes several different methods that are provided for a member institution to demonstrate that its credit card meets the 25 percent test. First, if a member institution has no commercial affiliates (other than those permitted for an FHC under section 4 of the BHC Act), the institution would be deemed to satisfy the 25 percent test if the institution has no reason to believe that it would fail the test. (A member institution could use this method of complying with the 25 percent test even if, for example, the institution's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member institution would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. *Most BHCs and FHCs should meet this test.* If an IDI has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the institution would be deemed to satisfy the 25 percent test if—

1. the institution establishes systems to verify compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test or
2. the institution presents information to the Board demonstrating that its card would comply with the 25 percent test. (One way that a member institution could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the institution's affiliates are less than 25 percent of the total purchases by cardholders.)

Second, for those member institutions that fall out of compliance with the 25 percent test, there is a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, member institutions that are required to validate their ongoing compliance with the 25 percent test have a fixed method, time frames, and examples for computing compliance.

Example of calculating compliance with the 25 percent test. A member institution seeks to qualify a credit card as a general-purpose credit card under section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member institution assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2008, however, the member institution determines that, for the 12-calendar-month period from June 1, 2007, through May 31, 2008, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member institution. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2008, the card will cease to qualify as a general-purpose credit card as of September 1, 2008. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member institution would become covered transactions at such time.

2020.1.13 AN IDI'S ACQUISITION OF AN AFFILIATE THAT BECOMES AN OPERATING SUBSIDIARY

Section 223.31 (a)-(c) of the rule provides guidance to an IDI that acquires an affiliate. The first situation is when an IDI directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the IDI for the affiliate's assets (if any) plus the amount of any liabilities assumed by the IDI in the transaction.

Regulation W provides that the acquisition by an IDI of a company that was an affiliate of the IDI before the acquisition is treated as a purchase of assets from an affiliate if (1) as a result of the transaction, the company becomes an operating subsidiary of the IDI and (2) the company has liabilities, or the IDI gives cash or any other consideration in exchange for the securities. The rule also provides that these transactions must be valued initially at the sum of (1) the total amount of consideration given by the IDI in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the IDI. In effect, the rule requires IDIs to treat such share donations and purchases in the same manner as if the IDI had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the IDI for the shares). See 12 C.F.R. 223.31.

Similarly, when an affiliate donates a controlling block of an affiliate's shares to an IDI, a covered transaction occurs if the affiliate has liabilities that the IDI assumes. For example, the parent holding company of an IDI contributes between 25 percent and 100 percent of the voting shares of a mortgage company to the IDI.

The parent holding company retains no shares of the mortgage company. The IDI gives no consideration in exchange for the transferred shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. The mortgage company's assets do not include any loans to an affiliate of the IDI or any other asset that would represent a separate covered transaction for the IDI upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the IDI. The transaction is treated as a purchase of the assets of the mortgage company by the IDI from an affiliate under paragraph (a) of section 223.31. The IDI initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at $100,000. However, if the member bank sells $15,000 of the transferred assets of the mortgage company or if $15,000 of the transferred assets amortize, the IDI may value the covered transaction at $85,000.

A similar situation is when an IDI acquires an affiliate by merger. Because a merger with an affiliate generally results in the IDI's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the IDI for the affiliate's assets (if any) plus the amount of any liabilities assumed by the IDI in the transaction.[78]

The assets and liabilities of an operating subsidiary of an IDI are treated in the rule as assets and liabilities of the IDI itself for purposes of section 23A.[79] The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the IDI was an affiliate of the IDI before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets from an affiliate. Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the IDI through the transfer.

If an IDI purchases, or receives a donation, of a partial interest in an entity that remains an affiliate, that transaction is treated as a purchase of, or investment in securities issued by an affiliate. This type of transaction is valued according to its purchase price or carrying value. (See 12 C.F.R. 223.23.)

2020.1.14 STEP-TRANSACTION EXEMPTION (SECTION 223.31(d) AND (e))

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when an affiliate owned the transferred company for a limited period of time. Regulation W provides an exemption when a company acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's subsidiary IDI. For example, a bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary IDI of the holding company notifies its appropriate federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the IDI. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the IDI's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the IDI at the time of the transfer. This transfer by the holding company to the IDI, although deemed an asset purchase by the IDI from an affiliate under paragraph (a) of section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

The rule exempts these "step" transactions under certain conditions. First, the IDI must acquire the target company immediately after the company became an affiliate (by being

78. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

79. Because an IDI usually can merge a subsidiary into itself, transferring all the shares of an affiliate to an IDI often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered-transaction amount would be equal to the total amount of liabilities assumed by the IDI.

acquired by the bank's holding company, for example). The IDI must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the IDI and when the IDI is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the IDI must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the IDI, of its intent ultimately to acquire the target company.

Regulation W requires that the IDI consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the IDI acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the IDI acquires the target company and more like two separate transactions, the latter of which involves the IDI acquiring assets from an affiliate.

The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits IDIs to avail themselves of the step-transaction exemption if the IDI acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the IDI has approved the longer time period.

The 100 percent ownership requirement (that the IDI must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good assets of the target company and transferring the bad assets to the holding company's subsidiary IDI. If a banking organization cannot meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule's internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

2020.1.14.1 Application of Sections 23A and 23B of Subpart G to U.S. Branches and Agencies of Foreign Banks

2020.1.14.1.1 Applicability of Sections 23A and 23B to Foreign Banks Engaged in Underwriting Insurance, Underwriting or Dealing in Securities, Merchant Banking, or Insurance Company Investment in the United States.

By its terms, sections 23A and 23B of the FRA do not apply to the U.S. branches, agencies, or commercial lending offices of foreign banks. The Board, however, used the authority granted to it by the Gramm-Leach-Bliley Act to impose restrictions on transactions between the branches, agencies, and lending offices and any affiliate of the foreign bank that operates in the United States in order to ensure that such transactions met certain prudential standards and provided competitive equality with U.S. banking organizations. The Board accomplished these goals by imposing the definition of affiliates within sections 23A and 23B on transactions between the branches, agencies, and lending offices and those affiliates if the company is also

1. directly engaged in the United States in certain activities. These activities are significant because a U.S. bank cannot engage in these activities directly or through an operating subsidiary and the 23A and 23B limitations help ensure competitive equality between U.S. banks and foreign banks. These activities are as follows:
   - Insurance underwriting pursuant to section 4(k)(4)(B) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(B));
   - Securities underwriting, dealing, or market making pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 USC 1843(k)(4)(E));
   - Merchant banking activities pursuant to section 4(k)(4)(H) of the Bank Holding Company Act (12 USC 1843(k)(4)(H)) (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);
   - Insurance company investment activities pursuant to section 4(k)(4)(I) of the Bank Holding Company Act (12 USC 1843(k)(4)(I)); or

   - Any other activity designated by the Board.
2. a portfolio company (as defined in the merchant banking subpart of Regulation Y (12 CFR 225.177(c)) controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the branch, agency, or commercial lending company of the foreign bank under paragraph (a)(9) of section 223.2 if such branch, agency, or commercial lending company were a member bank; or
3. a subsidiary of an affiliate as described in paragraph (b)(1) or (2) of section 223.61.

Regulation W also provides that for purposes of subpart G, the "capital stock and surplus" of a U.S. branch, agency, or commercial lending company of a foreign bank will be determined by reference to the capital of the foreign bank as calculated under its home-country capital standards.

2020.1.15 SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transaction with an affiliate, but excludes banks from the term "affiliate" as that term is defined in section 23A.

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between an IDI and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on an IDI's purchase, as fiduciary, of assets from an affiliate unless certain criteria are met; (3) a restriction on an IDI's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that an IDI will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B.

The following transactions with affiliates are covered by section 23B:

1. Any covered transaction with an affiliate.
2. The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase.
3. The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.
4. Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the institution or to any other person.
5. Any transaction or series of transactions with a nonaffiliate if an affiliate
   - has a financial interest in the third party or
   - is a participant in the transaction or series of transactions.

Any transaction by an IDI or its subsidiary with any person is deemed to be a transaction with an affiliate of the institution if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate. An IDI and its subsidiaries may engage in transactions covered by section 23B of the FRA, but only on terms and under certain circumstances, including credit standards, that are substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If comparable transactions do not exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonfinancial companies.

Section 23B restricts the following transactions with affiliates:

1. An IDI or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted (1) under the instrument creating the fiduciary relationship, (2) by court order, or (3) by law of the jurisdiction creating the fiduciary relationship.
2. An IDI or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the institution. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the institution. The purchase should be based on a determination that it is a sound investment for the

institution, irrespective of the fact that an affiliate is a principal underwriter of the securities.

2020.1.15.1 Transactions Exempt from Section 23B of the Federal Reserve Act

The market-terms requirement of section 23B applies to, among other transactions, any "covered transaction" between an IDI and an affiliate.[80] Section 23B(d)(3) makes clear that the term "covered transaction" in section 23B has the same meaning as the term "covered transaction" in section 23A, but does not include any transaction that is exempt under section 23A(d). For example, transactions between sister banks and IDIs that are part of a chain banking organization are exempt from section 23B;[81] Also exempt are transactions that are fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation.[82] Consistent with the statute, Regulation W's section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).[83]

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed IDI and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the IDI involved in the transaction should ensure that the terms of the transaction are not unfavorable to the IDI.

2020.1.15.2 Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit an IDI to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the IDI (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the IDI regardless of the fact that an affiliate of the IDI is a principal underwriter of the securities.[84] Section 223.53(b) includes this standard and clarifies that if an IDI proposes to make such a securities purchase in a fiduciary capacity, then the directors of the IDI must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the IDI is acting as fiduciary.

An IDI may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that an IDI also satisfies this director-approval requirement if a majority of the IDI's directors approve appropriate standards for the IDI's acquisition of securities otherwise prohibited by section 23B(b)(1)(B), and each such acquisition meets the standards adopted by the directors. In addition, a majority of the IDI's directors must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the "sound investment" criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the IDI's program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed IDIs, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval. The rule codifies staff's preexisting approach to the director-approval requirement.

2020.1.15.3 Definition of Affiliate under Section 23B

Section 23B states that the term "affiliate" under section 23B has the meaning given to such terms in section 23A, except that the term "affiliate" under section 23B does not include a

80. 12 U.S.C. 371c-1(a)(2)(A).

81. Although transactions between banks are exempt from section 23B, the safety-and-soundness provisions of section 23A(a)(4) apply and generally require that transactions be conducted on terms similar to those terms and standards outlined in section 23B.

82. 12 U.S.C. 371c-1(d)(3).

83. Regulation W will again be subsequently referred to as the "rule" or by its specified section-numbered discussion of section 23B provisions.

84. See 12 U.S.C. 371c-1(b)(2).

"bank," as defined in section 23A. In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are IDIs.

2020.1.15.4 Advertising and Guarantee Restriction

In section 23B(c), the "advertising restriction" prohibits an IDI from publishing any advertisement or entering into any agreement stating or suggesting that the IDI shall in any way be responsible for the obligations of its affiliates. Regulation W clarifies this restriction to permit such guarantees and similar transactions if the transaction satisfies the quantitative and collateral restrictions of section 23A. The rule also clarifies that section 23B(c) does not prohibit an IDI from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

2020.1.16 INSPECTION OBJECTIVES

1. To analyze and assess the financial impact of transactions (including loans and purchases of assets) between the IDIs and their subsidiaries and all affiliates.
2. To ascertain if all:
   a. credit transactions are properly secured; and
   b. covered transactions are consistent with the quantitative limits of section 23A.
3. To ascertain whether the IDIs are calculating credit exposure resulting from derivatives and securities borrowing and lending transactions. Also, to ascertain that any credit exposure is secured.
4. To determine if an IDI has engaged in a transaction with a third party when the proceeds are used for the benefit of, or transferred to, an affiliate.
5. To determine if an IDI has procedures for allowing intraday credit.
6. To determine whether covered transactions between a subsidiary IDI (and its subsidiaries), its holding company, and other affiliates are conducted consistent with the quantitative and collateral requirements of sections 23A and 23B of the FRA and Regulation W.
7. To determine if transactions between a subsidiary IDI and its affiliates in the holding company are on terms and conditions and under circumstances, including credit standards, are consistent with safe and sound banking practices and whether the terms and conditions of the transactions are the same as those that would be offered or applied to nonaffiliated companies.
8. To determine whether a subsidiary IDI or its subsidiary
   a. has purchased low-quality assets or
   b. has purchased, as fiduciary, any securities or other assets from an affiliate in the holding company.
9. To determine whether a subsidiary IDI, or any subsidiary or affiliate of the IDI, has published any advertisement or has entered into any agreement that states or suggests that it will, in any way, be responsible for the obligations of affiliates.
10. To determine if securities were purchased or acquired by the subsidiary IDI or its subsidiaries from an underwriting or selling syndicate affiliated with the IDI and, if so, if the majority of outside directors of the IDI approved the purchase or acquisition of securities before they were offered for sale to the public.
11. To confirm that the subsidiary IDI or its subsidiary has not purchased as fiduciary any securities or other assets from a nonbank affiliate in the holding company unless the purchase was permitted in accordance with the instrument creating the fiduciary relationship, by court order, or by the law governing the fiduciary relationship.
12. To ascertain if any subsidiary IDI (or its subsidiary) had knowingly purchased or acquired any security from an affiliate in which the principal underwriter of that security was a nonbank affiliate within the holding company organization.
13. To determine if the subsidiary IDI and its subsidiaries have conducted transactions with their parent holding company or any other company affiliated in the holding company organization that are not in compliance with the restrictions in sections 23A and 23B of the FRA or Regulation W.

2020.1.17 INSPECTION PROCEDURES

1. During the pre-inspection, perform the following activities:

a. Review examination reports of subsidiary IDIs for comments on loans to affiliates, intercompany transactions, other transactions with affiliates, and violations of the restrictions of sections 23A or 23B of the FRA, or Regulation W.
b. Review the most current FR Y-8 (The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates).

2. In the officer's questionnaire, request a list of subsidiary IDIs and their subsidiaries' transactions with affiliates since the previous inspection, including the amounts, types, and any collateral, consisting of—
   a. loans or extensions of credit to an affiliate, and purchases of extensions of credit from an affiliate;
   b. a purchase or sale of an investment in securities issued by, or sold to, the affiliate, or purchase or sale of other assets, including assets subject to an agreement to repurchase;
   c. the acceptance of securities or other debt instrument issued by the affiliate as collateral security for a loan or extension of credit;
   d. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit on behalf of an affiliate;
   e. a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate;
   f. a derivative transaction, as defined in 12 U.S.C. 84(b), with an affiliate, to the extent that the transaction causes an IDI or a subsidiary to have credit exposure to the affiliate.
   g. the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;
   h. transactions in which an affiliate acts as agent or broker or receives a fee for its services to the bank or to any other person;
   i. any transaction or series of transactions with a third party if—
      (1) the affiliate has a financial interest in the third party or
      (2) the affiliate is a participant in such transactions; and
   j. Any transaction by a subsidiary bank or its subsidiary with any person, if the proceeds of that transaction are used for the benefit of, or transferred to, the affiliate.

3. During the BHC's inspection, perform the following activities:
   a. Review the bank holding company's policies and procedures regarding intercompany transactions of subsidiary banks.
   b. Determine if the substantive transactions of the holding company organization comply with the restrictions on transactions with affiliates in sections 23A and 23B of the FRA and Regulation W.
   c. Verify that covered transactions count against Regulation W's limits and are collateralized when required.
      (1) Ensure that covered transactions are properly valued and adequately collateralized;
      (2) Review collateral documentation to ensure that a lien is adequately perfected and prioritized.
      (3) Review all related documentation, terms, conditions, and circumstances for each transaction, including any resolutions for securities purchased (or established standards for securities purchased from affiliates).
      (4) Determine the purpose and use of the transaction's proceeds.
   d. Review all outstanding guarantees, endorsements, or pledge agreements by the bank to support the affiliates' borrowings.
   e. Review, on a test-sample basis, advertisements and written agreements to ascertain whether the bank or any subsidiary or affiliate of the bank has stated or suggested that it shall be responsible for the obligations of any affiliates in the holding company organization.
   f. If the BHC engages in derivative transactions with affiliates, review the BHC's policies and procedures to determine if credit limits, collateral restrictions, and other limitations (each affiliate and all affiliates combined) have been imposed on interaffiliate derivative transaction (IDI) exposures to affiliates.
      (1) Determine if the limits are similar to those imposed on nonaffiliated counterparties.
   g. Review the listed transactions of the BHC or its subsidiary with the affiliates

that the IDI claims are exempt under 12 C.F.R. 223.42(k) provided in response to the officer's questionnaire (item 2). Determine if

(1) extensions of credit, and purchases of extensions of credit, are supported by independent credit evaluations and if advance loan commitments are provided before the affiliates make loans;
(2) no blank advance purchase commitments exist to purchase loans; and
(3) the purchases meet the quantitative restrictions of the exemption.

4. Give additional attention to the following problems involving the BHC and its subsidiaries:
   a. The subsidiary IDI would not have made the loan or would not have made the loan with such favorable terms and conditions, or engaged in any other covered transaction, except for the parent holding company's insistence due to the affiliate relationship.
   b. The IDI's condition is weakened due to the extension of credit or the nature of the transaction with the affiliate.
   c. The affiliate has not provided adequate qualifying collateral to support the loan or extension of credit provided by the subsidiary IDI.
   d. The IDI does not have a perfected security interest in the collateral.
   e. The loan, extension of credit, or transaction with an affiliate is not in compliance with the limits and restrictions in sections 23A or 23B of the FRA or Regulation W.
   f. Purchases of low-quality assets by a subsidiary bank or its subsidiaries from an affiliate, unless previously exempted by the Board's Regulation W, Board order, or unless the IDI subsidiary or subsidiary affiliate, pursuant to an independent credit evaluation, had committed itself to purchase the low-quality assets before the time such asset was acquired by the affiliate.
   g. During the existence of any underwriting or selling syndicate, a subsidiary IDI or its subsidiary has purchased or acquired a security from an IDI affiliate or bank holding company affiliate, including an affiliated broker-dealer, and the principal underwriter of that security is an affiliate of the IDI.
   h. The purchase or acquisition of securities (1) was not approved by a majority of the outside board of directors before the IDI's securities were offered for sale to the public and (2) was not, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would have been offered to, or would have applied to, nonaffiliated companies.
   i. The existence of advertisements or agreements that state or suggest that the IDI, its subsidiaries, or affiliate will be responsible for the obligations of its affiliates.
5. Review any checking accounts and IDI statements to check for overdrafts the parent company or any of its nonbank subsidiaries may have with a subsidiary IDI.
6. Review the accounts payable to the subsidiary IDI and other accounts payable accounts for servicers, contractors, lessors, and other affiliates to determine if they arose as the equivalent of an extension of credit, purchase of securities or other assets, or as a liability to third parties. Ascertain whether those transactions were listed in response to the officer's questionnaire and whether the transactions were in accordance with the restrictions in sections 23A and 23B of the FRA and Regulation W.
7. Review the accounts receivable from the subsidiary IDI and other accounts receivable of other affiliates for sales of securities or other assets and for the payment of money or the furnishing of services. Ascertain whether those transactions were reported in response to an officer's questionnaire and whether they are in accordance with section 23A and 23B of the FRA's and Regulation W's restrictions placed on transactions with affiliates.
8. Ascertain if the IDI's credit limits, collateral requirements, and monitoring of its exposures to affiliates are at least as strict as those it imposes on unaffiliated companies.
9. Determine if the IDI has policies and procedures to monitor and control its intraday credit exposure to each affiliate and to all affiliates in the aggregate.
10. Determine if the IDI's intraday extensions of credit to affiliates are on comparable market terms and if they comply with section 23B of the FRA.

11. Review all other transactions that the holding company organization has engaged in with its affiliated IDIs and their subsidiaries, including lease arrangements, to determine whether they are subject to the restrictions in sections 23A and 23B and Regulation W, and, if so, whether they are in compliance.
12. Discuss the findings with appropriate senior management and, if the findings are significant, the board of directors.
13. Determine management's corrective actions regarding any comments raised by the bank's primary regulator in an examination report.
    a. If violations are disclosed in a subsidiary bank's examination report or during an inspection of the holding company, the examiner may criticize management on the "Examiner's Comments and Matters Requiring Special Board Attention" page or section of the inspection report for causing the bank to be in violation or for engaging in unsafe and unsound practices.
    b. If loans to or transactions with affiliates within the holding company organization appear to adversely affect a subsidiary bank, request management's assessment of such effects and its rationale for the transactions. Use of the "Examiner's Comments and Matters Requiring Special Board Attention" report page or section may be appropriate.

2020.1.18 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*FRRS*[3]	*Orders*
Regulation W		223		
Treatment of transactions with financial subsidiaries of banks	371c(e), FRA section 23A	208.73(d)	3-383.1	
Limitations on amount—loans secured by paper eligible for rediscount or purchase by a Federal Reserve Bank	371c, FRA section 23A(c)	223.14(b)(i)(C)		
Applicability to FDIC-insured banks	1828(j), FDIA section 18(j)		1-398	
Restrictions on transactions with affiliates	371c-1, FRA section 23B		3-1116	
Market terms requirement—derivative transactions with affiliates		223.33		
Intraday extensions of credit by insured depository institutions to their affiliates		223.42(l)		
Exemptions-loans and extensions of credit by member bank to a third party		223.16(c)(3)		
Securities issued by an affiliate cannot be used as collateral for a loan to any affiliate	1813, Dodd-Frank Act 371c(c)(4)			
Credit exposure resulting from a derivative transaction with an affiliate is a covered transaction	371c(b)(7)(G)			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2010, this section was revised to include a cross reference to section 2010.2.7 of this manual, which discusses loan participations. References in the table of Laws, Regulations, Interpretations, and Orders have also been updated.

It is common practice for a bank to sell to or place with other banks loans that the bank itself has made to its customers. A loan participation is a share or part of a loan which entitles the holder to a pro rata share of the income determined by the extent of the holder's contribution to the original loan and a preference ordering for repayment. Such loans may be sold outright without liability to the selling bank in case of default by the borrower, or they may be sold with terms granting the purchasing bank recourse to the selling bank should the loans become uncollectible. Sales to or placement of loans with other banks are for the accommodation of either the selling or purchasing bank and are arranged for purposes of increasing the rate of return when loan rates differ between banks, achieving diversification of loans by type, and altering liquidity positions. It is also common practice for banks to sell or place with other banks those portions of individual loans that would be in excess of the bank's legal lending limit (overlines) if the total loan were retained. Participations of this type should be placed without recourse as a matter of prudent banking practice; otherwise, the purpose of compliance with the legal lending limitations would be defeated in the event of default. See section 2010.2.7 of this manual for supervisory and accounting guidance regarding a BHC's or bank's use, purchase, or sale of loan participation agreements.

Banks also sell or place loans or participations with their parent holding companies or nonbank affiliates. A BHC's purchase of loan participations from its subsidiary bank(s) generally constitutes the making of a loan or extension of credit within the meaning of section 225.28(b)(1) of Regulation Y, and as such, a BHC needs prior approval to purchase loan participations from its subsidiary bank(s).

A bank may participate in or purchase a loan originated by its parent holding company or one of its nonbank subsidiaries. A subsidiary bank's purchase, or participation of a loan, note, or other asset from an affiliate is considered a purchase of an asset from an affiliate within the meaning of section 23A of the Federal Reserve Act and thus is a ''covered transaction'' that is subject to the quantitative limitations and the prohibition against purchasing of low-quality assets. Subsidiary banks must make independent judgments as to the quality of such participations before their purchase to avoid compromising the asset quality of such banks for the benefit of other holding company entities. All loans and participations must be purchased on market terms.

A bank's purchase of a loan or loan participation, on a nonrecourse basis from an affiliate, may not be a covered transaction under section 23A that is subject to the quantitative limitations (12 C.F.R. 223.11- 223.12)), collateral requirements (12 C.F.R. 223.14), and low-quality asset prohibition (12 C.F.R. 223.15) if

1. the extension of credit was originated by the affiliate;
2. the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;
3. the member bank commits to purchase the extension of credit before the affiliate makes or commits to make the extension of credit;
4. the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate; and
5. the dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased from the affiliate during the preceding 12 calendar months by the member bank and its depository institution affiliates, does not represent more than 50 percent (or such lower percent as is imposed by the bank's appropriate Federal banking agency) of the dollar amount of extensions of credit originated by the affiliate during the preceding 12 calendar months. (See 12 C.F.R. 223.42(k).)

In some cases, a bank may renew a loan or a participation that it purchased from another affiliated bank even when the original participation has become a low-quality asset. In some instances, a bank's renewal of a low-quality asset, such as a troubled agricultural loan, or an extension of limited amounts of additional credit to such a borrower may enable both the originating and participating banks to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a participating bank from using sound banking judgment to take the steps that it may deem necessary to protect itself from harm in such a situation, so long as the loan was not a low-quality asset at the time of the original participation and the participating bank does not assume more than its original proportionate share of the credit.

The following factors thus characterize the situation where it would be reasonable to interpret section 23A as not applying to the renewal of an otherwise low-quality asset:

1. the original extension of credit was not a low-quality asset at the time the affiliated bank purchased its participation,
2. the renewal and/or the extension of additional credit has been approved by the board of directors of the participating bank as necessary to protect the bank's investment by enhancing the ultimate collection of the original indebtedness, and
3. the participating bank's share of the renewal and/or additional loan will not exceed its proportionate share of the original investment by more than 5 percent. In addition, it is expected that, consistent with safe and sound banking practices, the originating bank would make its best efforts to obtain adequate collateral for the loan(s) to further protect the banks from loss. (See 12 C.F.R. 223.15.)

Loans and loan participations by the various members of the holding company family to individual borrowers or to the same or related interests may represent concentrations of credit which are large in relation to the holding company's consolidated capital position. These concentrations of credit should be assessed for potentially harmful exposure to the holding company's financial condition.

2020.2.1 INSPECTION OBJECTIVES

1. To determine the BHC's loan participation policy.
2. To assess the impact of a subsidiary bank's participation in loans with affiliates and to ensure that the bank's financial condition is not compromised and that the bank is not providing the funding needs of the affiliates, except within the parameters of sections 23A and 23B of the Federal Reserve Act.
3. To assess the impact of any concentrations of credit on the holding company's overall financial position.

2020.2.2 INSPECTION PROCEDURES

1. During the preinspection process, review each subsidiary bank's examination report for comments on participations with affiliates.
2. In the officer's questionnaire to the holding company, request the BHC's policy on loan participation. Request a list of any loan participations the holding company or the nonbank subsidiaries have with the subsidiary bank(s).
3. During the inspection, review the policy statements and each participation the holding company or the nonbank subsidiaries have with the subsidiary bank(s). The following characteristics should be analyzed:
   a. any repetitive transaction patterns which may indicate policy;
   b. the adequacy of credit information on file;
   c. the extent to which the terms of the participation including interest rates are handled in an arm's-length manner;
   d. the degree that the bank is accommodating the funding needs of the nonbank subsidiaries or its parent;
   e. the impact of these transactions on the subsidiary bank;
   f. eligibility for exclusion from section 23A restrictions and, if applicable, compliance with such restrictions.
4. Review participations among the bank holding company, nonbank subsidiaries, and the subsidiary banks to determine potentially adverse concentrations of credit.
5. Discuss with management—
   a. written and verbal policies regarding participations both within the holding company and with nonaffiliated third parties and
   b. any adverse findings on intercompany participations.
6. Comment on policy on the appropriate page of the inspection report (see section 5010.6). If any adverse comments on participations with affiliates are contained in a bank subsidiary's examination report, comment on their current status and the BHC's efforts to remedy the problem.

2020.2.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations and restrictions	371c, FRA section 23A(c)			
Purchase of extensions of credit from affiliates		223.42(k)	3–1161	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Sales and transfers of assets between subsidiary banks and other entities in a bank holding company organization pose the potential of risk to the subsidiary banks. Asset purchases are covered by Section 23A and Section 23B of the Federal Reserve Act. The limitations state that all covered transactions, including asset purchases, by a bank with a single affiliate, may not exceed 10 percent of a bank's capital and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital and surplus. In addition, all transactions must be conducted on market terms.

A bank's purchase of a loan or loan participation from a bank holding company or its subsidiary may not be a covered transaction under Section 23A if:

1. the bank makes an independent credit evaluation on each loan prior to the affiliate making the loan;
2. the bank agrees to purchase the loan prior to the affiliate making the loan; and
3. the bank's purchase of the affiliate's loans is not the primary source of funding for the affiliate.

Sale and transfer of assets can also occur through swaps and spinoffs. Examples of such transactions which may have an adverse effect on a bank include the transfer of a profitable activity or subsidiary from the bank to the holding company, or the transfer of an unprofitable activity or subsidiary from the holding company to the bank. In addition, the transfer of a bank holding company subsidiary to a bank, whereby the bank assumes the liabilities of the affiliate raises supervisory concerns and may violate Sections 23A and 23B of the Federal Reserve Act.

Another example is the transfer of a subsidiary bank's deferred taxes, together with an equivalent amount of cash or earning assets, to the parent. In such a transaction, a subsidiary bank's liquidity position is weakened. All such transfers of deferred taxes must be reversed and the bank's asset and liability accounts restored to their level prior to the transfer. For a detailed discussion on transfers of a bank's deferred tax liability, see Manual section 2070.0.

A bank holding company may transfer a liquidating asset from a subsidiary bank to a section 4(c)(1)(D) liquidating subsidiary of the holding company. Also, pursuant to section 4(c)(3) of the Act, a BHC may transfer from a subsidiary bank an asset to be disposed of pursuant to the request of the bank's primary regulator. For more information on the transfer of such assets and the time parameters involved, refer to Manual section 3030.0.

The purchase of low-quality assets is prohibited by Section 23A of the Federal Reserve Act. Refer to section 2020.1.1.5 for a listing of transactions that are exempt from the limitations of Section 23A of the Federal Reserve Act.

2020.3.1 INSPECTION OBJECTIVES

1. To review intercompany sale and transfer of assets to assess the impact on the subsidiary bank.
2. To initiate corrective action to reverse the transaction, if necessary.

2020.3.2 INSPECTION PROCEDURES

1. During the preinspection process, review all notes to financial statements, the FR Y-8 report, and the examination reports of subsidiary banks to ascertain whether any purchase or transfer of assets has occurred between the subsidiary banks and the parent holding company or nonbank subsidiaries.
2. In the officer's questionnaire, request information on any transfer or sale of assets between the subsidiary bank and the parent holding company or the nonbank subsidiaries.
3. During the inspection, review all facts regarding any sale or transfer of assets transactions and assess their impact on the subsidiary bank. Examiners should determine:
   a. Whether the transaction required and received the approval of the bank's primary regulator; and
   b. The quality of the assets transferred or sold, and whether the sale of the assets was at a price significantly higher than would have been realized in an arm's-length transaction.
4. Discuss findings with management including:
   a. Apparent prejudicial transactions and violations of regulations; and
   b. Any unsound practices.

A compensating balance is a deposit maintained by a firm at a bank to compensate the bank for loans and lines of credit granted to the firm. Often, a commercial bank, when extending credit, requires an average deposit balance equal to a fixed percentage of the outstanding loan balance. Compensating balance requirements vary from informal understandings to formal contracts. Deposits maintained as compensating balances may be demand or time, active or dormant. Frequently, a lending bank will allow compensating balances to be supplied by a depositor other than the borrower itself. If compensating balances are maintained by a BHC's subsidiary bank on behalf of its parent, the practice is considered a diversion of bank income (i.e., the bank loses the opportunity to earn income on the balances that could be invested elsewhere). In general, this practice is inappropriate unless the bank is being compensated at an appropriate rate of interest. If the bank is not being appropriately reimbursed, the practice should be criticized and action taken to insure that the bank is compensated for the use of its funds.

BHCs borrow directly from nonaffiliated banks, using the proceeds for both bank and nonbank operations and investments. Also, bank holding companies seek credit lines from banks to back their borrowings in commercial paper markets and for other liquidity purposes. Nonbank subsidiaries of bank holding companies borrow from banks to fund activities such as mortgage banking, leasing and sales finance. In some cases, when a bank holding company or its nonbank subsidiaries borrow, the subsidiary bank's deposit at the lending institution may be accepted as a compensating balance for the borrowings of other members of the bank holding company organization. Such transactions raise questions under Section 23B of the Federal Reserve Act regarding the bank's compensation for such services.

Often the distinction between correspondent balances and compensating balances is not clear. Occasionally, the rate of the required compensating balance is written into the loan agreement; however, informal understandings usually appear to determine the amount of compensating balance maintained. At times, a balance may be identified in the bank's books as a compensating balance. A compensating balance may also be identified as an amount above a correspondent balance historically maintained by the bank. Compensating balances may also appear as a dormant account or may be the aggregate amount of a number of deposits of various subsidiary banks.

The interest rate on the loan to the holding company organization may also be helpful in determining the existence of compensating balances. Loans below the lending bank's normal rate may indicate that the lending bank is receiving compensation in another form.

At times, excess correspondent balances are maintained to encourage participation relationships and for other goodwill reasons. Therefore, the existence of excess balances may not always indicate that there is a compensating balance agreement.

Although a bank holding company may compensate its subsidiary banks for the use of the funds, the compensation may not equal the opportunity cost associated with providing the compensating balance. As a result, subsidiary banks which maintain compensating balances for holding company members may forego profit opportunities, and this practice may have a negative impact on the bank's earnings and capital adequacy. The amount of such compensation should be equal to a fair market rate.

If the lending bank has the right of offset to compensating balances maintained by the subsidiary bank in case of default by parent or nonbank subsidiaries, the subsidiary bank's funds are jeopardized. Such potential loss of funds should be commented on by the examiner.

2020.4.1 INSPECTION OBJECTIVES

1. To identify compensating balances maintained by a subsidiary bank for the parent holding company or any nonbank affiliate.
2. To determine whether the subsidiary bank is adequately reimbursed for the maintenance of any compensating balances.

2020.4.2 INSPECTION PROCEDURES

1. During the preinspection process:
   a. Review the subsidiary bank examination reports or contact management to determine whether the non-affiliated banks, lending to the holding company organization, are correspondents of the subsidiary banks. Where applicable, request detailed loan information which could

provide information on the compensating balances' terms required by the lending bank.

b. Review the notes to the financial statements and other available material, such as 10–K reports filed with the SEC, which may describe compensating balance agreements. FR Y–8 reports should be reviewed for questions applicable to compensating balances.

2. Review interbank loan agreements to determine whether compensating balances are formally required. Assess the terms of the loan to determine whether the loan appears to be at fair market rates for this type of credit request.

3. Request and review the account balance and monthly account statement provided by the lending bank to identify the amount of compensating balances. The statement should be available within the holding company or bank.

4. Request from management information regarding compensating balances maintained by subsidiary banks for the benefit of other affiliates.

5. Review the subsidiary bank's historical level of correspondent balances to assess trends. Compare levels of balances prior to any loan origination or interest rate changes.

6. Review intercompany accounts to determine the amount of compensation paid to the subsidiary bank for maintaining compensating balances. Assess adequacy of compensation. Assess impact of practice on the bank's financial condition.

7. Discuss with management the reasons for any apparent excess balances, and whether compensating balances are formally or informally required.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2012, this section was revised to update the references within the table of Laws, Regulations, Interpretations, and Orders.

Dividends are a means by which a corporation distributes earnings or assets to its shareholders. Although the word "dividends" usually applies to funds paid out of net profits or surplus and is usually thought of in such a context, dividends can also be made "in kind," which means in property or commodities. This section does not discuss "stock dividends" which represent transfers from retained earnings to paid-in capital rather than distributions of earnings. Dividends from the subsidiaries, both bank and nonbank, to the parent company are the means by which a cash return is realized on the investment in subsidiaries, thus enabling the parent to pay dividends to its shareholders and to meet its debt service requirements and other obligations.

Dividends paid by any corporation are generally limited by certain State laws. Banks, however, are subject to further legal restrictions on dividends by their chartering authority and other regulators. Aside from the statutory limitations, the primary consideration in this area is the subsidiary's level of capital and its ability to meet future capital needs through earnings retention.

Although there are no specific regulations restricting dividend payments by bank holding companies other than State corporate laws, supervisory concern focuses on the holding company's capital position, its ability to meet its financial obligations as they come due, and its capacity to act as a source of financial strength to its subsidiaries. Some one-bank holding companies may be restricted in the amount of dividends they may pay as a result of certain limitations placed on future dividend distributions at the time of the holding company's formation. (see Manual section 2090.2)

When analyzing the dividend practices of the subsidiaries and the parent company the following must be considered: the present level of capital in relation to total assets, risk assets, and classified assets; growth rates and additional plans for expansion; past earnings performance and projections; and the ability to service debt.

Aside from reasonable and timely fees for services rendered, the most appropriate way for funds to be paid by the bank to the parent is through dividends. This principle applies, in general, to bank payments of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is not considered an appropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.5.1 POLICY STATEMENT ON CASH DIVIDEND PAYMENTS

On November 14, 1985 the Board approved a policy statement on the payment of cash dividends by state member banks and *bank holding companies that are experiencing financial difficulties.* The policy statement addresses the following practices of supervisory concern by institutions that are experiencing earnings weaknesses, other serious problems, or that have inadequate capital:

- The payment of dividends not covered by earnings,
- The payment of dividends from borrowed funds,
- The payment of dividends from unusual or nonrecurring gains, such as the sale of property or other assets.

It is the Federal Reserve's view that an organization experiencing earnings weaknesses or other financial pressures should not maintain a level of cash dividends that exceeds its net income, that is inconsistent with the organization's capital position, or that can only be funded in ways that may weaken the organization's financial health. In some instances, it may be appropriate to eliminate cash dividends altogether. The policy statement is as follows:

2020.5.1.1 Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies

The Board of Governors of the Federal Reserve System considers adequate capital to be critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a bank's or bank holding company's capital adequacy is the strength of its earnings and the extent to which its earnings are retained and added to capital or paid out to shareholders in the form of cash dividends.

Normally, during profitable periods, dividends represent an appropriate return of a portion of a banking organization's net earnings to its shareholders. However, the payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, the Board believes that a bank or bank holding company generally should not maintain its existing rate of cash dividends on common stock unless 1) the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends *and* 2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious consideration to cutting or eliminating its dividends. Such an action will help to conserve the organization's capital base and assist it in weathering a period of adversity. Once earnings have begun to improve, capital can be strengthened by keeping dividends at a level that allows for an increase in the rate of earnings retention until an adequate capital position has been restored.

The Board also believes it is inappropriate for a banking organization that is experiencing serious financial problems or that has inadequate capital to borrow in order to pay dividends since this can result in increased leverage at the very time the organization needs to reduce its debt or increase its capital. Similarly, the payment of dividends based solely or largely upon gains resulting from unusual or nonrecurring events, such as the sale of the organization's building or the disposition of other assets, may not be prudent or warranted, especially if the funds derived from such transactions could be better employed to strengthen the organization's financial resources.

A fundamental principle underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as a source of managerial and financial strength to their subsidiary banks. The Board believes, therefore, that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of bank subsidiaries, or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a source of strength. Thus, for example, if a major subsidiary bank is unable to pay dividends to its parent company—as a consequence of statutory limitations, intervention by the primary supervisor, or noncompliance with regulatory capital requirements—the bank holding company should give serious consideration to reducing or eliminating its dividends in order to conserve its capital base and provide capital assistance to the subsidiary bank. . . .

This statement of principles is not meant to establish new or rigid regulatory standards; rather, it reiterates what for most banks, and businesses in general, constitutes prudent financial practice. Boards of directors should continually review dividend policies in light of their organizations' financial condition and compliance with regulatory capital requirements, and should ensure that such policies are consistent with the principles outlined above. Federal Reserve examiners will be guided by these principles in evaluating dividend policies and in formulating corrective action programs for banking organizations that are experiencing earnings weaknesses, asset quality problems, or that are otherwise subject to unusual financial pressures.

2020.5.2 INSPECTION OBJECTIVES

1. To assure compliance with statutes and the Board's November 1985, Policy Statement.
2. To determine reasonableness of dividend payout at both the subsidiary and holding company levels.

Depending on the type of charter and membership in the Federal Reserve, all insured commercial banks are subject to certain legal restrictions on dividends. In the case of nonbank subsidiaries and holding companies, there are no specific federal statutes, other than the policy statements discussed, which apply to dividend payments. State corporate laws would apply.

One objective of the inspection process is to check for compliance with these laws and to follow-up on any violations.

In some cases dividends which comply with the regulations still may not be in the best interest of the bank. It is the examiner's responsibility to assess the reasonableness of dividend payments in relation to each subsidiary's capital needs. Evaluation of the holding company's dividend policy and payment requires a review at both the parent company and the consolidated levels. On a consolidated basis the holding company's capital level in relation to the quantity and quality of total assets, earnings history and potential, and growth rates are important in the assessment of a reasonable dividend payout. At the parent level, the method of funding dividends should be reviewed. For example, a well capitalized corporation with strong earnings might pay dividends which could be considered unreasonable if the organization were in a strained liquidity position.

2020.5.3 INSPECTION PROCEDURES

1. Review dividend payments by subsidiaries and the parent company. Check for compliance with appropriate statutes and the Board's November 14, 1985 policy statement on the Payment of Cash Dividends. Discuss violations with management and comment on the "Examiner's Comments and Matters Requiring Special Attention" page.

This step will often require a review of net earnings and changes in the capital accounts in the past years, as legal restrictions on dividends often apply to cumulative income for several years rather than just the year the dividend is actually paid. For this reason detailed working papers are important, as these can help to avoid duplications of effort at future inspections. In some situations the regulations provide that dividends may be paid in excess of current year's earnings. If prior approval from the bank's primary regulator is necessary, verify that it has been obtained. Any violations of dividend statutes should be discussed with management and cited in the "Examiner's Comments and Matters Requiring Special Attention" page of the inspection report.

2. Analyze dividend payouts of subsidiaries and the parent in terms of capital adequacy, earnings and earnings potential.

Discuss excessive dividend payouts at any level with management and comment on the "Examiner's Comments and Matters Requiring Special Attention" page of the inspection report. In assessing the reasonableness of dividend payments by subsidiaries and the holding company, the organization's capital adequacy and future capital needs must be judged with the following in mind: the volume of total assets; asset quality (the percentage of weighted classified assets to gross capital could be used as an indicator of quality); asset mix and liquidity; asset growth rates and projections; and plans for expansion and development of new areas. The subsidiary's or the holding company's ability to augment capital through earnings is also important. If a bank, nonbank or holding company has a consistently strong earnings record and its capital position is healthy, a higher dividend payout may be acceptable than would be otherwise. In analyzing the strength of earnings both quantity and quality must be considered. The actual quality of earnings and earnings potential are related to operating income rather than extraordinary items, significant capital or securities gains, or substantial increases resulting from tax considerations.

3. Review the funding of dividends paid by the holding company. Analyze the parent's cash flow and income statements in accordance with section 4010.0 of this manual. Discuss any inappropriate funding with management and comment on, based on their severity, either on the "Cash Flow Statement (Parent)," or the "Analysis of Financial Factors" and the "Examiner's Comments and Matters Requiring Special Attention" pages.

An analysis of the parent company's cash flow statement supplemented by the income statement will identify the source of cash for dividend payments. The parent company has cash inflow from various sources including: dividends from subsidiaries, income from activities conducted for its own account, interest income on advances to subsidiaries, management and service fees, borrowings, and tax savings resulting from filing a consolidated tax return. Dividends should be internally funded from dividends paid by the subsidiaries, the parent company's earnings from activities for its own account or from interest income on advances to subsidiaries. Should the analysis of the cash flow statement indicate that dividends paid by the parent exceed cash inflow from these sources, further attention to the area is required to determine the actual underlying source of dividend funding. As discussed in the section on management and service fees, these are properly assessed at market value or cost of services rendered. They are not to be charged simply to divert income from subsidiaries in order to pay dividends. Borrowing to fund dividends is fundamentally an unsound practice.

When dividends paid by the holding company are funded by the bank subsidiary, it is possible to control indirectly the holding company's dividend payout level when it is determined to be detrimental to the bank subsidiary. It is important to remember that the primary responsibility of bank regulators is the promotion of safe and sound banking operations. Other than the mentioned policy statement there are no specific federal laws restricting dividends paid by bank holding companies; however, the System's cease and desist authority over bank holding companies does afford the ability to curb excessive dividend payouts.

Whenever the examiner determines that dividend payments at the subsidiary level or parent level are not reasonable, are not in the best interest of the organization, or are not funded in a proper manner, discussion with management and a close look at its philosophy are essential. Remarks on the matter should appear on the "Examiner's Comments and Matters Requiring Special Attention" page of the report.

2020.5.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Dividend limits for national banks	5199(b)			
Dividend limits	5204			
Dividend limits for State member banks	Section 9, F.R. Act			
Capital limitations and earnings limitations on the payment of dividends by state member banks		208.5	3–160	
Board policy statement on assessment of financial factors, one bank holding companies (para. 4 dividend restrictions)		225 appendix C	4–868	1980 FRB 320
Board policy statement on dividends for banking organizations having financial difficulties			4–877	1986 FRB 26

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Intercompany Transactions (Management and Service Fees) Section 2020.6

A bank holding company is permitted to own nonbank subsidiaries that furnish services to or perform services for its other subsidiaries pursuant to section 4(a)(2)(A), 4(c)(1)(C), or 4(c)(8) of the BHC Act. Many bank holding companies charge fees for providing to their subsidiaries services such as management advice, personnel services, data processing, marketing, supply administration, investment advice, bookkeeping, and trust services. The fees for these services that are assessed against subsidiary banks take many forms and are an area of potential abuse. In addition to direct fees paid to an affiliate, the compensation for providing these services might take the form of salaries or directors' fees paid to the bank holding company's management. A holding company should not, directly or indirectly through other subsidiaries, burden its bank subsidiaries with excessive fees or charge for services unrelated to value received in order to fund its debt service, dividend payments, or support of other subsidiaries.

Examiners should review the fees charged by a holding company's bank and nonbank subsidiaries to any banking subsidiary and judge the reasonableness of those fees by examining the reasonableness of the services provided and the basis for allocating fees. Fees charged nonbank subsidiaries and independent third parties should not be more favorable than fees charged banking subsidiaries. They should be reasonable and justifiable and be based on the fair market value of services provided or, when there is no market established for a particular service, on actual cost plus a reasonable profit. *The market value of similar services is the preferred basis of fee assessment.* When fees are based on cost plus a reasonable profit, there is less incentive for the efficient and effective use of resources, because a profit margin is built in regardless of the costs involved. In many situations, however, the cost method is the only method possible.

Any method of pricing services provided to bank subsidiaries that is based on anything other than value received is inappropriate. The fee mechanism should not be used to divert income from any bank subsidiary to meet the parent's financial needs if those needs are unrelated to the provision of services to that subsidiary. In addition, banks are prohibited from paying management fees* if it would cause the institution to become undercapitalized (see title I, section 131 of the FDIC Improvement Act of 1991 or section 38 of the FDIC Act).

Any fee for services to a banking subsidiary should be supported by evidence that the parent or other affiliate provided the service. Services provided by bank holding companies should serve the needs of the subsidiary bank; charges for services that appear to duplicate existing subsidiary-bank functions should be supported by a detailed explanation of the net benefit derived by the subsidiary bank and by an analysis of the reasonableness of the fee.

When it is impractical to allocate expenses on a direct-charge basis, bank holding companies frequently allocate overhead expenses to subsidiaries. Although this practice can be considered acceptable with regard to nonbanking subsidiaries, allocating all bank holding company expenses to bank subsidiaries is not permitted. The parent company should bear a portion of the costs connected with, for example, the holding company's investor/shareholder relations, regulatory reporting requirements, acquisitions, formations, applications, board of directors, and strategic planning. Bank holding companies are, however, expected to support their subsidiary banks, and expenses incurred to serve the needs of the subsidiary banks, such as expenses incurred in raising capital for subsidiary banks, can appropriately be allocated to those subsidiary banks that benefit from the services provided, in proportion to the benefit received from the service.

All fees for services rendered should be supported by written agreements that describe the service, the fees to be charged, and the method of allocating the fees among the subsidiaries. The absence of such contracts between the subsidiaries of the holding company is considered inappropriate and an unsafe and unsound banking practice. Supervisory action should be taken, in a manner consistent with the financial condition of the holding company and the subsidiary bank, to eliminate the improper practices. The practices should be criticized in the inspection report and actions taken to see that the situation is satisfactorily resolved. If the practices are having a serious impact on the bank, or if they might reasonably be expected to have a severe impact given the bank's financial condition, formal administrative action should be considered in order to require the holding company to terminate the practices and make restitution to the subsidiary bank.

* "Management fees" does not include fees for such services as electronic data processing or auditing.

A bank's prepayment of service fees to the parent company and payment of expenses incurred primarily in conjunction with holding company activities unconnected with the bank also are cause for supervisory concern. In general, prepayment for services is inappropriate unless the bank holding company can demonstrate that prepayment is standard industry practice for nonbanking companies acquiring the same service. Prepayment of sums for services that are not to be provided in the immediate future (for example, prepayment of an entire year's fees for services to be rendered throughout the year) can have an adverse impact on the bank and is therefore inappropriate. These practices should be addressed by requiring timely and reasonable payments for services and reimbursement to the banks for what are essentially holding company expenses. If bank expenses are incurred substantially in support of a holding company activity, the bank should be reimbursed for that portion of its cash outlay that benefits the holding company. Reimbursement is necessary to ensure that bank resources are not diverted to a holding company affiliate with little or no benefit to the bank.

Aside from reasonable and timely fees for services rendered, the most appropriate way, from a supervisory standpoint, for funds to be paid to the parent company is through dividends. This principle applies, in general, to bank payment of funds to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is an inappropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.

2020.6.1 TRANSACTIONS SUBJECT TO FEDERAL RESERVE ACT SECTION 23B

Section 23B of the FRA applies to any covered transaction with an ''affiliate,'' as that term is defined in section 23A of the FRA. Section 23B also applies to a number of transactions that are not covered by section 23A, for example, transactions that involve the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise, or transactions in which an affiliate acts as an agent or a broker or receives a fee for its services. Although transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B, section 23A requires that covered transactions between a bank and an affiliate be conducted at arm's length. See section 2020.1.2 for other transactions that are covered by section 23B and the requirements that pertain to all such transactions. For examples of transactions that could violate section 23B, see section 3700.10, dealing with an application to provide armored car services through a bank holding company's nonbank subsidiary.

2020.6.2 INSPECTION OBJECTIVES

1. To determine whether the holding company and its subsidiaries charge fees to bank subsidiaries based on value received and fair market value.
2. To determine whether the subsidiaries are actually receiving these services.
3. To determine that the timing of fee payments is appropriate.
4. To determine whether there is an agreement between the entities relating to specific services and fees charged.
5. To determine if any fees result in an unsafe or unsound condition in any subsidiary bank.

Once the management policy underlying the fee structure is clearly understood, it is important for the examiner to determine that practice is consistent with policy. For example, if management indicates that fees charged are based on the fair market value of services received but the fee structure is actually geared to the bank subsidiary's asset size, an inconsistency exists. Assuming either that all of the bank subsidiaries have access to the same or similar markets for the services being provided by the bank holding company or that cost is used consistently to determine pricing, the established pricing structure should be used for all subsidiaries. Deviations from established policy intended to channel a greater proportion of income from financially sound banks to financially weak ones should be noted.

When it has been established that the fee structure is reasonable and is consistently followed, a final question remains. Are the bank subsidiaries actually receiving the services for which they are charged? This may be difficult to ascertain in many cases, but serious efforts must be made.

It is important that the basic business principles of an arm's-length transaction be applied to all transactions between banks and their affiliates. This approach provides protection for all the interests involved. In addition, payment should be made within a reasonable time of the rendering of the services. It is inequitable for the bank subsidiary to pay fees far in advance in order to suit the parent's cash needs. A clearly understood agreement between the holding company and its bank subsidiaries detailing the duties and responsibilities of each party and the method to be used for fee assessment is also important to the servicing arrangement.

2020.6.3 INSPECTION PROCEDURES

1. Review and analyze the policy regarding management and other services provided to bank subsidiaries and the method of assessing fees.
2. Determine the basis for valuation.
3. Review the actual pricing structure as it is applied.
4. Verify the following:
   a. Fees are charged in accordance with pricing structure.
   b. Pricing structure is consistently applied for all bank subsidiaries.
   c. Bank subsidiaries are actually receiving services for which they are assessed. Determine whether fee payments have caused the institution to become undercapitalized.
   d. Payments are made in a timely manner.
5. Review examination reports on bank subsidiaries for comments on fee assessment.
6. Analyze the parent company's cash flow and income statements for intercompany fees.
7. Review recordkeeping.

A review of management's written or stated policy regarding services provided subsidiaries and fee assessment is a logical starting point for the analysis of this area. The policy should be discussed with the holding company's officers to ensure that the examiner has a clear understanding of the purpose and basic underlying philosophy. Any policy that calls for fee assessment based on standards other than fair market value or the cost of providing the services requires discussion with management and comment on page 1 of the report.

The determination of fair market value or cost of providing services is the responsibility of the holding company. The examiner should review the market or cost information used to justify the pricing of services and be satisfied that the data presented actually supports the fee structure. Request a copy of the pricing schedule as it is applied, and determine that it is actually based on the valuation of the services received and consistent with stated policy. Any variations from the basic structure among the bank subsidiaries would also require support from the market or cost data furnished.

Once the holding company's policy, valuation data, and pricing structure are analyzed, they should be verified. Check the service at the bank-subsidiary level. The verification process can be modified as deemed appropriate by the examiner.

Note the timing of payment for services. Fees for services should be billed and paid as they are received, just as they would be with an unaffiliated servicer. Prepayments are inappropriate in most cases.

Written service agreements should be in effect specifically detailing the types and extent of services being rendered and the method of pricing. Any significant exceptions found during the verification process merit follow-up and comments in the report.

Thus far, these inspection procedures for management and service fees have emphasized a review of management's stated intent and the actual fees charged on the individual bank-subsidiary level and have been somewhat oriented toward micro-level analysis. An overall view of the parent company's cash flow and income statements can also provide certain indicators of appropriateness of fees. The parent company should be servicing its debt and paying dividends from sources other than management fees and service fees collected from bank subsidiaries. If the ratio of management and service fees to parent-company salaries and other expenses significantly exceeds 100 percent, the holding company could be charging fees that are unrelated to the value of the service. This situation would call for further investigation.

2020.6.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of practice and procedure in reference to unsound banking practices; diversion-of-bank-income practices (SR-79-533, March 19, 1979)			4–876	
Potential violations of section 23B of the Federal Reserve Act:				1993 FRB 352
1. Proposal by a bank holding company to provide armored car services to its banking subsidiary through a de novo nonbank subsidiary. The cost of the service would be more than the cost of armored car services currently received from an unaffiliated provider.				
2. Proposal whereby the bank holding company's de novo nonbanking subsidiary would pay a flat fee based on a percentage of its direct operating expenses to cover all the back-office services provided by the holding company's banking subsidiary.				

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The transfer of low-quality assets to an insured depository institution can be reason for supervisory concern. Such transfers may be made to avoid detection and classification during regulatory examinations, and may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated entities. The donation of an asset with liabilities also is treated as a purchase of assets. An insured depository institution may not purchase a low-quality asset from an affiliate unless, pursuant to an independent credit evaluation, the member bank had committed itself to purchase the asset before the time the asset was acquired by the affiliate. Examiners should be alert to situations where an institution's intention appears to be the concealment of low-quality assets for the purpose of avoiding examination scrutiny and possible classification.

During holding company inspections, examiners should identify situations where low-quality assets have been transferred between the holding company and its subsidiaries and a subsidiary-insured depository institution. Low-quality assets are defined in the Federal Reserve Board's Regulation W (12 CFR 223.3(v)). In general, low-quality assets include assets that are classified or specially mentioned, or if subjected to review would most likely be classified or specially mentioned, including assets classified based on the institution's internal rating system. Low-quality assets also include past due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection. Other assets of questionable quality would include noninvestment grade securities and other real estate owned (OREO). The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and may be a violation of section 23A of the Federal Reserve Act and the Federal Reserve Board's Regulation W that should be addressed through formal supervisory enforcement action, if necessary.

Any situations involving the transfer of low-quality assets to an insured depository institution should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary federal supervisor(s) of the other depository institution(s) involved in the transaction. For example, Reserve Banks should notify the primary federal supervisor of any depository institution to whom a state member bank or holding company is transferring or has transferred low-quality assets. Reserve Banks also should notify the primary regulator of any depository institution from which a state member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations and savings banks, as well as commercial banking organizations.

Legitimate transfers of assets should be properly recorded on the books of the acquiring institution at fair market value. If the transfer was with the parent holding company or a nonbank affiliate, determine that the transaction also should be properly recorded on the books of the affiliate.

2020.7.1 INSPECTION OBJECTIVES

1. To ensure that loan transfers involving state member banks, bank holding companies, savings and loan holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification, and to determine the effect of the transfer on the condition of the institution and to ascertain whether the transfer was consistent with the requirements of section 23A. Under section 23A of the Federal Reserve Act, an asset purchase is a "covered transaction." All "covered transactions" by a bank with a single affiliate and with all affiliates combined may not exceed 10 percent and 20 percent, respectively, of a bank's capital and surplus.
2. To ensure that the primary supervisor of the other financial institution involved in the transfer of low-quality assets is notified.

2020.7.2 INSPECTION PROCEDURES

1. Determine whether assets were transferred prior to the date of examination to avoid possible criticism during the examination.
2. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason were considered to be low-quality assets.

3. Review the institution's policies and procedures to determine whether assets or participations purchased are given an independent, complete and adequate credit evaluation. If a bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the organization to determine if the asset purchases are given an arms-length and independent credit evaluation by the purchasing bank.

4. Determine whether any purchases of assets from an affiliate comply with section 23A, which generally prohibits purchases of low-quality assets from an affiliate and limits asset purchases and all other "covered transactions" by a bank from a single affiliate and all affiliates combined to 10 percent and 20 percent, respectively, of a bank's capital and surplus.

5. Determine whether any assets purchased are properly reflected at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any assets sold at less than book value.

6. Determine whether transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair value on the books of both the bank and the holding company affiliate.

7. If low-quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary supervisor, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal supervisor of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

- Name of originating and receiving institutions.
- Type of assets involved and type of transfer (i.e., participation, purchase/sale, swap).
- Date(s) of transfer.
- Total number and dollar amount of assets transferred.
- Status of the assets when transferred (e.g., nonperforming, classified)
- Any other information that would be helpful to the other supervisor.

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. See SR-93-37 and its attachments for further discussion of the Federal Reserve's position on such arrangements between bank holding companies and their subsidiary banks.

2020.9.1 SPLIT-DOLLAR LIFE INSURANCE POLICY ARRANGEMENTS

Certain split-dollar life insurance policy arrangements involving banks and their parent bank holding companies raise legal and safety-and-soundness concerns. These arrangements fall into two general categories: (1) those in which the subsidiary bank owns the policy, pays all or substantially all of the premiums and is reimbursed for the premium payments (if at all) at some time in the future (endorsement plans) and (2) those in which the parent holding company owns the policy, and pays the premium, but uses the insurance policy as collateral for loans from its subsidiary bank (collateral assignment plans).

2020.9.1.1 Split-Dollar Life Insurance Endorsement Plan

Under an endorsement plan, the subsidiary bank purchases a policy in which its parent bank holding company or an officer, director, or principal shareholder thereof is the primary beneficiary, rather than the bank or one of its officers or directors. In this instance, the subsidiary bank receives only a limited portion of the death benefit—usually an amount equal to its premium payments plus interest. The primary beneficiary—the holding company or one of its officers, directors, or principal shareholders—receives a majority of the insurance proceeds but pays little or nothing for the benefit. Many of the policies in this category are single-premium universal life policies, whereby the subsidiary bank pays one large lump sum premium payment for the policy. Generally, a subsidiary bank involved in an endorsement plan records the cash surrender value of the policy as an asset on its books; the bank holding company does not record anything at the parent-only level.

A variation of the endorsement plan is an arrangement in which the bank pays an annual premium towards the policy and the parent holding company reimburses the bank for a nominal amount of the annual premium payments. These amounts are substantially lower than the premium payments made by the subsidiary bank and therefore do not accurately reflect the economic benefit derived by the holding company as primary beneficiary of the insurance policy.

2020.9.1.2 Split-Dollar Life Insurance Collateral Assignment Plan

Under a collateral assignment plan, the parent bank holding company owns the policy and pays the entire premium. The subsidiary bank makes annual loans to the bank holding company in an amount equal to the annual increase in the cash surrender value of the policy (or, in some cases, in amounts equal to premiums paid) with the policy itself serving as collateral for the loan. The loans are repayable at either the termination of employment or the death of the insured employee, and will be paid using the death benefits available from the policy.

2020.9.2 COMPLIANCE WITH APPLICABLE LAWS

2020.9.2.1 Compliance with Sections 23A and 23B of the FRA

Both of the aforementioned types of split-dollar life insurance policy arrangements may be inappropriate if they are inconsistent with sections 23A or 23B of the Federal Reserve Act (FRA). Section 23A places quantitative restrictions and other requirements on certain transactions, including loans, between banks and their affiliates. The statute also requires that loans between banks and their affiliates be secured with collateral having a specified market value that depends on the type of collateral used to secure the loan. Under an endorsement plan, where the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the subsidiary bank to its parent holding company generally results because the subsidiary bank has paid the bank holding company's portion of the premium, and the bank will not be reimbursed fully for its payment until sometime in the future.

Under a collateral assignment plan, if the insurance policy held by the parent bank holding company serves as collateral to secure a loan from its subsidiary bank, the loan may be a violation of section 23A unless it meets the quantitative requirements of section 23A and the cash surrender value of the insurance policy used as security is equal to 130 percent of the amount of the loan. Thus, a bank loan to the parent bank holding company that equals the cash surrender value of the insurance policy that is serving as collateral would not be adequately secured under section 23A, unless additional collateral was provided.

Both categories of split-dollar life insurance policy arrangements may also lead to violations of section 23B of the Federal Reserve Act, which requires that certain transactions involving a bank and its affiliates be on terms and under circumstances substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. Because the bank holding company is the beneficiary of the life insurance policy, it is a participant in a transaction between a bank and a third party; therefore, the split-dollar life insurance transaction must meet the standards of section 23B.[1] In order to conform to the statutory restrictions of section 23B, the return to the bank from ownership of the policy should be commensurate with the size and nature of its financial commitment. In most split-dollar insurance arrangements, the bank makes an investment in the policy not for the purpose of insuring itself against risk but for the purpose of obtaining insurance for its holding company. The only return that the bank will get from its participation in ownership of the policy is the return of its initial investment and possibly some interest. However, the insurance company deducts the cost of maintaining the insurance coverage from interest that would otherwise be credited to the equity in the policy. These costs include policy loads, surrender charges, and mortality costs. The holding company should fully reimburse the bank for all of these charges. Examiners should carefully evaluate these arrangements because, in many cases, the reimbursement the bank receives from the holding company is based on an implied value of the insurance coverage received by the holding company that is less than the assessments made to the policy equity.

In the process of evaluating split-dollar insurance arrangements, examiners should keep in mind the fact that the advances made by a bank to purchase the insurance are the equivalent of a loan to the holding company. Therefore, to comply with section 23B, the terms of the loan, such as its duration and interest rate, must be on market terms.

2020.9.2.2 Investment Authority Under the National Bank Act

Participation by bank holding companies and their state-chartered and national bank subsidiaries in split-dollar life insurance policy arrangements may also raise concerns whether the policies are permissible bank investments under section 24(7) of the National Bank Act. The Office of the Comptroller of the Currency's interpretation of this provision of the National Bank Act (OCC Banking Circular 249, May 9, 1991).[2] In addition, under section 24 to the Federal Deposit Insurance Act, a state-chartered bank generally may not, without the FDIC's permission, engage in any activity that is impermissible for a national bank.[3]

2020.9.3 SAFETY-AND-SOUNDNESS CONCERNS

The purchase of a split-dollar life insurance policy may also constitute an unsafe and unsound banking practice involving the diversion of bank income or assets. If a subsidiary bank pays the entire insurance premium but is not the beneficiary, it provides an economic benefit to its parent holding company or other beneficiary for which it is not being adequately reimbursed or compensated. In this instance, the bank loses the opportunity to use its assets productively. Generally, the bank pays the premium in return for the insurance company's payment of the entire proceeds. When the bank receives less than the entire proceeds, it has, in effect,

1. The Federal Deposit Insurance Corporation has taken the same position in a published interpretive letter, FDIC 92-40, dated June 18, 1992.

2. National banks may not purchase life insurance as an investment. See OCC Banking Circular 249, for the tests under which life insurance may be purchased and held for noninvestment purposes.

3. SR-92-97 (FIS) and SR-92-98 (FIS), dated December 16 and 21, 1992, respectively, describe the provisions of section 24 of the Federal Deposit Insurance Act.

paid a higher than market price for whatever limited benefit it may receive. This is also the case when the primary beneficiary of the policy is an officer, director, or principal shareholder of the parent holding company. Such an arrangement is not consistent with safe and sound banking practices because the subsidiary bank is conferring an economic benefit on an insider of the parent bank holding company without receiving adequate compensation.

2020.9.4 EXAMINER REVIEW OF SPLIT-DOLLAR LIFE INSURANCE

Examiners should be fully aware of the problems inherent in split-dollar life insurance policy arrangements between bank holding companies and their subsidiary banks. During the course of all bank examinations and bank holding company inspections, examiners should review corporate life insurance policy arrangements for compliance with applicable banking laws and safety-and-soundness standards.[4] If a split-dollar life insurance policy arrangement exists in either a bank holding company or a state member bank, it should be reviewed and modified if it does not comply fully with the law and principles of safe and sound banking. If a bank holding company or a state member bank fails to take appropriate action to bring its split-dollar life insurance policy arrangements into compliance, then the Reserve Bank should consider appropriate follow-up supervisory action (including a formal enforcement action) against the banking organization or its institution-affiliated parties, or both.

2020.9.5 INSPECTION OBJECTIVES

1. To determine if split-dollar life insurance arrangements between the parent holding company and its subsidiary banks are consistent with the provisions of sections 23A and 23B of the FRA.

4. Examiners conducting examinations of U.S. branches and agencies of foreign banks and Edge corporations should also be alerted to the problems associated with split-dollar life insurance arrangements because these institutions could purchase insurance for the benefit of a parent foreign bank or company, or one of the parent's officers or directors. In addition, section 7(h) of the International Banking Act of 1978 prohibits state-licensed branches or agencies from engaging in any activity that is impermissible for a federal branch unless the Board determines that such activity is consistent with ''sound banking practice'' and, in the case of an FDIC-insured branch, the FDIC determines that the activity poses no significant risk to the deposit insurance fund.

2. To ascertain whether participation by bank holding companies and their national bank or state-chartered bank subsidiaries is consistent with section 24(7) of the National Bank Act and section 24 of the Federal Deposit Insurance Act.

3. To verify the cash surrender values of split-dollar life insurance policies and to establish whether those values have been impaired by loans to, liens by, or assignments to, third parties or by unauthorized borrowings or cancellations.

2020.9.6 INSPECTION PROCEDURES

1. Review corporate life insurance policy arrangements between the parent company and its subsidiary banks.

   a. Determine if there are split-dollar life insurance arrangements between any subsidiary bank and the parent company or officers or directors of the parent company.

   b. If any such insurance arrangement exists, establish if the plan is either an endorsement plan or a collateral assignment plan.

   c. Review arrangements involving a split-dollar life insurance policy purchased by the parent company.

      (1) Review external documentation evidencing the cash surrender value. If no documentation exists, ask the audit committee and its internal auditors—

         (a) to obtain external documentation verifying its value and

         (b) to verify that there are no outstanding loans, liens, or assignments against the insurance policies.

      (2) Establish whether the parent company's board of directors has established policies and implemented procedures for transactions between the insurance carrier and the parent company to prevent unauthorized borrowing or cancellation of any insurance policy that has a cash surrender value.

      (3) Determine whether the corporate life insurance policy arrangements are consistent with applicable safety-and-soundness standards.

      (4) Verify that the recorded value of the respective asset is equal to the unimpaired cash surrender value of the asset.

2. If an endorsement plan arrangement is purchased by a subsidiary bank, establish whether the bank holding company is the beneficiary. If the parent company is the beneficiary, such an arrangement may result in an unsecured exten-

sion of credit when the subsidiary bank pays all or substantially all of the insurance premiums but is not reimbursed until some time in the future. Ascertain if the investment return to the bank from ownership of the policy is commensurate with the size and nature of its financial commitment.

3. If a collateral assignment plan (when the insurance policy held by the parent company serves as collateral to secure a loan from a subsidiary bank), ascertain whether the cash surrender value of the insurance policy is equal to 130 percent of the amount of the loan.

4. For both types of split-dollar life insurance:

a. Determine if the investment return from ownership of the policy is commensurate with the size and nature of the financial commitment, including all costs incurred for maintaining the insurance coverage.

b. Determine if the terms (duration and market interest rate) of the advances made to purchase the insurance are on market terms.

c. If the bank holding company is the beneficiary of a bank insurance policy and a bank is a participant in the purchase of the insurance from a third party, determine if the transaction was on terms and under circumstances that were substantially the same as or at least as favorable to the bank as those then prevailing for comparable transactions with or involving nonaffiliated companies.

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Split-dollar life insurance:				
1. Endorsement plan: When a subsidiary bank has paid all the BHC's portion of the premium and the bank will not be reimbursed until some time in the future, a loan results that must be secured.	371c, FRA section 23A			
2. Collateral assignment plan securing a loan: Cash surrender value must be 130 percent of the loan.	371c, FRA section 23A			
3. Both plans:				
a. Transactions must be on terms and under circumstances substantially the same as those prevailing for third-party transactions.	371c, FRA section 23B			

2020.9.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
b. When the BHC is the beneficiary, the bank's investment return from the split-dollar life insurance policy should be commensurate with the size and nature of the financial commitment.	371c-1, FRA section 23B			
Split-dollar life insurance premiums paid by a bank on behalf of an executive officer of the bank are not deemed an extension of credit for purposes of Regulation O, if the officer reported the premiums as taxable compensation to the IRS.			Regulation O staff opinion 3-1081.3	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The history of bank holding company legislation reflects a principle that banking and commerce should be separated in order to prevent abuses in the distribution of credit. The 1956 Act generally required companies to divest their nonbank activities and shares within two years. In the 1970 Amendments, the same requirement applied to companies formed in the future. However, one-bank holding companies in existence at the time of these amendments were given a "grace period" to comply with divestiture requirements of the legislation. Those companies whose bank and nonbank interests had been combined on or before June 30, 1968, were permitted to continue the existing combination for an indefinite period (indefinite or permanent grandfather privileges). But those BHCs which existed at the time of the 1970 Amendments, but whose bank was acquired or whose nonbank activity was initiated after June 30, 1968, were permitted to continue their nonbank activities for only 10 years until December 31, 1980. An exception to the divestiture deadline existed with respect to certain real estate holdings.

Although indefinitely grandfathered companies may continue to engage in nonbanking activities, these grandfather privileges are subject to review by the Federal Reserve Board at the time when a company's banking assets exceed $60 million.[1]

2030.0.1 INDEFINITE GRANDFATHER PRIVILEGES

Under the provisions of section 4(a)(2) of the Act, as amended in 1970, relating to grandfather privileges for certain nonbanking activities of bank holding companies, the Reserve Banks have been delegated the authority to determine that termination of grandfathered activities of a particular bank holding company is not warranted; provided, the Reserve Bank is satisfied that all of the following conditions are met:

1. The company or its successor is "a company covered in 1970;"
2. The nonbanking activities for which indefinite grandfather privileges are being sought do not present any significant unsettled policy issues; and
3. The bank holding company was lawfully engaged in such activities as of June 30, 1968 and has been engaged in such activities continuously thereafter.

A company covered in 1970 is defined in section 2(b) of the Act as "a company which becomes a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date." The Board has also determined that the company must have owned at least 25 percent of the voting shares of the same subsidiary bank on June 30, 1968, and December 31, 1970, in order to qualify as a company covered in 1970. If a company was not actively engaged in a nonbank activity prior to June 30, 1968, either directly, or indirectly through a subsidiary, it may still qualify for indefinite grandfather privileges if the company had entered into a binding contract prior to June 30, 1968. The binding contract must be a written document which specifies that the company (or its subsidiary) or persons representing the company will purchase another company which is already engaged in the activity.

Within two years after the subsidiary bank of an indefinitely grandfathered company attains banking assets in excess of $60 million, the status of the company's grandfather privileges is subject to review to determine whether the rights should remain in effect or be terminated. The Board or Reserve Bank may also review any company's grandfather privileges and terminate them if it determines that such action is necessary to prevent (1) undue concentration of resources, (2) decreased or unfair competition, (3) conflicts of interests, or (4) unsound banking practices. Moreover, when a company applies for approval of an acquisition, it may expect the Board or Reserve Bank to review the legitimacy of its grandfather privileges.

2030.0.2 ACTIVITIES AND SECURITIES OF NEW BANK HOLDING COMPANIES

A company that becomes a bank holding company may, for a period of two years, engage in

1. Effective October 20, 1981 the Board amended its Rules Regarding Delegation of Authority to delegate to the Reserve Banks authority to make these determinations regarding indefinite grandfather privileges.

nonbanking activities and control voting securities or assets of a nonbank subsidiary, if the bank holding company engaged in such activities or controlled such voting securities or assets on the date it became a bank holding company. The Board can grant requests for up to three one-year extensions of the two-year period. This is in accordance with a December 1983 revision to Regulation Y (12 C.F.R. 225.22(e)). The regulatory provision implements Section 4(a)(2) of the BHC Act.

2030.0.3 LIMITATIONS ON EXPANSION OF GRANDFATHER RIGHTS FOR INSURANCE AGENCY NONBANKING ACTIVITIES OF BANK HOLDING COMPANIES

Refer to Manual section 3170.0.3.4.1.

2030.0.4 SUCCESSOR RIGHTS

When a bank holding company transfers its bank shares to another company in a manner that produces no substantial change in the control of the bank, the transferee qualifies under section 2(e) of the Act as a "successor." The "successor" provision prevents a bank holding company from transferring its bank to some other organization. A successor is considered a bank holding company from the date the transferor became a bank holding company. Thus, it may hold the same grandfather privileges as its predecessor. By the same token, it becomes subject to any conditions or restrictions, such as divestiture requirements, imposed by the System upon its predecessor. For example, an irrevocable declaration filed by the predecessor would be binding upon the successor.

2030.0.5 EXPANSION OF GRANDFATHER ACTIVITIES

Grandfather privileges apply to activities, not to companies. As a general rule, these activities are permitted to be expanded through internal growth; however, there are a few exceptions. See Appendix 1 in this section.

In Appendix 1 it is important to distinguish between a purchase in the ordinary course of business and a purchase, in whole or in part, of a going concern. Each of the following conditions must be satisfied in order for the transaction to be in the "ordinary course of business," which is permissible: (1) less than a substantial amount of the assets of the company to be acquired must be involved; (2) the operations of the purchased company must not be terminated or substantially discontinued; (3) the assets acquired must not be significant in relation to the size of the same line of nonbank activity already in the holding company (an acquisition is deemed significant if the book value of the acquired nonbank assets exceeds 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity); (4) if the transaction involves the acquisition of assets for resale, the sale must be a nominal business activity of the acquiring company; and (5) the major purpose of the transaction must not be to hire essentially all of the seller's principal employees who are expert, skilled and experienced in the business of the company being acquired. If any of these five conditions is not satisfied, the transaction may be considered to be an acquisition of a going concern, which is not permissible without prior approval. Refer to 12 C.F.R. 225.132.

2030.0.6 DIVESTITURES *(also see Manual section 2090.6)*

The act specifies the time in which a company must divest of any impermissible activity. Any company becoming a bank holding company subsequent to the 1970 Amendments has two years in which to divest its impermissible activity. The Act allowed a temporarily grandfathered company ten years from December 31, 1970, to divest of its impermissible activities, except certain real estate holdings discussed earlier; and allows indefinitely grandfathered companies ten years from the date on which grandfather privileges are terminated by the Board or Reserve Bank, should they be terminated for good cause.

As mentioned earlier, reviews of a company's grandfather privileges may be precipitated by such circumstances as: (1) a subsidiary bank of an indefinitely grandfathered company attaining assets in excess of $60 million (reviewed within two years); (2) a company seeking approval to engage in another activity or acquire another bank; (3) a company which violates the Act; or (4) a company operating in a manner which results in an undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

When a company has filed an application requiring the Board's or Reserve Bank's approval, the Board or Reserve Bank may approve the application subject to the condition that the company divest of certain grandfathered shares or assets within a specified time period. The specified time period generally will be shorter than the aforementioned time periods stipulated in the Act.

The plan of divestiture should have provided for the removal of any control relationship between the company and its divested activities. These control requirements, as outlined in section 2(g) of the Act, include one or more of the following: (1) no interlocking directorates; (2) ownership of less than 25 percent of the voting shares by the BHC and related parties; (3) no interlocking management positions in policymaking functions; (4) no indebtedness between the transferor and the transferee; (5) no agreement or understanding which restricts the voting privileges of shares. Further discussion of these and other control requirements and issues is found in Manual sections 2090.1 and 2090.6.

2030.0.7 INSPECTION OBJECTIVES

1. To determine when the company acquired its subsidiary bank.
2. To determine when the company commenced its nonbanking activities and whether these activities were conducted continuously thereafter.
3. To determine if the banking assets of a bank controlled by a holding company with indefinite grandfather privileges have reached $60 million.
4. To determine if a change of ownership or control of the company has taken place, and whether the transferee qualifies as a "successor."
5. To determine if expansions of grandfathered activities occurred in accordance with the Act.

2030.0.8 INSPECTION PROCEDURES

1. If necessary, examine the subsidiary bank's stock certificate book to determine when the company acquired 25 percent or more of the bank.
2. Review the minute books and historical financial records of the company and its subsidiaries for evidence of the date of commencement of any nonbank activity and its continuation thereafter. In particular, the financial records should reflect the activity's impact as either an asset and/or an income item. From these records, also determine whether there has been expansion of the activity and whether such expansion complies with the Act.
3. If necessary, review the latest quarterly Call Report of Condition for the subsidiary bank to determine whether total assets exceeded $60 million. If appropriate, advise management that its grandfather status is subject to review.
4. If necessary, examine the stock certificate records and minutes of the bank or BHC to determine if the bank's shares have been transferred from one bank holding company to another in such a manner that the transferee qualifies as a successor.
5. Upon review of the aforementioned records, discuss the status of the company's grandfather privileges with the Reserve Bank's management, if necessary.
6. If divestment is required, encourage its execution as soon as possible during the divestment period. Request a divestment plan which specifies the manner by which divestment will be accomplished, the specific steps necessary to effect the divestment, and the time schedule for taking such steps. Advise management that failure to divest within the prescribed time period will be viewed as a violation of the Act.

2030.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Divestment of activities which are temporarily grandfathered			S-2346 February 15, 1977	
Escrow agreements used in divestiture				1976 FRB 151
Companies with temporarily grandfathered activities encouraged to submit plans by June 30, 1978				1977 FRB 962
Divestment policies	4(a)(2)			1977 FRB 263
Denial of grandfather rights for activities which were shifted from subsidiary bank to nonbank subsidiary				Whitney Holding Corporation, New Orleans, Louisiana; April 27, 1973
Denied continued ownership of a savings and loan association, despite permanent grandfather rights				D.H. Baldwin Company, Cincinnati, Ohio; February 22, 1977
Discussion of indefinite grandfather rights acquired through the indirect power to exercise a controlling influence				Patagonia Corporation, Tucson, Arizona; February 24, 1977
Denial of grandfather rights on additional stock acquired after June 30, 1968, for lack of a controlling influence over the subsidiary as of June 30, 1968				Patagonia Corporation, Tucson, Arizona; July 6, 1973
Successor rights				Republic of Texas Corporation, Dallas, Texas; October 25, 1973

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interprets "Company covered in 1970" and "Successor"				American Security Corporation, Washington, D.C.; July 21, 1976
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets				Colorado Funding Company, Denver, Colorado; September 9, 1977
Review of grandfather rights as a result of subsidiary bank reaching $60 million in total assets—charitable trust involved				General Education Fund, Inc., Burlington, Vermont; September 13, 1977
Companies going out of business are not going concerns				Senate Report 90–1084, page 5524
Failing companies are not going concerns				1974 FRB 725
Ownership of less than 25 percent of a nonbanking company represents an investment rather than a subsidiary				1973 FRB 539
Divestitures		225.138 and 225.140		
Extension of divestiture deadline for real estate interests	Monetary Control Act of 1980 Section 701(b)			
Delegation of authority to Reserve Banks re: Indefinite Grandfathered activities		265.2(f)(42)		1981 FRB 856 and 860

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities and securities of new bank holding companies		225.22(e)		
Denial of a BHC acquisition—''successor''				1984 FRB 667
Acquisition of assets		225.132		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2030.0.10 APPENDIX 1—EXPANSION OF GRANDFATHERED ACTIVITIES

Permissible Type of Expansion	*Without Approval*	*Requires Approval*
FOR COMPANIES WITH AN INDEFINITELY GRANDFATHERED NONBANK ACTIVITY		
1. Opening of additional offices of existing subsidiary	X	
2. Acquisition of assets in the ''ordinary course of business'' as defined	X	
3. Acquisition of a going concern:		
a. Additional shares of the grandfathered nonbanking subsidiary	X	
b. Additional shares of a nonbanking company which is regarded as an investment (generally companies in which the holding company has an interest of between 5 and 25 percent)		X
c. Initial acquisition of shares of any other company engaging in the activity		X

Commitments to the Board arise most often through the application process. Many commitments are included within the text of accompanying Board orders or letters transmitted to the applicants. Commitments can also arise through the supervisory process. Commitments should be specific and furnished in written form.

The most common type involves a commitment to inject capital (either equity or debt capital) into the company or subsidiary to be acquired or possibly into other subsidiaries of the bank holding company. The required injections may be for a specific dollar amount or for an unspecified amount necessary to achieve a predetermined capital relationship. Determining compliance with such commitments is generally not difficult since an agreed upon quantifiable result must be achieved.

Types of commitments made to the Board in the past include: divestiture of nonpermissible stock holdings or activities; introduction of new services; and reduction or elimination of dividends or management fees from subsidiaries.

Several of the above forms of commitments are rather difficult to monitor due to their inexact nature. The examiner should determine in such cases whether good faith compliance efforts have been made. Where an order approving an application imposes specific conditions, however, compliance is of the utmost importance since a conditional order is based on the theory that such conditions were necessary to eliminate or outweigh adverse factors. Willful noncompliance in these cases might necessitate the use of cease-and-desist powers to prevent evasion of the purposes of the Act. Pursuant to the Board's request, each Reserve Bank reports semi-annually on the status of all outstanding commitments made by holding companies in its District.

2040.0.1 INSPECTION OBJECTIVES

1. To determine that the bank holding company is taking the necessary steps to fulfill any outstanding commitments as scheduled.
2. To determine whether additional commitments or conditions should be imposed to achieve complete compliance.
3. To determine whether a request for an extension of time to fulfill any outstanding commitment is warranted.

2040.0.2 INSPECTION PROCEDURES

1. Review semi-annual commitment reports to the Board for commitments fulfilled since the last inspection. Determine whether such commitments were completed as required.
2. Review with management any actions taken to comply with outstanding commitments or plans to effect fulfillment.
3. If warranted, initiate action to consider an extension for compliance on outstanding commitments.

WHAT'S NEW IN THIS REVISED SECTION

This section was updated to discuss amendments to the Federal Reserve Act regarding insider lending. The definition of "extension of credit" was revised to include an insured depository institution's (IDI) credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. See the Federal Reserve Act, section 22(h)(9)(D)(i), as amended by the Dodd-Frank Act, section 614(a).

The Federal Deposit Insurance Act was amended to prohibit the purchase or sale of assets between an IDI and an executive officer, director, or principal shareholder of the IDI, and any related interest of such person, unless the transaction is on market terms. In addition, if the asset purchase or sale represents more than 10 percent of the IDI's capital stock and surplus, the transaction must be approved in advance by a majority of the members of the board of directors of the IDI who do not have an interest in the transaction. See section 615(1) of the Dodd-Frank Act.

2050.0.1 BHC OFFICIAL AND RELATED INTEREST TRANSACTIONS BETWEEN THE PARENT COMPANY OR ITS NONBANK SUBSIDIARIES

Business transactions between a parent bank holding company or its nonbank subsidiary and a BHC official or a BHC official's related interests require close supervisory review. "Bank holding company official" is defined as any director, executive officer, or principal shareholder of the parent company or any of its subsidiaries, excluding the subsidiary bank's nonbank subsidiaries.

Most of these transactions are soundly structured and have a legitimate business purpose that result in equitable treatment for all parties. However, examiners should pay close attention to all extensions of credit by a BHC or its nonbank subsidiary to a BHC official or related interest to ensure that the terms of the credit, particularly interest-rate and collateral terms, are not preferential and that the credit does not involve more than a normal risk of repayment.

An extension of credit by a BHC or nonbank subsidiary may be considered abusive or self-serving if its terms are unfavorable to the lender, or if the credit would not have been extended on the same terms absent the official relationship; that is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained.

In addition to the above supervisory considerations, the Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204) (the act) imposed certain insider lending restrictions on public companies, including BHCs that are public companies. A BHC generally is considered a public company for these purposes if it has a class of securities registered under section 12 of the Securities Exchange Act of 1934 (the 1934 act) or is required to file reports with the Securities and Exchange Commission (SEC) under section 15 of the 1934 act. The Sarbanes-Oxley Act[1] prohibits a publicly owned BHC (public BHC) and its subsidiaries from extending credit, or arranging for another entity to extend credit, in the form of a personal loan to any director or executive officer of the public BHC.[2] This prohibition does not apply to any extension of credit made before July 30, 2002, so long as the loan is not renewed or materially modified after that date.

The Sarbanes-Oxley Act includes two exceptions to this loan prohibition. First and most importantly, the prohibition does not apply to any loan made by an insured depository institution that is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act, as implemented by the Board's Regulation O. Thus, loans by the insured depository institution subsidiaries of a public BHC to a director or executive officer of the BHC likely are exempt from the prohibition, although they would be subject to Regulation O as discussed below. The second exception permits the directors and executive officers of a public BHC to obtain home improvement and manufactured home loans, consumer loans, and loans under open-end credit plans or charge cards from the public BHC or its subsidiaries, so long as the

1. See 15 U.S.C. 78m (section 402 of the act).

2. The act does not restrict lending by a subsidiary of a public BHC to the subsidiary's own directors and executive officers, so long as these persons are not also directors or executive officers of the public BHC.

credit (1) is extended in the ordinary course of the company's consumer credit business, (2) is a kind of credit generally made available to the public, and (3) is made on market terms or on terms that are no more favorable than those offered to the general public.

2050.0.2 TRANSACTIONS INVOLVING OTHER PROPERTY OR SERVICES

Other transactions involving BHC officials, their related interests, and the BHC and nonbank subsidiary that should be reviewed by the examiner include the—

1. purchase of assets or services from the BHC or nonbank subsidiary, particularly if at a discount or on preferential terms;
2. sale of assets or services to the BHC or nonbank subsidiary, particularly if at a premium;
3. lease of property to or from the BHC or nonbank subsidiary; and
4. use of BHC or nonbank subsidiary property or personnel by a BHC official or related interest.

As with loans and other extensions of credit to BHC officials on preferential terms, abusive or self-serving insider transactions involving other property or services deprive the BHC or nonbank subsidiary of higher returns or gains that may have been achieved had the same transaction been at a fair market price. A fair market price would be that price charged or received from an unaffiliated party.

The Dodd-Frank Act amended the Federal Deposit Insurance Act (FDIA) to impose a prohibition on asset purchases and between an IDI and an executive officer, director, or principal shareholder of the IDI, and any related interest of such person, unless the transaction is on market terms. In addition, if the asset purchase or sale represents more than 10 percent of the IDI's capital stock and surplus, the transaction must be approved in advance by a majority of the members of the board of directors of the IDI who do not have an interest in the transaction. See section 18(z) of the FDIA, as amended by the Dodd-Frank Act, section 615(a).

A fair market price is often difficult to determine because the assets or services involved may be unique to a given situation and individuals. In general, the fair market price of even unique assets or services can be approximated by the cost of the assets or services to the party selling or furnishing them, if appropriate. The value of services or properties provided by a BHC or nonbank subsidiary should be established and justified either by policy or on a case-by-case basis, and appropriate documentation should be available to the examiner.

Services provided by a BHC official or a related interest to a BHC or nonbank subsidiary, while not unusual, may be most difficult to value. In part because of the problem of valuation, this type of transaction is among the most susceptible to abuse. The cost of providing services is frequently derived by placing value on the time of the individuals providing the services. When services are provided by a BHC official who normally places a very high billing value on time provided, the benefits to the BHC must be assessed in order to form a basis for determining a fair price. The BHC official may be a highly regarded professional whose time and services have great value to the organization. However, when the BHC requires routine clerical services, officials should not charge the BHC a professional-level rate for such services. Under these or similar circumstances, the BHC would be considered imprudent in paying such rates and could be subject to critical comment.

2050.0.3 REGULATION O

For ease of reference, certain Regulation O definitions and limitations, as revised by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), are presented here, some in abbreviated form. A thorough review of the entire regulation (found at FRRS 3–960), and the Board's press releases pertaining to Regulation O, is necessary for a complete understanding of the regulation. (Note that section 108 of the Financial Institutions Regulatory Act of 1978 amended section 18(j) of the Federal Deposit Insurance Act to make section 22(h) of the Federal Reserve Act applicable to nonmember insured banks.)

Purpose of Regulation O. Regulation O governs any extension of credit by a member bank and its subsidiaries (based on amendments contained in FDICIA, Regulation O also applies to nonmember insured depository institutions) to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. It also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person.

Supervision of BHCs and their nonbank subsidiaries. Regulation O deals exclusively with extensions of credit by banks and their subsidiaries, not extensions of credit by BHCs and their nonbank subsidiaries. However, because the regulations curtail or eliminate abusive transactions, they can be used as a guide or model in providing standards for the supervisory review of extensions of credit by BHCs and nonbank subsidiaries. Although a direct extension of credit by a BHC could not be determined to be a *violation* of Regulation O, if the credit fails to meet the requirements that Regulation O establishes for banks, it may be possible to conclude that the BHC is engaging in either an unsafe or unsound practice that exposes the entire banking organization to undue risk and exposure to loss. Regulation O limits credit extensions by a bank to officials of that bank and their related interests; therefore, examiners should be especially alert to credit extensions from BHCs and nonbank subsidiaries. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management and noted in the inspection report for follow-up review and possible formal corrective action by regulatory authorities.

2050.0.3.1 FDICIA and BHC Inspection Guidance for Regulation O

On April 22, 1992, the Board adopted amendments to Regulation O, effective May 18, 1992, to implement the changes required by section 306 of FDICIA. Section 306 amended section 22(h) of the Federal Reserve Act and replaced the language of section 22(h) with the provisions of the Board's Regulation O. Section 306 also made several substantive modifications to section 22(h) that required revisions to Regulation O. These changes are outlined in the Board's press release and *Federal Register* notice of May 28, 1992 (57 *Fed. Reg.* 22,417).

The following are some of the more significant changes that were made effective May 18, 1992:[2a]

2a. The Regulation O cites are to the February 18, 1994, amendment.

1. *Aggregate lending limit (section 215.4(d)).* The aggregate limit on the total amount that a bank can lend to its insiders and their related interests as a class was changed. In general, this amount is equal to the bank's unimpaired capital and unimpaired surplus. The Board also decided as a one-year interim measure to permit banks with deposits under $100 million to adopt a higher limit, not to exceed 200 percent of the bank's unimpaired capital and unimpaired surplus. (This interim period was extended twice by the Board, extending the higher limit through February 18, 1994, when the higher limit became permanent. The board of directors must provide an annual resolution authorizing the use of this higher limit. Other conditions also apply.)

2. *Lending limits for directors and related interests (section 215.4(c)).* Loans to directors (and their related interests) are subject to the same lending limit that is applicable to executive officers and principal shareholders (and their related interests).

3. *Credit standards (section 215.4(a)).* When lending to an insider[2b] a bank must follow credit underwriting procedures that are as stringent as those applicable to comparable transactions by the bank with persons outside the bank.

4. *Definition of "principal shareholder" (section 215.2(m)(1)).* The definition of *principal shareholder* was tightened for banks located in small communities. The previously existing 10 percent limitation was made applicable to all banks, regardless of the size of the communities in which they were located.[3]

5. *Definition of "member bank" (section 215.2(j)).* The term *member bank* was redefined to include any subsidiary of the member bank. This revision clarified that an extension of credit from a subsidiary of a member bank is subject

2b. The term *insider* refers to an executive officer, director, or principal shareholder, and includes any related interest of such a person.

3. The Board amended the definition of *principal shareholder of a member bank,* effective December 17, 1992, so that it does not include a company of which a member bank is a subsidiary. This amendment excludes from Regulation O loans to a company that owns, controls, or exercises a controlling influence over a member bank, as those relationships are defined in section 2(d) of the Bank Holding Company Act, as well as the related interests of such a parent bank holding company. The definition of *principal shareholder* for purposes of reporting obligations under section 215.11 of Regulation O was not changed as a result of the Housing and Community Development Act of 1992 because those portions of Regulation O implement provisions of law in addition to section 22(h) of the Federal Reserve Act.

to the same insider restrictions as an extension of credit from a member bank itself.

6. *Coverage of all companies that own banks (section 215.2(b)).* All companies that own banks became subject to Regulation O, regardless of whether they are technically bank holding companies.

7. *Prohibition on knowingly receiving unauthorized extensions of credit (section 215.6).* Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extension of credit not authorized by section 22(h) of the Federal Reserve Act.

8. *Reporting requirement for certain credit (section 215.12).* Executive officers and directors of member banks that do not have publicly traded stock are required to report annually to their institutions the outstanding amount of any credit secured by shares of the insider's institution.

In a February 18, 1994, press release, the Federal Reserve Board announced its approval of a final rule that further amended several provisions of Regulation O, effective on that date. Some of the provisions carried out or further refined provisions of FDICIA. The amendments were designed to increase the ability of banks to make extensions of credit that pose minimal risk of loss, to eliminate recordkeeping requirements that impose a paperwork burden, and to remove certain transactions from the regulation's coverage consistent with bank safety and soundness. The amendments were expected to increase the availability of credit, particularly in communities served by small banks. The following is a discussion of some of the rule's primary provisions.

1. *Aggregate lending limit—exception for small, adequately capitalized banks (section 215.4(d)).* This revision of Regulation O made permanent an interim rule increasing the aggregate lending limit for small, adequately capitalized banks from 100 percent of the bank's unimpaired capital surplus to 200 percent, provided the bank satisfies three conditional criteria.

2. *Exceptions to the general limits on lending (section 215.4(d)(3)).* The Board adopted certain exceptions to the general restrictions on lending to insiders. The exceptions apply to loans fully secured by—

a. obligations of the United States or other obligations fully guaranteed as to principal and interest by the United States;

b. commitments or guarantees of a department or agency of the United States; or

c. a segregated deposit account with the lending bank.

An exception is also made for loans arising from the discount of installment consumer paper by an insider with full or partial recourse endorsement or guarantee by the insider, if the maker of the paper is not an insider and the loan was made relying primarily on the maker and this is properly documented. Such loans continue to be subject to the prohibitions against preferential lending.

3. *Including closing costs in the refinancing of home mortgage loans (section 215.5(c)(2)).* Section 22(g) of the Federal Reserve Act allows a bank to make a loan to its executive officer, without restrictions on the amount, if the loan is secured by a first lien on a dwelling that is owned and used by the executive officer as a residence after the loan is made. The Board's amendment includes the refinancing of home mortgage loans in this category only if the proceeds are used to pay off the previous home mortgage loan or for the other purposes listed in this section. The regulation states that closing costs can be included as part of the exempt portion of a home mortgage refinancing.

4. *Alternative recordkeeping procedures (section 215.8).* Banks are permitted to follow alternative recordkeeping procedures on loans to insiders of affiliates. The amendment allows a bank to decide on its own how to gather information on related interests, so long as its method is effective. For example, a nonbank credit card bank or other bank that does not make commercial loans could decide not to keep records on related interests. For banks that make commercial loans, one of two acceptable methods is required, unless a bank can demonstrate that another method is equally effective: (a) the "survey" method or (b) the "borrower inquiry" method. Every bank, regardless of the recordkeeping method it selects, must conduct an annual survey to identify *its own insiders*, but not those of its holding company affiliates. Every bank is expected to check this short list before extending credit, even if it is using the borrower-inquiry method of recordkeeping for affiliates in lieu of the survey method.

5. *Tangible-economic-benefit rule (section 215.3(f)).* This rule was similar to a provision in section 23A of the Federal Reserve Act and was adopted at a time when the Board was required by section 22(h) of the Federal Reserve Act to use the definition of "extension of credit" found in section 23A. However, the definition of extension of credit in section 22(h) is no longer

tied to section 23A. The Board has therefore revised the tangible-economic-benefit rule to clarify that it does not reach certain transactions that may benefit an insider. The Board explicitly provided that the rule does not apply to an arm's-length extension of credit by a bank to a third party where the proceeds of the credit are used to finance the bona fide acquisition of property, goods, or services from an insider or an insider's related interest.

2050.0.3.2 Definitions in Regulation O (abbreviated listing)

Note: Regulation O definitions, prohibitions, exceptions, and exemptions are particularly detailed and complex. Therefore, inspection staff should consult with Reserve Bank or Board supervisory or legal staff before discussing with management or presenting in an inspection report any BHC inspection findings that rely upon Regulation O.

(a) "Affiliate" means any company of which a member bank is a subsidiary or any other subsidiary of that company.

(b) "Company" means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity. The term, however, does not include (1) an insured bank (as defined in 12 U.S.C. 1813) or (2) a corporation the majority of the shares of which are owned by the United States or by any state.

(c)(1) "Control of a company or bank" means that a person directly or indirectly, or acting through or in concert with one or more persons (i) owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank; (ii) controls in any manner the election of a majority of the directors of the company or bank; or (iii) has the power to exercise a controlling influence over the management or policies of the company or bank. (Note: If a company does not have voting securities (that is, a partnership), review the degree of interest in the company to determine control.)

(2) A person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank if (i) the person is an executive officer or director of the company or bank and directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank or (ii) the person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank, and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

(3) An individual is not considered to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank.

(d) "Director" of a company or bank means any director of the company or bank, whether or not receiving compensation.[3a] An advisory director is not considered a director if the advisory director (1) is not elected by the shareholders of the bank or company, (2) is not authorized to vote on matters before the board of directors, and (3) provides solely general policy advice to the board of directors.

(e)(1) "Executive officer" of a company or bank means a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation.[4]

3a. Extensions of credit to a director of an affiliate of a bank are not subject to the general prohibitions (section 215.4), the prohibitions on knowingly receiving unauthorized extensions of credit (section 215.6), and the alternative recordkeeping procedures (section 215.8) if—

(1) the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, and the director does not actually participate in those functions;

(2) the affiliate does not control the bank; and

(3) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the director of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the director of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (1) include the director (by name or by title) in a list of persons excluded from participation in such functions or (2) not include the director in a list of persons authorized (by name or by title) to participate in such functions.

4. The term "executive officer" is not intended to include persons who may have official titles and may exercise a certain measure of discretion in the performance of their duties, including discretion in the making of loans, but who do not participate in determining major policies of the bank or company and whose decisions are limited by policy standards

The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered executive officers, unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein.

(2) Extensions of credit to an executive officer of an affiliate of a member bank (other than a company that controls the bank) are not subject to sections 215.4, 215.6, and 215.8 of Regulation O if—

(i) the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, and the executive officer does not actually participate in those functions;

(ii) the affiliate does not control the bank; and

(iii) as determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that controls the bank and is not controlled by any other company, and the executive officer of the affiliate is not otherwise subject to sections 215.4, 215.6, and 215.8 of Regulation O.

If the executive officer of the affiliate is excluded, by resolution of the board of directors or by the bylaws of the bank, from participation in major policymaking functions of the bank, a resolution of the board of directors or a corporate bylaw may (i) include the executive officer (by name or by title) in a list of persons excluded from participation in such functions or (ii) not include the executive officer in a list of persons authorized (by name or by title) to participate in such functions.

(f) ''Immediate family'' means the spouse of an individual, the individual's minor children, and any of the individual's children (including adults) residing in the individual's home.

(g) ''Insider'' means an executive officer, director, principal shareholder, and any related interest of such person.

fixed by the senior management of the bank or company. For example, the term does not include a manager or assistant manager of a branch of a bank unless that individual participates, or is authorized to participate, in major policymaking functions of the bank or company.

(h) The ''lending limit'' for a member bank is an amount equal to the limit on loans to a single borrower established by section 5200 of the Revised Statutes,[5] 12 U.S.C. 84. This amount is 15 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are not fully secured, and an additional 10 percent of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan. The lending limit also includes any higher amounts that are permitted by section 5200 of the Revised Statutes for the types of obligations listed therein as exceptions to the limit.

A member bank's *unimpaired capital* and *unimpaired surplus* equals the (1) member bank's tier 1 and tier 2 capital included in the bank's risk-based capital, under the capital guidelines of the appropriate federal banking agency, and (2) balance of the member bank's allowance for loan and lease losses that was not included in the bank's tier 2 capital. This computation is based on the bank's risk-based capital under the capital guidelines of the appropriate federal banking agency, based on the bank's most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3).

(i) ''Member bank'' means any banking institution that is a member of the Federal Reserve System, including any subsidiary of a member bank. The term does not include any foreign bank that maintains a branch in the United States, whether or not the branch is insured (within the meaning of 12 U.S.C. 1813(s)) and regardless of the operation of 12 U.S.C. 1813(h) and 12 U.S.C. 1828(j)(3)(B).

(j) ''Person'' means an individual or a company.

(k) ''Principal shareholder''[6] means an individual or a company (other than an insured bank) that directly or indirectly, or acting through or in concert with one or more persons,

5. Where state law establishes a lending limit for a state member bank that is lower than the amount permitted in section 5200 of the Revised Statutes, the lending limit established by the applicable state laws shall be the lending limit for the state member bank.

6. On October 28, 1992, in section 955 of the Housing and Community Development Act of 1992, Congress amended section 22(h) of the Federal Reserve Act to exclude from the definition of *principal shareholder* a company of which a member bank is a subsidiary. Regulation O was amended, effective December 17, 1992, to implement this change. As a result of the amendment, extensions of credit by a bank to its holding company and to any related interests of its subsidiary are governed solely by sections 23A and 23B of the Federal Reserve Act.

owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual. A principal shareholder of a member bank includes (1) a principal shareholder of a company of which the member bank is a subsidiary and (2) a principal shareholder of any other subsidiary of that company, exclusive of nonbank subsidiaries of member banks.

(*l*) "Related interest" means (1) a company that is controlled by a person or (2) a political or campaign committee that is controlled by a person or the funds or services of which will benefit a person.

(m) "Subsidiary" has the meaning given in section 2(d) of the BHC Act, but does not include a subsidiary of a member bank.

2050.0.3.2.1 Extension of Credit

For the purposes of Regulation O, an "extension of credit" is

(a) a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever and includes:

(1) a purchase under repurchase agreement of securities, other assets, or obligations;

(2) an advance by means of an overdraft, cash item, or otherwise;

(3) issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance;

(4) an acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;

(5) an increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (i) accrued interest or (ii) taxes, insurance, or other expenses incidental to the existing indebtedness;

(6) an advance of unearned salary or other unearned compensation for a period in excess of 30 days; and

(7) any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

The Dodd-Frank Act added to the definition of an "extension of credit" an insured depository institution's (IDI) credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction.

An extension of credit *does not* include—

(1) an advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank;

(2) a receipt by a bank of a check deposited in or delivered to the bank in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid under terms that are not more favorable than those offered to the general public).

(3) an acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through (i) a merger or consolidation of banks or a similar transaction by which a bank acquires assets and assumes liabilities of another bank or similar organization or (ii) foreclosure on collateral or similar proceeding for the protection of the bank, provided that such indebtedness is not held for a period of more than three years from the date of the acquisition, subject to extension by the appropriate federal banking agency for good cause;

(4)(i) an endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith or (ii) any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it;

(5) indebtedness of $15,000 or less arising by reason of any general arrangement by which a bank (i) acquires charge or time credit accounts or (ii) makes payments to or on behalf of participants in a bank credit card plan, check credit plan, or similar open-end credit plan, provided—

(A) the indebtedness does not involve prior individual clearance or approval by the bank other than for the purposes of determining authority to participate in the arrangement and compliance with any dollar limit under the arrangement and

(B) the indebtedness is incurred under terms that are not more favorable than those offered to the general public;

(6) indebtedness of $5,000 or less arising by reason of an interest-bearing overdraft credit plan (see Regulation O, section 215.4(e)); or

(7) a discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, without recourse.

Non-interest-bearing deposits to the credit of a bank are not considered loans, advances, or extensions of credit to the bank of deposit. Also, the giving of immediate credit to a bank upon collected items received in the ordinary course of business is not considered to be a loan, advance, or extension of credit to the depositing bank.

An extension of credit by a member bank (for the purposes of section 215.4 of Regulation O) is considered to have been made at the time the bank enters into a binding commitment to make the extension of credit. A participation without recourse is considered to be an extension of credit by the participating bank, not by the originating bank.

Tangible-economic-benefit rule. In general, an extension of credit is considered made to an insider to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider. An extension of credit is not considered made to an insider if—

(1) the credit is extended on terms that would satisfy the standard set forth in section 215.4(a) of Regulation O for extensions of credit to insiders and

(2) the proceeds of the extension of credit are used in a bona fide transaction to acquire property, goods, or services from the insider.

2050.0.3.2.2 Insider Use of a Bank-Owned Credit Card

Board staff issued a May 22, 2006, legal opinion in response to an FDIC request for clarification on the application of the Board's Regulation O (12 C.F.R. 215) to credit cards that are issued to bank insiders for the bank's business purposes.[7] The FDIC asked whether, and under what circumstances, an insider's use of a bank-owned credit card would be deemed an extension of credit by the bank to the insider for purposes of Regulation O.

The FDIC indicated that insiders of a bank often use a bank-owned credit card to purchase goods and services for the bank's business purposes. A bank-owned credit card is a credit card that is issued by a third-party financial institution to a bank to enable the bank (through its employees) to finance the purchase of goods and services for the bank's business. Board staff commented that it was understood that (1) a bank that provides a bank-owned credit card to its employees typically forbids or discourages use of the card by employees for their personal purposes and that an employee who uses the card for personal purposes is obligated to promptly reimburse the bank and (2) a bank is liable to the card-issuing institution for all extensions of credit made under the card (whether for the bank's business purposes or for an employee's personal purposes)[8].

Although section 215.3(a) of Regulation O broadly defines an extension of credit to include "a making or renewal of a loan, a granting of a line of credit, or an extending of credit in any manner whatsoever," the rule also provides several important exceptions to the definition that are relevant to the FDIC's inquiry. Section 215.3(b)(1) of Regulation O excludes from the definition of extension of credit any advance by a bank to an insider for the payment of authorized or other expenses incurred or to be incurred on behalf of the bank. Also, section 215.3(b)(5) of Regulation O excludes from the definition of extension of credit indebtedness of up to $15,000 incurred by an insider with a bank under an ordinary credit card.

Considering the provisions of Regulation O and the purposes of the insider lending restrictions in the Federal Reserve Act, Board legal staff opined that a bank does not make an extension of credit to an insider for purposes of Regulation O at the time of issuance of a bank-owned credit card to the insider (regardless of whether the line of credit associated with the card is greater than $15,000). The opinion states also that a bank does not extend credit to an insider for the purposes of Regulation O when the insider uses the card to purchase goods or services for the bank's business purposes. However, when an insider uses the card to purchase goods or services for the insider's personal purposes, the bank may be making an extension of

7. The provisions of Regulation O apply to a bank holding company of which a member bank is a subsidiary, and any other subsidiary of that bank holding company. (See 2050.0.3.)

8. In the responding letter, Board legal staff notes that it was understood that some banks directly issue credit cards to their employees to enable the employees to finance the purchase of goods and services for the bank's business (bank-issued credit cards). Also, the letter states that the principles set forth with regard to bank-owned credit cards also would apply to bank-issued credit cards.

credit to the insider. The opinion states that an extension of credit would occur for the purposes of Regulation O if—and to the extent that—the amount of outstanding personal charges made to the card, when aggregated with all other indebtedness of the insider that qualifies for the credit card exception in section 215.3(b)(5) of Regulation O, exceeds $15,000.

The FDIC also asked whether incidental personal expenses charged by an insider to a bank-owned credit card are per se violations of the market-terms requirement in section 215.4(a) of Regulation O because non-insiders do not have access to this form of credit from the bank. In response, Board staff stated that section 215.4(a) requires extensions of credit by a bank to its insiders to (1) be on substantially the same terms (including interest rates and collateral) as, and subject to credit underwriting standards that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders and (2) not involve more than the normal risk of repayment or other features unfavorable to the bank.

The opinion states that a bank may be able to satisfy the market-terms requirement, however, if the bank approves an insider for use of a bank-owned credit card only (1) if the insider meets the bank's normal credit underwriting standards and (2) the card does not have preferential terms (or the card does not have preferential terms in connection with uses of the card for personal purposes). Nonetheless, use of a bank-owned credit card by an insider for personal purposes may violate the market- terms requirement of Regulation O if the card carries a lower interest rate or permits a longer repayment period than comparable consumer credit offered by the bank.

The Board staff's legal opinion applies only to the specific issues and circumstances described in the letter and does not address any other issues or circumstances.

2050.0.3.3 General Prohibitions and Limitations of Regulation O

(a) *Terms and creditworthiness*. No member bank may extend credit to any insider of the bank or insider of its affiliates unless the extension of credit (1) is made on substantially the same terms (including interest rates and collateral) as, and following credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by Regulation O and who are not employed by the bank and (2) does not involve more than the normal risk of repayment or present other unfavorable features.

Nothing stated above (as to "terms and creditworthiness") should prohibit any extension of credit made in accordance with a benefit or compensation program that—

1. is widely available to employees of the member bank, and in the case of extensions of credit to an insider of its affiliates, is widely available to employees of the affiliates at which that person is an insider and
2. does not give preference to any insider of the member bank over other employees of the member bank and, in the case of extensions of credit to an insider of its affiliates, does not give preference to any insider of its affiliates over other employees of the affiliates of which that person is an insider.

(b) *Prior approval*. A member bank may not extend credit (including granting a line of credit) to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit to that person and to all related interests of that person, exceeds the higher of $25,000 or 5 percent of the member bank's unimpaired capital and unimpaired surplus, but in no event can it exceed $500,000. This provision applies unless (1) the extension of credit or line of credit has been approved in advance by a majority of the entire board of directors of that bank and (2) the interested party has abstained from participating directly or indirectly in the voting.

The board of directors' approval is not required for an extension of credit that is made pursuant to a line of credit that was approved by the board of directors within 14 months of the date of the extension of credit. Participation in the discussion, or any attempt to influence the voting, by the board of directors regarding an extension of credit constitutes indirect participation in the voting by the board of directors on an extension of credit.

(c) *Individual lending limit*. A member bank may not extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit described above in section 2050.0.3.2 (paragraph h). This prohibition does not apply to an extension of credit by a member bank to a company of which the member bank is a subsidiary or to any other subsidiary of that company.

(d) *Aggregate lending limit.*

(1) *General limit.* A member bank may not extend credit to any insider of the bank or insider of its affiliates unless the extension of credit is in an amount that, when aggregated with all outstanding extensions of credit to all such insiders, would exceed the bank's unimpaired capital and unimpaired surplus as defined in section 215.2(i) of Regulation O (see section 2050.0.3.2, paragraph h).

(2) A member bank with deposits of less than $100,000,000 may, by an annual resolution of its board of directors, increase the general limit (specified above) to a level that does not exceed two times the bank's unimpaired capital and unimpaired surplus if the board of directors determines that such higher limit is consistent with prudent, safe, and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent the restriction of the availability of credit in small communities.

The board of directors' resolution must set forth the facts and reasoning on which it bases its finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution. In addition, the bank must meet or exceed, on a fully phased-in basis, all applicable capital requirements established by the appropriate federal banking agency. The bank would also have had to receive a satisfactory composite rating in its most recent bank examination report.

If a member bank has adopted a resolution authorizing a higher limit and subsequently fails to meet the above-listed requirements, the member bank cannot extend any additional credit (including a renewal of any existing extension of credit) to any insider of the bank or its affiliates unless the extension or renewal is consistent with the general limit.

(3) *Exceptions to the general limit.* Effective May 3, 1993, the general limit, described in manual section 2050.0.3.3 (paragraph d) and specified in section 215.4(d)(1) of the Board's Regulation O does not apply to—

(i) extensions of credit secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States or in other such obligations fully guaranteed as to principal and interest by the United States;

(ii) extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission, or establishment of the United States or any corporation wholly owned directly or indirectly by the United States;

(iii) extensions of credit secured by a perfected security interest in a segregated deposit account in the lending bank; or

(iv) extensions of credit arising from the discount of negotiable installment consumer paper that is acquired from an insider and carries a full or partial recourse endorsement or guarantee by the insider,[9] provided that—

(A) the financial condition of each maker of such consumer paper is reasonably documented in the bank's files or known to its officers;

(B) an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for the payment of the obligation and not upon any endorsement or guarantee by the insider; and

(C) the maker of the instrument is not an insider.

(e) *Overdrafts.* A member bank may not pay an overdraft of an executive officer or director of the bank[10] on an account at the bank, unless the payment of funds is made in accordance with (1) a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment or (2) a written, preauthorized transfer of funds from another account of the account holder at the bank.

The prohibition above does not apply to payment of inadvertent overdrafts on an account in an aggregate amount of $1,000 or less, provided (1) the account is not overdrawn for more than five business days and (2) the member bank charges the executive officer or director the same fee charged any other customer of the bank in similar circumstances.[11]

9. The exceptions to the aggregate lending limit pertaining to extensions of credit secured in the manner described above (i through iii) apply only to the amounts of such extensions of credit that are secured in such manner.

10. This prohibition does not apply to the payment by a member bank of an overdraft of a principal shareholder of the member bank, unless the principal shareholder is also an executive officer or director. This prohibition also does not apply to the payment by a member bank of an overdraft of a related interest of an executive officer, director, or principal shareholder of the member bank.

11. The requirement that the member bank charge the executive officer or director the same fee charged any other customer of the bank in similar circumstances does not prohibit the member bank from charging a fee provided for in a benefit or compensation program that satisfies the require-

2050.0.3.4 Additional Restrictions on Loans to Executive Officers of Member Banks

The following restrictions on extensions of credit by a member bank to any of its executive officers are in addition to any restrictions on extensions of credit by a member bank to insiders of itself or its affiliates. The restrictions listed below apply only to the executive officers of the member bank and not to the executive officers of its affiliates.

A member bank may not extend credit to any of its executive officers, and no executive officer of a member bank can borrow from or otherwise become indebted to the bank, except in the amounts, for the purposes, and upon the conditions specified in items 3 and 4 below.

A member bank is authorized to extend credit to any executive officer of the bank—

(1) in any amount to finance the education of the executive officer's children;

(2) in any amount to finance or refinance the purchase, construction, maintenance, or improvement of a residence of the executive officer, provided—

(i) the extension of credit is secured by a first lien on the residence and the residence is owned (or expected to be owned after the extension of credit) by the executive officer; and

(ii) in the case of refinancing, that only the amount used to repay the original extension of credit, together with the closing costs of the refinancing, and any additional amount thereof used for any of the purposes enumerated in item 2 above, are included within this category of credit;

(3) in any amount, if the extension of credit is secured in a manner described in the first three exceptions to the general limit of the aggregate lending limit (see section 2050.0.3.3, paragraph d, subparagraphs i to iii); and

(4) for any other purpose (not specified in items 1 through 3 above), if the aggregate amount of loans to that executive officer does not exceed, at any one time, the higher of 2.5 percent of the bank's unimpaired capital and unimpaired surplus or $25,000, but in no event more than $100,000.

Any extension of credit by a member bank to any of its executive officers must be—

(1) promptly reported to the member bank's board of directors,

(2) in compliance with the general prohibitions of section 215.4 of Regulation O (manual section 2050.0.3.3),

(3) preceded by the submission of a current detailed financial statement of the executive officer, and

(4) made subject to the condition in writing that the extension of credit will, at the option of the member bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit that may be made available by a member bank to any of its executive officers.

No member bank may extend credit in an aggregate amount greater than the amount permitted for general-purpose loans to an executive officer (section 215.5(c)(4) of Regulation O) to a partnership in which one or more of the bank's executive officers are partners and, either individually or together, hold a majority interest. The total amount of credit extended by a member bank to such partnership is considered to be extended to each executive officer of the member bank who is a member of the partnership.

Prohibition on knowingly receiving unauthorized extensions of credit. Insiders are prohibited from knowingly receiving (or permitting their related interests to receive) any extensions of credit not authorized by section 22(h) of the Federal Reserve Act and by Regulation O.

2050.0.3.5 Grandfathering Provisions

(a) *Under FDICIA.* FDICIA provided that the amendments to Regulation O would not affect extensions of credit entered into on or before the effective date of the regulation. Therefore, extensions of credit, including lines of credit, made on or before May 18, 1992, are not required to comply with either the individual-borrower limit made applicable to directors and their related interests, or with the aggregate limit on all loans to insiders. All extensions of credit, loan renewals, and loan rollovers made after May 18, 1992, must comply with all of the provisions of Regulation O. In other words, banks cannot make new loans or renew outstanding extensions of credit in amounts that, when aggregated with all other outstanding loans to insiders, would exceed either of the new limits.

(b) *Extensions of credit outstanding on March 10, 1979.* Any extension of credit that was outstanding on March 10, 1979, and that would have, if made on or after March 10, 1979, violated the individual lending limit, had to be

ments detailed in section 2050.0.3.3, item (a).

reduced in amount by March 10, 1980, to be in compliance with the aggregate lending limit of Regulation O. Any renewal or extension of such a credit extension on or after March 10, 1979, must have been made only on terms that would have brought it into compliance with the aggregate lending limit by March 10, 1980. However, any extension of credit made before March 10, 1979, that bears a specific maturity date of March 10, 1980, or later, had to be repaid in accordance with the repayment schedule in existence on or before March 10, 1979.

2050.0.3.6 Reports by Executive Officers

Each executive officer of a member bank who becomes indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in section 215.5(c) of Regulation O (manual section 2050.0.3.4) must make a written report to the board of directors of the officer's bank within 10 days of the date the indebtedness reaches such a level. The report must state the lender's name, the date and amount of each extension of credit, any security for it, and the purposes for which the proceeds have been or are to be used.

Report on credit secured by BHC stock. In addition to the report required above, each executive officer or director of a member bank the shares of which are not publicly traded must report annually to the bank's board of directors the outstanding amount of any credit that was extended to the executive officer or director that is secured by shares of the member bank. (See also Regulation Y section 225.4(f) for the identical restriction on executive officers and directors of a bank holding company with loans secured by shares of the bank holding company.)

2050.0.3.7 Report on Credit to Executive Officers

Each member bank must include with (but not as part of) each report of condition (and copy thereof) filed pursuant to 12 U.S.C. 1817(a)(3) a report of all extensions of credit made by the member bank to its executive officers since the date of the bank's previous report of condition.

2050.0.3.8 Disclosure of Credit from Member Banks to Executive Officers and Principal Shareholders

(a) *Definitions.* For the purposes of this section, the following definitions apply:

(1) "Principal shareholder of a member bank" means a person (individual or a company), other than an insured bank, or branch or representative office of a foreign bank as defined in 12 U.S.C. 3101(7)[12] that, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has power to vote more than 10 percent of any class of voting securities of the member bank or company. The term includes an individual or company that controls a principal shareholder (for example, a person that controls a bank holding company). Shares of a bank (including a foreign bank), bank holding company, or other company owned or controlled by a member of an individual's immediate family are considered to be held or controlled by the individual for the purposes of determining principal shareholder status.[13]

(2) "Related interest" means (i) any company controlled by a person; or (ii) any political or campaign committee the funds or services of which will benefit a person or that is controlled by a person. A related interest does not include a bank or a foreign bank (as defined in 12 U.S.C. 3101(7)).

(b) *Public disclosure.* Upon receipt of a written request from the public, a member bank shall make available the names of each of its executive officers (with the exception of any executive officer of a bank holding company of which the member bank is a subsidiary or of any other subsidiary of that bank holding company unless the executive officer is also an executive officer of the member bank) and each of its principal shareholders to whom, or to whose related interests, the member bank had outstanding at the end of the latest previous quarter of the year, an extension of credit that, when aggregated with all other outstanding extensions of credit at that time from the member bank to such person and to all related interests of such

12. A *foreign bank* means any company organized under the laws of a foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands that engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such company. This includes foreign commercial banks, foreign merchant banks, and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized or operating.

13. See footnote 3.

person, equaled or exceeded 5 percent of the member bank's capital and unimpaired surplus or $500,000, whichever amount is less. No disclosure under this paragraph is required if the aggregate amount of all extensions of credit outstanding at that time from the member bank to the executive officer or principal shareholder of the member bank and to all related interests of such a person does not exceed $25,000.

A member bank is not required to disclose the specific amounts of individual extensions of credit.

(c) *Maintaining records.* Each member bank is required to maintain records of all requests for the information described above and the disposition of the requests. These records may be disposed of two years after the date of the request.

2050.0.3.9 Civil Penalties of Regulation O

Any member bank, or any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, that violates any provision of Regulation O is subject to a civil penalty, as specified in section 29 of the Federal Reserve Act.

2050.0.3.10 Records of Member Banks (and BHCs)

To help inspection and examination personnel identify BHC officials, Regulation O requires each member bank to maintain records necessary to monitor compliance with this regulation. BHCs and nonbank subsidiaries should be given access to the records identifying ''bank officials.'' Each state member bank is required to (1) identify, through an annual survey, all insiders of the bank itself; and (2) maintain records of all extensions of credit to insiders of the bank itself, including the amount and terms of each such extension of credit.

2050.0.3.10.1 Recordkeeping for Insiders of the Member Bank's Affiliates

A member bank is required to maintain records of extensions of credit to insiders of the member bank's affiliates by—

(1) a ''survey'' method, which identifies, through an annual survey, each of the insiders of the member bank's affiliates. Under the survey method, the member bank must maintain records of the amount and terms of each extension of credit by the member bank to such insiders or

(2) a ''borrower inquiry'' method, which requires, as part of each extension of credit, the borrower to indicate whether the borrower is an insider of an affiliate of the member bank. Under this method, the member bank must maintain records that identify the amount and terms of each extension of credit by the member bank to borrowers so identifying themselves.

Alternative recordkeeping method for insiders of affiliates. A member bank may use a recordkeeping method other than those identified above if the appropriate federal banking agency determines that the bank's method is at least as effective.

2050.0.3.10.2 Special Rule for Noncommercial Lenders

A member bank that is prohibited by law or by an express resolution of the bank's board of directors from making an extension of credit to any company, or other entity that is covered by Regulation O as a company, is not required to maintain any records of the related interests of the insiders of the bank or its affiliates. The bank is also not required to inquire of borrowers whether they are related interests of the insiders of the bank or its affiliates.

2050.0.3.11 Section 23A Ramifications

Loans to a holding company parent and its affiliates are governed by section 23A of the Federal Reserve Act and are not subject to Regulation O.

2050.0.4 REMEDIAL ACTION

Self-serving and abusive transactions deprive a BHC of opportunities and benefits that may otherwise have been available and may strip a BHC of its ability to serve as a source of financial and managerial strength to its subsidiary banks. Even if not extended on preferential terms, self-serving loans and other extensions of credit to insiders may be an imprudent business practice and may reduce the lender's liquidity or otherwise overextend the BHC. In such situations, formal or informal remedial measures by the Federal Reserve may be necessary. Formal enforcement action is provided for in the 1974 amendments to the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818), which grant the Board authority to issue cease-and-desist orders in appropriate situations. For complete details on formal corrective actions, see section 2110.0.

2050.0.5 INSPECTION OBJECTIVES

1. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries are based on preferential treatment.
2. To determine if any transactions between BHC officials, their related interests, and the BHC or its nonbank subsidiaries result in any undue loss exposure to the BHC or its subsidiaries.
3. To determine if any BHC or nonbank extension of credit to a BHC official or related interest is in the spirit of Regulation O's requirements or whether it is an attempt to circumvent Regulation O's prohibition on various bank extensions of credit to similar parties.
4. To determine that BHC officials are aware of Regulation O's limitations and prohibitions and have established internal policies and procedures for the bank subsidiaries to ensure compliance by the banks.
5. To determine that the BHC has arranged to make available, upon request, a listing or some other form of information sufficient to identify all ''BHC officials'' and to make certain that such information is available to the bank subsidiaries in particular.

2050.0.6 INSPECTION PROCEDURES

1. Review the balance sheets and other records of the parent-only and nonbank subsidiaries to determine if there are any loans or other extensions of credit to BHC officials.
2. Review the income statements and supporting records of the parent-only and nonbank subsidiaries to determine if any interest income, other income, or expense is associated with a transaction with a BHC official or a related interest.
3. Ask management to identify all such transactions and to provide supporting documentation.
4. Review management's familiarity with Regulation O's limitations and the steps they have taken to establish policies for the internal administration of their subsidiary banks' extensions of credit to BHC officials.
5. Review any information prepared by management that presents a listing of all BHC officials and their related interests.
6. Review any corporate resolutions declaring an individual not to be an ''executive officer'' for purposes of Regulation O and, if necessary, confirm the individual's nonparticipation in the formulation of corporate policy.
7. As the provision of Regulation O apply to the BHC and its subsidiaries, determine if the BHC provides employees or other insiders with extensions of credit, including BHC-owned or BHC-issued credit cards. Find out if any of the credit cards are used to conduct the BHC's business.
   a. Verify that the BHC has a written policy that forbids or discourages an employee or other insider from using a BHC-owned or BHC-issued credit card for the insider's personal purposes and that the policy obligates the insider to promptly make reimbursement to the BHC.
   b. Determine the BHC's compliance with Regulation O regarding its extensions of credit (including BHC-owned or BHC-issued credit card loans) to insiders. Verify that the BHC monitors the amount of personal charges outstanding on its BHC-owned or BHC-issued credit cards that are held by insiders so that the outstanding charges, when aggregated with all of an insider's other indebtedness owed to the BHC, do not exceed $15,000.
   c. Verify the BHC's compliance with the market-terms requirement of Regulation O. Determine if—
      - the BHC requires employees and other insiders who have extensions of credit, or use BHC-owned or BHC-issued credit cards for personal purposes, to meet the BHC's normal credit underwriting standards and

- the BHC has verified that the insiders' extensions of credit (or BHC-owned or BHC-issued credit cards) do not have more preferential terms (for example, a lower interest rate or a longer repayment period) than the consumer credit cards offered by the BHC.

2050.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans and extensions of credit to executive officers, directors, and principal shareholders	375a and 375b (sections 22(g) and 22(h) of F.R. Act)	215.4 215.5 (Reg. O)		
Granting of below-market interest rate mortgage loans to executives of BHC subsidiaries as compensation	1972(2)		4–514 3–1094	
Restrictions on loans to insiders of a bank or its correspondent bank	1972 (2)			
Board staff interpretation on the use of bank-owned or bank-issued credit cards by bank insiders			3–1081.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Management Information Systems refers to the policies and operating procedures, including systems of internal control, that the board of directors of a bank holding company initiates to monitor and ensure control of its operations and activities, while maintaining and improving the financial strength and objectives of the overall organization. These policies should focus on the overall organizational structure with respect to identifying, monitoring, and managing risks. Subsequent sections of the manual focus on the essential elements of various management information systems. Included are inspection objectives and procedures to be used by Federal Reserve Bank examiners when conducting inspections of bank holding companies.

See 2060.05 Internal Audit Function and Its Outsourcing
2060.1 Audit
2060.2 Budget
2060.3 Records and Statements
2060.4 Reporting
2060.5 Insurance
5052.0 Targeted MIS Inspection

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2014, this section was revised to include new and revised inspection objectives and inspection procedures for both the 2003 interagency guidance, "Policy Statement on the Internal Audit Function and its Outsourcing," and the January 23, 2013, Federal Reserve "Supplemental Policy Statement on Internal Audit Function and its Outsourcing." Refer to SR-03-5 and SR 13-1/CA 13-1 and Manual section 2060.07.

2060.05.01 AN EFFECTIVE SYSTEM OF INTERNAL CONTROLS

Effective internal control[1] is a foundation for the safe and sound operation of a financial institution (institution).[2] The board of directors and senior management of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties. An important element in assessing the effectiveness of the internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action. The federal banking agencies'[3] (agencies) long-standing inspection policies call for examiners to review an institution's internal audit function and recommend improvements, if needed. In addition, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831p-1), the agencies have adopted Interagency Guidelines Establishing Standards for Safety and Soundness that apply to insured depository institutions.[4] Under these guidelines and policies, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms and other outside professionals (outsourcing vendors) in recent years to perform work that traditionally has been done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter, collectively referred to as outsourcing). Typical outsourcing arrangements are more fully illustrated in part II below.

Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements do not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing vendors do not leave directors and senior management with the erroneous impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002.[5] The act addresses weaknesses in corporate governance and the

1. In summary, internal control is a process designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report *Internal Control—Integrated Framework*. In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for purposes of this policy statement, encompass both financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

2. The term "institution" includes depository institutions insured by the Federal Deposit Insurance Corporation (FDIC), U.S. financial holding companies and bank holding companies supervised by the Federal Reserve System, thrift holding companies supervised by the Office of Thrift Supervision (OTS), and the U.S. operations of foreign banking organizations.

3. The Board of Governors of the Federal Reserve System (FRS), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS).

4. For national banks, appendix A to part 30; for state member banks, appendix D-1 to part 208; for insured state nonmember banks and insured state-licensed branches of foreign banks, appendix A to part 364; for savings associations, appendix A to part 570.

5. Pub. L. No. 107-204.

accounting and auditing professions, and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee composed entirely of independent directors. Public banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

The act also established a Public Company Accounting Oversight Board (PCAOB) that has the authority to set and enforce auditing, attestation, quality control, and ethics (including independence) standards for auditors of public companies, subject to SEC review. (See SR-02-20.) Accounting firms that conduct audits of public companies (i.e., registered accounting firms) must register with the PCAOB and be subject to its supervision. The PCAOB is also empowered to inspect the auditing operations of public accounting firms that audit public companies, as well as impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards.

[Sections 2060.05.02–2060.05.04 are reserved.]

2060.05.05 APPLICATION OF THE SARBANES-OXLEY ACT TO NONPUBLIC BANKING ORGANIZATIONS

In May 2003, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced that they did not expect to take actions to apply the corporate-governance and other requirements of the Sarbanes-Oxley Act generally to nonpublic banking organizations that are not otherwise subject to them.[5a] (See SR-03-08.) The agencies, however, encouraged nonpublic banking organizations to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the organization's size, operations, and resources. Furthermore, the agencies stated that a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and the agencies may take appropriate supervisory action if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

5a. As discussed below, some aspects of the auditor-independence rules established by the Sarbanes-Oxley Act apply to all federally insured depository institutions with $500 million or more in total assets. See part 363 of the FDIC's regulations.

2060.05.06 INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve and other federal banking agencies[6] adopted on March 17, 2003, an interagency policy statement addressing the internal audit function and its outsourcing (See SR 03-5). The policy statement revises and replaces the former 1997 policy statement and incorporates recent developments in internal auditing. In addition, the revised policy incorporates guidance on the independence of accountants who provide institutions with both internal and external audit services in light of the Sarbanes-Oxley Act of 2002 and associated SEC rules. (See also sections 2124.0.2.4, 2060.1, 3230.0.10.2.5, 5010.7, and 5030.0 [page 7] pertaining to internal and external audits.)

The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit services to the company. The policy statement discusses the applicability of this prohibition to institutions that are public companies, insured depository institutions with assets of $500 million or more that are subject to the annual audit and reporting requirements of section 36 of the Federal Deposit Insurance Act, and also nonpublic institutions that are not subject to section 36.

6. The FDIC, OCC, and OTS.

2060.05.1 INTERNAL AUDIT FUNCTION (PART I)

2060.05.1.1 Director and Senior Management Responsibilities for Internal Audit

The board of directors and senior management are responsible for having an effective system of internal control and an effective internal audit function in place at their institution. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. Accordingly, directors and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies.[7]

Some institutions have chosen to rely on so-called management self-assessments or control self-assessments, wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and members of senior management who rely too much on these reviews may not learn of control weaknesses until they have become costly problems, particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. To accomplish this objective, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality-assurance reviews. Furthermore, directors and senior management should ensure that the following matters are reflected in their institution's internal audit function.

2060.05.1.1.1 Internal Audit Placement and Structure Within the Organization

Careful thought should be given to the placement of the audit function in the institution's management structure. The internal audit function should be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee,[8] using objective criteria it has established, should oversee the internal audit function and evaluate its per-

7. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 C.F.R. 363), FDIC-insured depository institutions with total assets of $500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must contain the following: (1) a statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness, including management's assessment of the institution's compliance with those laws and regulations; and (2) for an institution with total assets of $1 billion or more at the beginning of the institution's most recent fiscal year, the report should include an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See 12 C.F.R. 363.2(b) and 70 *Fed. Reg. 71,232, November 28, 2005.)*

8. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain an independent audit committee (i.e., consisting of directors who are *not* members of management). For institutions with between $500 million and $1 billion in assets, only a majority, rather than all, of the members of the audit committee—who must be outside directors—must be independent of management. For insured institutions having total assets of more than $3 billion, the audit committee must (1) have members with banking or related financial management expertise, (2) have access to outside legal counsel, and (3) not include any large customers of the institution. The audit committee also may be required to satisfy other audit committee membership criteria (see 12 U.S.C. 831m(g)(1)(c) and section 363.5(b)(12 C.F.R. 363.5(b)). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term ''audit committee'' is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement.

formance.[9] The audit committee should assign responsibility for the internal audit function to a member of management (that is, the manager of internal audit or internal audit manager) who understands the function and has no responsibility for operating the system of internal control. The ideal organizational arrangement is for this manager to report directly and solely to the audit committee regarding both audit issues and administrative matters (e.g., resources, budget, appraisals, and compensation). Institutions are encouraged to consider the IIA's *Practice Advisory 2060-2: Relationship with the Audit Committee*, which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

Many institutions place the manager of internal audit under a dual reporting arrangement: functionally accountable to the audit committee on issues discovered by the internal audit function, while reporting to another senior manager on administrative matters. Under a dual reporting relationship, the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role. The objectivity and organizational stature of the internal audit function are best served under such a dual arrangement if the internal audit manager reports administratively to the CEO.

Some institutions seek to coordinate the internal audit function with several risk-monitoring functions (for example, loan review, market-risk assessment, and legal compliance departments) by establishing an administrative arrangement under one senior executive. Coordination of these other monitoring activities with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better use available resources, and enhance the institution's ability to comprehensively manage risk. Such an administrative reporting relationship should be designed so as to not interfere with or hinder the manager of internal audit's functional reporting to and ability to directly communicate with the institution's audit committee. In addition, the audit committee should ensure that efforts to coordinate these monitoring functions do not result in the manager of internal audit conducting control activities nor diminish his or her independence with respect to the other risk-monitoring functions. Furthermore, the internal audit manager should have the ability to independently audit these other monitoring functions.

In structuring the reporting hierarchy, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden in adopting a dual reporting organizational structure. The audit committee should document its consideration of this risk and mitigating controls. The IIA's *Practice Advisory 1110-2: Chief Audit Executive Reporting Lines* provides additional guidance regarding functional and administrative reporting lines.

2060.05.1.1.2 Internal Audit Management, Staffing, and Audit Quality

In managing the internal audit function, the manager of internal audit is responsible for control risk assessments, audit plans, audit programs, and audit reports.

1. A control risk assessment (or risk-assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. They should be updated regularly to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
2. An internal audit plan is based on the control risk assessment and typically includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
3. An internal audit program describes the objectives of the audit work and lists the

9. For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

procedures that will be performed during each internal audit review.

4. An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk-management, control, and governance processes. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganizations. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its independence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff. The form and content of these policies and procedures should be consistent with the size and complexity of the department and the institution. Many policies and procedures may be communicated informally in small internal audit departments, while larger departments would normally require more formal and comprehensive written guidance.

2060.05.1.1.3 Internal Audit Frequency and Scope

The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[10]

2060.05.1.1.4 Communication of Internal Audit Findings to the Directors, Audit Committee, and Management

To properly carry out their responsibility for internal control, directors and senior management should foster forthright communications and critical inspection of issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions to these weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether management is expeditiously resolving internal control weaknesses and other exceptions. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

10. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include (1) new management; (2) areas or activities experiencing rapid growth or rapid decline; (3) new lines of business, products, or technologies or disposals thereof; (4) corporate restructurings, mergers, and acquisitions; and (5) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

Furthermore, each audit committee should establish and maintain procedures for employees of their institution to submit confidentially and anonymously concerns to the committee about questionable accounting, internal accounting control, or auditing matters.[11] In addition, the audit committee should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

2060.05.1.1.5 Contingency Planning

As with any other function, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Lack of contingency planning for continuing internal audit coverage may increase the institution's level of operational risk.

2060.05.1.2 U.S. Operations of Foreign Banking Organizations

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. Its U.S.-domiciled audit function, head-office internal audit staff, or some combination thereof normally performs the internal audit of the U.S. operations. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

2060.05.1.3 Internal Audit Systems and the Audit Function for Small Financial Institutions

An effective system of internal control and an independent internal audit function form the foundation for safe and sound operations, regardless of an institution's size. Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is the responsibility of the audit committee and management to carefully consider the extent of auditing that will effectively monitor the internal control system after taking into account the internal audit function's costs and benefits. For institutions that are large or have complex operations, the benefits derived from a full-time manager of internal audit or an auditing staff likely outweigh the cost. For small institutions with few employees and less complex operations, however, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The key characteristic of such reviews is that the person(s) directing and/or performing the review of internal controls is not also responsible for managing or operating those controls. A person who is competent in evaluating a system of internal control should design the review procedures and arrange for their implementation. The person responsible for reviewing the system of internal control should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure that senior management has or will take appropriate action to correct the control deficiencies.

2060.05.2 INTERNAL AUDIT OUTSOURCING ARRANGEMENTS (PART II)

2060.05.2.1 Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal

11. Where the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as ''internal audit assistance'' or ''audit co-sourcing.''

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

2060.05.2.2 Additional Inspection and Examination Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing vendors provide internal audit services, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively. In any outsourced internal audit arrangement, the institution's board of directors and senior management must maintain ownership of the internal audit function and provide active oversight of outsourced activities. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control will go undetected.

To clearly distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, often taking the form of an engagement letter.[12] Contracts between the institution and the vendor typically include provisions that—

1. define the expectations and responsibilities under the contract for both parties;
2. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
3. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
4. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;
5. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
6. specify the locations of internal audit reports and the related workpapers;
7. specify the period of time (for example, seven years) that vendors must maintain the workpapers;[13]
8. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
9. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
10. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if

12. The engagement letter provisions described are comparable to those outlined by the American Institute of Certified Public Accountants (AICPA) for financial statement audits (see AICPA Professional Standards, AU section 310). These provisions are consistent with the provisions customarily included in contracts for other outsourcing arrangements, such as those involving data processing and information technology. Therefore, the federal banking agencies consider these provisions to be usual and customary business practices.

13. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

applicable, will comply with AICPA, SEC, PCAOB, or regulatory independence guidance.

2060.05.2.2.1 Management of the Outsourced Internal Audit Function

Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor. Small institutions that do not employ a full-time audit manager should appoint a competent employee who ideally has no managerial responsibility for the areas being audited to oversee the outsourcing vendor's performance under the contract. This person should report directly to the audit committee for purposes of communicating internal audit issues.

2060.05.2.2.2 Communication of Outsourced Internal Audit Findings to Directors and Senior Management

Communication between the internal audit function and the audit committee and senior management should not diminish because the institution engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

2060.05.2.2.3 Competence of Outsourced Internal Audit Vendor

Before entering an outsourcing arrangement, the institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. The staff's qualifications may be demonstrated, for example, through prior experience with financial institutions. Because the outsourcing arrangement is a personal-services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive timely notice of key staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations.

2060.05.2.2.4 Contingency Planning to Avoid Discontinuity of Internal Audit Coverage

When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it may increase its operational risk. Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

2060.05.3 INDEPENDENCE OF THE INDEPENDENT PUBLIC ACCOUNTANT (PART III)

The following discussion applies only when a financial institution is considering using a public accountant to provide both external audit and internal audit services to the institution.

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. These concerns arise because, rather than having two separate functions, this outsourcing arrangement places the independent public accounting firm in the position of appearing to audit, or actually auditing, its own work. For example, in auditing an institution's financial statements, the accounting firm will consider the extent to which it may rely on the internal control system, including the internal audit function, in designing audit procedures.

2060.05.3.1 Applicability of the SEC's Auditor Independence Requirements

2060.05.3.1.1 Institutions That Are Public Companies

To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC under section 15(d) of that act.[14] The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.[15] In addition, if a public company's external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company's audit committee must preapprove each of these services.

According to the SEC's final rules (effective May 6, 2003) implementing the act's nonaudit service prohibitions and audit committee preapproval requirements, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited nonaudit services to the public company audit client. The SEC's final rules generally become effective May 6, 2003, although a one-year transition period is provided if the accountant is performing prohibited nonaudit services and actual audit services for a public company pursuant to a contract in existence on May 6, 2003. The services provided during this transition period, however, must not have impaired the auditor's independence under the preexisting independence requirements of the SEC, the Independence Standards Board, and the AICPA. Although the SEC's pre-Sarbanes-Oxley independence requirements (issued November 2000 (effective August 2002)) did not prohibit the outsourcing of internal audit services to a public company's independent public accountant, they did place conditions and limitations on internal audit outsourcing.

2060.05.3.1.2 Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

Under section 36, as implemented by part 363 of the FDIC's regulations, each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant.[16] The part 363 guidelines address the qualifications of an independent public accountant engaged by such an institution by stating that ''[t]he independent public accountant should also be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff.''[17]

Thus, the guidelines provide for each FDIC-insured depository institution with $500 million or more in total assets, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit. These requirements include the nonaudit-service prohibitions and audit committee preapproval requirements implemented by the SEC's January 2003 auditor independence rules, once the rules come into effect.[18]

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14. 15 U.S.C. 78*l* and 78o(d).

15. In addition to prohibiting internal audit outsourcing, the Sarbanes-Oxley Act (15 U.S.C. 78j-1) also identifies other nonaudit services that an external auditor is prohibited from providing to a public company whose financial statements it audits. The legislative history of the act indicates that three broad principles should be considered when determining whether an auditor should be prohibited from providing a nonaudit service to an audit client. These principles are that an auditor should not (1) audit his or her own work, (2) perform management functions for the client, or (3) serve in an advocacy role for the client. To do so would impair the auditor's independence. Based on these three broad principles, the other nonaudit services . . . referred to in this section . . . that an auditor is prohibited from providing to a public company audit client include bookkeeping or other services related to the client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service determined to be impermissible by the PCAOB.

16. 12 C.F.R. 363.3(a). (See FDIC Financial Institutions Letter, FIL-17-2003 (Corporate Governance, Audits, and Reporting Requirements), Attachment II, March 5, 2003.)

17. Appendix A to part 363, Guidelines and Interpretations, paragraph 14, Independence.

18. If a depository institution subject to section 36 and part 363 satisfies the annual independent audit requirement by relying on the independent audit of its parent holding company, once the SEC's January 2003 regulations prohibiting an external auditor from performing internal audit outsourcing services for an audit client take effect May 6, 2003, or May 6, 2004, depending on the circumstances, the holding company's external auditor cannot perform internal audit outsourcing

2060.05.3.1.3 Institutions Not Subject to Section 36 of the FDI Act That Are Neither Public Companies Nor Subsidiaries of Public Companies

The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company[19] to have its financial statements audited by an independent public accountant.[20] The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies. As previously mentioned, some institutions seek to enhance the quality of their control environment by obtaining the services of an outsourcing vendor who can critically assess their internal control system and recommend improvements. The agencies believe that a small nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. These circumstances include, but are not limited to, situations where—

1. splitting the audit activities poses significant costs or burden,
2. persons with the appropriate specialized knowledge and skills are difficult to locate and obtain,
3. the institution is closely held and investors are not solely reliant on the audited financial statements to understand the financial position and performance of the institution, and
4. the outsourced internal audit services are limited in either scope or frequency.

In circumstances such as these, the agencies view an internal audit outsourcing arrangement between a small nonpublic institution and its external auditor as not being inconsistent with their safety-and-soundness objectives for the institution.

When a small nonpublic institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement.[21] In this regard, the audit committee should consider the independence standards described in parts I and II of the policy statement, the AICPA guidance discussed below, and the broad principles that the auditor should not perform management functions or serve in an advocacy role for the client.

Accordingly, the agencies will not consider an auditor who performs internal audit outsourcing services for a small nonpublic audit client to be independent unless the institution and its auditor have adequately addressed the associated independence issues. In addition, the institution's board of directors and management must retain ownership of and accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

A small nonpublic institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. In this situation, if warranted for safety-and-soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor independence requirements of the Act.[22]

2060.05.3.1.4 AICPA Guidance

As noted above, the independent public accountant for a depository institution subject to section 36 of the FDI Act also should be in compliance with the AICPA's *Code of Professional Conduct*. This code includes professional ethics standards, rules, and interpretations that are binding on all certified public accountants (CPAs) who are members of the AICPA in order

work for that holding company or the subsidiary institution.

19. FDIC-insured depository institutions with less than $500 million in total assets are not subject to section 36 of the FDI Act. Section 36 does not apply directly to holding companies, but it provides that, for an insured depository institution that is a subsidiary of a holding company, its audited financial statements requirement and certain of its other requirements may be satisfied by the holding company.

20. See, for example, the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions.

21. If a small nonpublic institution is considering having its external auditor perform other nonaudit services, its audit committee may wish to discuss the implications of the performance of these services on the auditor's independence.

22. 15 U.S.C. 78j-1.

for the member to remain in good standing. Therefore, this code applies to each member CPA who provides audit services to an institution, regardless of whether the institution is subject to section 36 or is a public company.

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct*.

2060.05.4 INSPECTION GUIDANCE (PART IV)

2060.05.4.1 Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their inspection work and may subject the institution to follow-up supervisory actions.

Examiners should assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners should consider whether—

1. the internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the institution's activities;
2. the internal audit activities have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
3. the internal audit activities are consistent with the long-range goals and strategic direction of the institution and are responsive to its internal control needs;
4. the audit committee promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
5. the internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired;
6. the institution has promptly responded to significant identified internal control weaknesses;
7. the internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and results of audits are promptly communicated to senior management and members of the audit committee and board of directors;
8. workpapers adequately document the internal audit work performed and support the audit reports;
9. management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing*, when assessing the performance of internal audit; and
10. the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. In addition, when reviewing outsourcing arrangements, examiners should determine whether—

1. the arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
2. key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
3. the scope of the outsourced work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
4. the directors have ensured that the outsourced internal audit activities are effectively managed by the institution;
5. the arrangement with the outsourcing vendor satisfies the independence standards described in this policy statement and

thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant; and
6. the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

2060.05.4.2 Inspection Concerns About the Adequacy of the Internal Audit Function

If the examiner concludes that the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet the institution's internal audit needs; does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, if applicable; or is otherwise inadequate, he or she should determine whether the scope of the inspection should be adjusted. The examiner should also discuss his or her concerns with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's concerns, he or she should bring these matters to the attention of senior management and the board of directors or audit committee. Should the examiner find material weaknesses in the internal audit function or the internal control system, he or she should discuss them with appropriate agency staff in order to determine the appropriate actions the agency should take to ensure that the institution corrects the deficiencies. These actions may include formal and informal enforcement actions.

The institution's management and composite ratings should reflect the examiner's conclusions regarding the institution's internal audit function. The report of inspection should contain comments concerning the adequacy of this function, significant issues or concerns, and recommended corrective actions.

2060.05.4.3 Concerns About the Independence of the Outsourcing Vendor

An examiner's initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards described in parts I and II of the policy statement, whether or not the vendor is an accounting firm, and in part III if the vendor provides both external and internal audit services to the institution. In such cases, the examiner first should ask the institution and the outsourcing vendor how the audit committee determined that the vendor was independent. If the vendor is an accounting firm, the audit committee should be asked to demonstrate how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff prior to taking any further action.

If the agency staff concurs that the independence of the external auditor or other vendor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor or other vendor. In addition, the agency may refer the external auditor to the state board of accountancy, the AICPA, the SEC, the PCAOB, or other authorities for possible violations of applicable independence standards. Moreover, the agency may conclude that the institution's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including sections 36 and 39 of the FDI Act and related guidance and regulations, if applicable.

2060.05.5 INSPECTION OBJECTIVES

1. To determine with reasonable assurance whether the institution[23] has an adequate system of internal controls that ensures efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
2. To determine if the internal audit function and the internal audit outsourcing arrangements of the banking organizations are adequately and competently managed by the board of directors and senior management.

23. The term ''institution'' is used to maintain consistency with the interagency policy statement, but these inspection objectives and procedures apply to financial holding companies, bank holding companies, and their bank and nonbank subsidiaries.

3. To ascertain that the banking organization's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the management process: the control environment, risk assessment, control activities, information and communication, and monitoring activities.
4. To make an overall determination as to whether an institution's internal audit function and its processes are effective or ineffective based on the 2003 interagency policy statement and the FR supplemental policy guidance.
5. To determine whether the internal audit function reports vital information about weaknesses in the system of internal control to the board of directors (or its audit committee) and senior management and that expeditious remedial action is taken to resolve the internal control weaknesses as well as any other exceptions.
6. To determine if
   a. the audit committee has established and maintains procedures for employees of the institution to confidentially and anonymously submit concerns to the committee about questionable accounting, internal control, or auditing matters; and
   b. the audit committee has procedures for the timely investigation of complaints received and the retention, for a reasonable time period, of documentation concerning the complaint and its subsequent resolution.
7. To determine the adequacy of the internal audit function (including its use of outsourced internal audit vendors) as to organizational structure, prudent management, staff having sufficient expertise, audit quality, and the ability of auditors to directly and freely communicate internal audit findings to the board of directors, its audit committee, and senior management.
8. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor, under standards established in the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" and the 2013 Federal Reserve's "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."
9. To determine whether the internal audit function and its processes can be relied upon for the current supervisory review period.
10. For high risk areas, to make a determination as to whether additional inspection work is needed even when the internal audit may be deemed effective and its work reliable.

2060.05.6 INSPECTION PROCEDURES

Examiners should obtain assurances from the audit committee and senior management that they will have full and timely access to an institution's internal audit resources, including personnel, work papers, risk assessments, work plans, programs, reports, and budgets. Examiners should consider widening the scope of their inspection work when such assurances are not provided or if there are any significant delays in gaining access to the internal audit resources. Such a delay may subject the institution to follow-up supervisory action.

This inspection program should include a review of audit function and audit outsourcing, which would include a review of the holding company's internal and external audits and the audit procedures they encompass. The audit guidelines are general and all sections or questions may not be applicable to every entity within the consolidated organization.

Before reviewing any specific audit procedures, the examiner should first determine the independence and competence of the auditors. If the examiner believes the auditors to be both competent and independent, he or she should then determine the effectiveness and adequacy of their work, and whether the auditors made an assessment as to whether the institution's internal audit function incorporated the enhanced practices outlined in the FR's "Supplemental Policy Statement on Internal Audit Function and its Outsourcing" (Supplemental Guidance).

Based on a review of the audit function and on the auditor's work, the examiner must then determine the scope of the inspection. The program and related supporting documentation should be completed in an organized manner and should be retained as part of the inspection work papers.

Upon completion of the review of the internal audit program, the examiner should be able to formulate a conclusion on the effectiveness of audit processes and coverage. Conclusions about any weaknesses in the internal or external audit work performed for the FR supervised bank or savings and loan holding company should be summarized and included in the inspection report. Matters Requiring Immediate Attention (MRIA) or Matters Requiring Attention (MRA) to be included in the inspection report should be discussed with the audit committee and board of directors, the Chief Audit Executive, (CAE) and senior bank management.

2060.05.6.1 Internal Audit Function

The following inspection procedures should encompass a review of the structure of the internal audit organization and function:

1. *Organizational structure of the audit department.* Review the internal audit's charter and its organization chart for direct and indirect reporting lines of the CAE, and the minutes of the board's audit or examining committee to determine how effectively the CAE and board of directors are discharging their responsibility. If the CAE reports to someone other than the chief executive officer (CEO), determine if the audit committee has documented its rationale for the reporting structure, including any mitigating controls for situations that could adversely impact the objectivity of the CAE. Determine if the audit committee has quarterly, but at least annually, evaluated whether (1) the CAE is impartial and not unduly influenced by the administrative reporting line and (2) any conflicts of interest for the CAE and other audit staff are accompanied by appropriate restrictions to mitigate those conflicts.
2. *Independence of the audit function.* Interview the CAE and observe the operation of the audit department to determine its functional responsibilities.
3. *CAE's qualifications.* Review biographical data and interview the CAE to determine his or her ability to manage the institution's internal audit function and his or her responsibility within the institution (i.e., bank holding or savings and loan holding company).
4. *Audit staff qualifications.* Review the biographical data and interview the management staff of the audit department to determine their qualifications commensurate with their delegated responsibilities compared to the institution's strategy and operations. Review the educational background, professional certifications and relevant banking and audit experience of staff to assess overall staff qualifications and to identify any knowledge gaps.
5. *Skills gap assessments.* Review how often they are performed, and how gaps in coverage are addressed (e.g. targeted staff hires; training; business- line rotation programs, and co-sourcing/ outsourcing arrangements).
6. *Training.* Ensure there is a process in place to determine and monitor the annual training, typically 40 hours minimum, for each staff member based on their needs.
7. *Content and use of the audit frequency and scope schedule.* Review the methodology utilized to determine the audit universe and frequency of coverage per auditable entity.
8. *Audit department participation in systems design projects.* Determine through interviews and documentation reviews, internal audit's role in assessing systems change control processes.
9. *Internal audit charter.* Review the internal audit charter to determine its current adequacy. Determine whether the CAE periodically reviews the current adequacy of the charter and makes recommendations to the audit committee for improving internal audit function and whether outsourcing to external experts may be needed.
10. *Audit manual.* Review the audit manual to ensure that it includes all applicable audit processes, practices, and procedures, and applicable references to Institute of Internal Auditor (IIA) standards.
11. *Maintenance of audit records.* Review a sample of the audit reports and associated work papers to determine compliance with prescribed procedures and proper documentation, including appropriate distribution to senior managers.
12. *Audit department's formal reporting procedures.* Review CAE presentations and MIS reporting to the audit or examining committee to ensure the committee is providing effective oversight of the internal audit function.
13. *Issue Tracking Follow-up Processes.* Review processes utilized to validate closure of internal audit findings. Review a sample of closed issues to ensure that internal audit maintains sufficient documentation to validate issue closure.

14. *Use and effectiveness of audit computer programs.* Interview the CAE and/or the appropriate staff members regarding the use of the computer and access to the files for audit purposes. Obtain a walkthrough of automated auditing systems and methodologies.

2060.05.6.2 Other Internal Audit Function Inspection Procedures

1. Broaden the scope of the inspection if the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet its internal audit needs, does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, or is otherwise inadequate.
2. Discuss supervisory concerns and outstanding internal-external audit report comments with the CAE or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or audit committee.
3. If material weaknesses in the internal audit function or the internal control system exist, discuss them with appropriate Federal Reserve Bank supervisory staff to determine the appropriate actions that should be taken to ensure that the institution corrects the deficiencies (including formal and informal enforcement actions).
4. Incorporate conclusions about the institution's internal audit function into its management and composite supervisory ratings.
5. Include in the inspection report comments concerning the adequacy of the internal audit function, significant issues or concerns, and recommended corrective actions.

2065.05.6.3 Additional Aspects of the Examiner's Review of an Outsourcing Arrangement

1. Review the internal audit outsourcing arrangement and determine if the institution has a written contract or an engagement letter with the vendor.
2. Determine whether the written contract or engagement letter includes provisions that—
   a. define the expectations and responsibilities under the contract for both parties;
   b. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
   c. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
   d. establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and establish stipulations for default and termination of the contract;
   e. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related work papers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the work papers prepared by the outsourcing vendor;
   f. specify the locations of internal audit reports and the related work papers;
   g. specify the period of time (for example, seven years) that vendors must maintain the work papers;[24]
   h. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related work papers prepared by the outsourcing vendor;
   i. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
   j. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, SEC, PCAOB, or regulatory independence guidance.
3. Determine whether—
   a. the outsourcing arrangement maintains or improves the quality of the internal

24. If the work papers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the banking organization and examiners to access the electronic work papers for a specified time period.

audit function and the institution's internal control;
b. key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
c. the scope of work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
d. the directors have ensured that the outsourced internal audit function is effectively managed by the institution;
e. the arrangement with the outsourcing vendor satisfies the independence standards described in the Policy Statement on the Internal Audit Function and Its Outsourcing and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant;
f. the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and whether there are adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement; and
g. the institution has a contingency plan to ensure continuity in audit coverage, especially for high-risk areas.

4. Adjust the scope of the inspection if the outsourcing arrangement has diminished the quality of the institution's internal audit. If the quality of the internal audit is diminished, inform senior management and the board of directors and consider it in the institution's management and composite ratings.

2060.05.6.4 Assessment of Auditor Independence

1. The initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards discussed in parts I, II, and III of the "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (2003 Policy Statement) and the Federal Reserve's 2013 Supplemental Guidance. If the vendor provides both external and internal audit services to the institution—
   a. question the bank or savings and loan holding company's CAE and audit committee how they determined that the vendor was independent; and
   b. if the vendor is an accounting firm, ask the CAE or audit committee how they assessed that the arrangement had not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence.
2. If the answers to the above raise supervisory concern, or are not adequately addressed, discuss the matter with appropriate Reserve Bank management and supervisory staff.
3. If the Reserve Bank management and supervisory staff concurs that the independence of the external auditor or other vendor appears to be compromised, discuss the inspection findings and what appropriate supervisory actions the Federal Reserve may take with the bank holding or savings and loan holding company's senior management, board of directors (or audit committee), and the external auditor or other vendor.

2060.05.6.5 Supplemental Procedures to Evaluate the Effectiveness of the Internal Audit Function

1. Determine whether the internal audit function and its processes are effective or ineffective and whether internal audit's work can be potentially relied upon as part of the supervisory review process. An institution's internal audit function generally would be considered effective if the institution's internal audit function structure and practices are consistent with the 2003 interagency policy statement and the Federal Reserve's 2013 supplemental guidance (supplemental guidance).
2. To determine if the institution has incorporated the Federal Reserve's Supplemental Guidance, evaluate whether the factors and requirements underpinning the following characteristics and processes are in place:
   Attributes
   - Independence
   - Competent internal audit staff
   - Objectivity and ethics

Governance
- Role of board of directors
- Role of audit committee
- Role of Chief Audit Executive (CAE)

Audit Processes
- *Audit methodology*—Review the internal audit's risk-assessment methodology that drives its risk-assessment process and determine if it represents the audit universe. Determine if the methodology included a documented analysis of cross-institutional risk and thematic control issues and the processes and procedures for evaluating the effectiveness of risk-management, control, and governance processes. Evaluate internal audit's plan for continuous monitoring and in determining and evaluating risk. Assess internal audit's process for incorporating other risk identification techniques (i.e., risk and control self-assessment) that the institution's management utilizes.
- *Audit universe*—Determine if internal audit has effective processes to identify all auditable entities within the audit universe. Review the documentation of the audit universe and verify whether it has been reviewed periodically (e.g., during the annual audit planning process) and when significant organizational changes have occurred.
- *Risk assessment*—Review internal audit's documentation of its understanding of the institution's significant business activities and their associated risks. Verify that internal audit includes, at least annually, a review of critical risk-management functions as well as changes in the system of internal controls, infrastructure, work processes, new or changed business lines, or laws and regulations. Review the disposition of the results of the overall risk assessment summary and determine if internal audit gave consideration to key performance or risk indicators and the most significant risks facing the institution, including how the risks are addressed within the internal audit plan.
- *Audit plan*—Verify that internal audit develops and periodically revises its comprehensive audit plan. Determine if it verifies that the plan includes audit coverage for all identified, auditable entities within the audit universe appropriate for the size and complexity of the institution's activities.
- *Continuous monitoring*— Supplement inspection procedures with continuous monitoring and an assessment of key elements of internal audit, including:
  - — the adequacy and independence of the audit committee;
  - — the independence, professional competence, and quality of the internal audit function;
  - — the quality and scope of the audit methodology, audit plan, and risk assessment; and
  - — the adequacy of audit programs and work paper standards.

  1) Review these key elements at least annually to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.
  2) Make a determination on whether the work of internal audit can be relied upon when internal audit's overall function and related processes are effective and when recent work was performed by internal audit in an area where examiners are performing inspection procedures.
  3) Evaluate and determine whether additional inspection work is needed in high risk areas even where internal audit has been deemed effective and its work reliable.

Audit Performance and Monitoring
- *Scope*—Adjust the scope of the inspection if the bank holding or savings and loan holding company's internal audit function does not sufficiently meet the institution's internal audit needs (whether or not the audit function is outsourced), or is otherwise ineffective.
- *Work papers*—Determine whether the internal audit work papers adequately document the work program, the work performed and work paper standards, including documentation of any observations and analysis made, the conclusions, and audit results.
- *Audit reports:*

1) Ascertain whether internal audit has effective audit reporting processes that communicate audit report issues throughout the institution and they are addressed in a timely manner.
2) Review the inspection period's audit reports and verify that they contain an executive summary describing the auditable area, its conclusions, rationale, key issues, and management's documented action plans to address audit findings.

- *Audit issues tracking*
  1) Verify that internal audit has effective processes in place to track, monitor, and follow up on open audit issues.
  2) Determine if the institution conducts independent quality assurance reviews of internal audit work performed.
  3) Verify that the CAE implements appropriate improvements in internal audit processes or staff training through the quality assurance and improvement programs.
  4) Determine whether the institution conducts an internal quality assessment at least annually and if the CAE reports the results and status of internal assessments to senior management and the audit committee at least annually.
  5) Discuss supervisory concerns and outstanding internal-external audit report comments with the CAE or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or the audit committee.
- *Retrospective review processes.*
  1) Determine if management has conducted a post-mortem and "lessons learned" analysis when adverse events (fraud or a significant loss) have occurred.
  2) Find out if internal audit function verified that a review took place and that appropriate action was taken to remediate identified issues.
  3) Ascertain if internal audit function evaluated management's analysis of the reasons for the event and if the adverse event was the result of a control break down or failure, and whether management identified measures to be put in place to prevent a similar event from occurring in the future.

Quality Assurance

— *Internal Quality Assurance.* Ensure that the internal audit function process is documented in the audit manual. Review samples of work, overall results and status of any action plans.

— *External Quality Assurance.* Determine whether an independent assessment had been performed within the five-year requirement. Review results and action plan status to remediate issues.

1) Assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Consider whether—
   a. the internal audit function's risk assessment, plans, and programs are appropriate for the institution's activities;
   b. the internal audit function is adequately managed to ensure that audit plans are accomplished, programs are carried out, and results of audits are promptly communicated to the managers and directors;
   c. the internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
   d. the activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and
   e. the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

3. If there are deficiencies in any internal audit characteristics, use your judgment to:
   - evaluate the significance of the deficiencies and their relevance to the institution's safety and soundness or compliance with laws and regulations, and
   - determine whether these deficiencies would preclude overall audit processes from being deemed effective.

   While the internal audit function's overall processes could be deemed effective, some elements of the internal audit function may require enhancements or improvements, such as documentation with respect to specific audit processes (for example, risk assessments or work papers).
4. If examiners find the key elements of the internal audit function to be insufficient, the overall effectiveness of the internal audit function should come into question. Such findings may be include:
   - Lack of an appropriate risk-assessment process
   - Lack of sufficient and competent resources
   - Lack of audit coverage in key areas
   - Inappropriate classification of audit findings
   - Insufficient root cause analyses
   - Numerous work paper deficiencies
   - A large number of unresolved control-related issues
5. Internal audit processes may be considered ineffective if there are significant, unresolved supervisory matters requiring immediate attention (MRIAs) and/or matters requiring attention (MRAs) pertaining to internal audit, or if other supervisory concerns exist relating to the effectiveness of the internal audit function.

2060.05.6.6 Continuous Monitoring between Inspections of Internal Audit

1. Supplement the inspection procedures through continuous monitoring. Include an assessment of key elements of internal audit during the period following the institution's most recent inspection. The assessment of key elements of internal audit should include:
   - The adequacy and independence of the audit committee;
   - The independence, professional competence, and quality of the internal audit function;
   - The quality and scope of the audit methodology, audit plan, and risk assessment; and
   - The adequacy of audit programs and work paper standards.
2. Review, at least annually, the above key elements and determine whether there have been significant changes to the internal audit infrastructure or whether there are potential concerns regarding their adequacy.

2060.05.6.7 Evaluating the Ability to Rely on Internal Audit

1. Consider relying on internal audit at a supervised institution based on whether:
   a. an internal audit was deemed effective at the most recent supervisory inspection of internal audit;
   b. internal audit's overall function and related processes are considered effective and when recent work was performed by internal audit in a area where examiners are performing inspection procedures and the examiners can evaluation whether they may rely on the work of internal audit;
   c. an evaluation was performed of the significance and degree of risk of particular activities, business lines or other areas or business and if a determination was made as to the existence of appropriate internal controls over such risks; and
   d. the extent of continuous monitoring activities that did not identify any significant deficiencies or discover any adverse changes in audit processes or the quality of internal audit's work.
2. Leverage off an internal audit function's assessment of how emerging risks and high-risk areas are mitigated within the institution, including whether appropriate internal controls are in place over such risks;
3. For emerging risks and high-risk areas, determine if additional inspection work is needed, even when internal audit has been deemed effective and its work considered reliable.
4. Document the results of the supervisory review, supporting the basis for a conclusion as to whether the examiners can rely upon internal audit and whether there are any specific auditable areas (that is, function or business line) or elements of internal

audit (e.g. open audit issues) on which the examiners cannot rely.

2060.05.6.8 Considerations for Consolidated Supervision

1. Tailor the nature and scope of the Federal Reserve's supervisory and inspection work to the organization's legal entity and regulatory structure and also the risks associated with the organization's activities. Promote effective consolidated supervision by fostering strong, cooperative relationships among the Federal Reserve, relevant domestic and foreign supervisors, and functional regulators. Achieve this objective while limiting the potential for duplication of effort or undue burden on the institution under review.
2. Focus on the scope and depth of the other supervisor's or regulator's internal audit review. Determine the Federal Reserve's ability to rely on the work of the relevant supervisor or functional regulator:
   - Rely to the fullest extent possible on assessments and information developed by other relevant domestic and foreign supervisors and functional regulators;
   - Focus Federal Reserve supervisory attention on material risks from activities that are not supervised by another supervisor or regulator, or that cut across legal entities; and
   - Participate in the exchange of information among domestic and foreign supervisors and functional regulators, consistent with applicable laws and information-sharing arrangements, providing for the comprehensive, consolidated supervision of each banking organization's global activities.
3. The Federal Reserve's conduct of consolidated supervision is central to and dependent on the coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators. The Federal Reserve's direction for achieving these objectives is closely integrated into the supervisory framework for consolidated bank holding companies and the combined U.S. operations of foreign banking organizations.
4. When the Federal Reserve is not the primary supervisor or functional regulator of all entities consolidated under the holding company, the Federal Reserve will evaluate whether, and the degree to which, the major subsidiaries of the holding company implemented the supplemental guidance.

The Federal Reserve issued this January 23, 2013, policy statement to supplement the guidance in the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (referred to as the 2003 Policy Statement).[1] Federal Reserve staff has identified areas for improving regulated institutions' internal audit functions. This supplemental policy statement addresses the characteristics, governance, and operational effectiveness of an institution's internal audit function. Further, this statement reflects certain changes in banking regulations that have occurred since the issuance of the 2003 Policy Statement. The Federal Reserve is providing this supplemental guidance to enhance regulated institutions' internal audit practices and to encourage them to adopt professional audit standards and other authoritative guidance, including those issued by the Institute of Internal Auditors (IIA).[2]

This supplemental statement applies to supervised institutions with greater than $10 billion in total consolidated assets, including state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banking organizations.[3] This supplemental guidance is also consistent with the objectives of the Federal Reserve's consolidated supervision framework for large financial institutions with total consolidated assets of $50 billion or more, which promotes an independent internal audit function as an essential element for enhancing the resiliency of supervised institutions.[4]

Assessment of the effectiveness of the internal audit function. The degree to which an institution implements the internal audit practices outlined in this policy statement will be considered in the Federal Reserve's supervisory assessment of the effectiveness of an institution's internal audit function as well as its safety and soundness and compliance with consumer laws and regulations. Moreover, the overall effectiveness of an institution's internal audit function will influence the ability of the Federal Reserve to rely upon the work of an institution's internal audit function.

This supplemental policy statement builds upon the 2003 Policy Statement, which remains in effect, and follows the same organizational structure, with a new section entitled "Enhanced Internal Audit Practices" and updates to Parts I-IV of the 2003 Policy Statement. Refer to SR-13-1/CA13-1 and its attachment. To avoid historical references and duplication some introductory paragraphs and other small phrases are omitted from the policy statement here, as indicated by a line of asterisks.

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2060.07.1 SUPPLEMENTAL POLICY GUIDANCE

2060.07.1.1 Enhanced Internal Audit Practices

An institution's internal audit function should incorporate the following enhanced practices into their overall processes:

2060.07.1.1.1 Risk Analysis

Internal audit should analyze the effectiveness of all critical risk-management functions both with respect to individual risk dimensions (for example, credit risk), and an institution's overall risk-management function. The analysis should focus on the nature and extent of monitoring compliance with established policies and processes and applicable laws and regulations within the institution as well as whether monitoring processes are appropriate for the institution's business activities and the associated risks.

2060.07.1.1.2 Thematic Control Issues

Internal audit should identify thematic macro control issues as part of its risk-assessment pro-

1. Refer to SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing."

2. In this guidance, references have been provided to the IIA's International Standards for the Professional Practice of Internal Auditing (Standards). Refer to the IIA website at https://na.theiia.org/standards-guidance/pages/standards-and-guidance-ippf.aspx.

3. Section 4 of this document, however, clarifies certain changes to the Federal Deposit Insurance Corporation regulation (12 CFR part 363) on independence standards for independent public accountants at insured depository institutions with total assets of $500 million or more, which were adopted pursuant to 2009 amendments to section 36 of the FDI Act.

4. Refer to SR-12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions."

cesses and determine the overall impact of such issues on the institution's risk profile. Additional audit coverage would be expected in business activities that present the highest risk to the institution. Internal audit coverage should reflect the identification of thematic macro control issues across the firm in all auditable areas. Internal audit should communicate thematic macro control issues to senior management and the audit committee.

In addition, internal audit should identify patterns of thematic macro control issues, determine whether additional audit coverage is required, communicate such control deficiencies to senior management and the audit committee, and ensure management establishes effective remediation mechanisms.

2060.07.1.1.3 Challenging Management and Policy

Internal audit should challenge management to adopt appropriate policies and procedures and effective controls. If policies, procedures, and internal controls are ineffective or insufficient in a particular line of business or activity, internal audit should report specific deficiencies to senior management and the audit committee with recommended remediation. Such recommendations may include restricting business activity in affected lines of business until effective policies, procedures, and controls are designed and implemented. Internal audit should monitor management's corrective action and conduct a follow-up review to confirm that the recommendations of both internal audit and the audit committee have been addressed.

2060.07.1.1.4 Infrastructure

When an institution designs and implements infrastructure enhancements, internal audit should review significant changes and notify management of potential internal control issues. In particular, internal audit should ensure that existing, effective internal controls (for example, software applications and management information system reporting) are not rendered ineffective as a result of infrastructure changes unless those controls are compensated for by other improvements to internal controls.

2060.07.1.1.5 Risk Tolerance

Internal audit should understand risks faced by the institution and confirm that the board of directors and senior management are actively involved in setting and monitoring compliance with the institution's risk tolerance limits. Internal audit should evaluate the reasonableness of established limits and perform sufficient testing to ensure that management is operating within these limits and other restrictions.

2060.07.1.1.6 Governance and Strategic Objectives

Internal audit should evaluate governance at all management levels within the institution, including at the senior management level, and within all significant business lines. Internal audit should also evaluate the adequacy and effectiveness of controls to respond to risks within the organization's governance, operations, and information systems in achieving the organization's strategic objectives. Any concerns should be communicated by internal audit to the board of directors and senior management.

2060.07.1.2 Internal Audit Function *(Part I of the 2003 Policy Statement)*

The primary objectives of the internal audit function are to examine, evaluate, and perform an independent assessment of the institution's internal control system, and report findings back to senior management and the institution's audit committee. An effective internal audit function within a financial institution is a vital means for an institution's board of directors to maintain the quality of the internal control environment and risk-management systems.

The guidance set forth in this section supplements the existing guidance in the 2003 Policy Statement by strongly encouraging internal auditors to adhere to professional standards, such as the IIA guidance. Furthermore, this section clarifies certain aspects of the IIA guidance and provides practices intended to increase the safety and soundness of institutions.

2060.07.1.2.1 Attributes of Internal Audit

Independence. Internal audit is an independent function that supports the organization's business objectives and evaluates the effectiveness of risk management, control, and governance processes. The 2003 Policy Statement addressed the structure of an internal audit function, noting that it should be positioned so that an institution's board of directors has confidence that the internal audit function can be impartial and not unduly influenced by managers of day-to-day operations. Thus, the member of management responsible for the internal audit function (hereafter referred to as the chief audit executive or CAE)[5] should have no responsibility for operating the system of internal control and should report functionally to the audit committee. A reporting arrangement may be used in which the CAE is functionally accountable and reports directly to the audit committee on internal audit matters (that is, the audit plan, audit findings, and the CAE's job performance and compensation) and reports administratively to another senior member of management who is not responsible for operational activities reviewed by internal audit. When there is an administrative reporting of the CAE to another member of senior management, the objectivity of internal audit is served best when the CAE reports administratively to the chief executive officer (CEO).

If the CAE reports administratively to someone other than the CEO, the audit committee should document its rationale for this reporting structure, including mitigating controls available for situations that could adversely impact the objectivity of the CAE. In such instances, the audit committee should periodically (at least annually) evaluate whether the CAE is impartial and not unduly influenced by the administrative reporting line arrangement. Further, conflicts of interest for the CAE and all other audit staff should be monitored at least annually with appropriate restrictions placed on auditing areas where conflicts may occur.

For foreign banking organizations (FBOs), the internal audit function for the U.S. operations of an FBO should have appropriate independent oversight for the total assets of U.S. operations.[6] When there is a resident U.S. audit function, the CAE of the U.S. audit function should report directly to senior officials of the internal audit department at the head office such as the global CAE. If the FBO has separate U.S. subsidiaries, oversight may be provided by a U.S. based audit committee that meets U.S. public company standards for independence or by the foreign parent company's internal audit function.

Professional competence and staffing. Internal audit staff should have the requisite collective skill levels to audit all areas of the institution. Therefore, auditors should have a wide range of business knowledge, demonstrated through years of audit and industry-specific experience, educational background, professional certifications, training programs, committee participation, professional associations, and job rotational assignments. Internal audit should assign staff to audit assignments based on areas of expertise and, when feasible, rotate staff within the audit function.

Internal audit management should perform knowledge-gap assessments at least annually to evaluate whether current staff members have the knowledge and skills commensurate with the institution's strategy and operations. Management feedback surveys and internal or external quality assurance findings are useful tools to identify and assess knowledge gaps. Any identified knowledge gaps should be filled and may be addressed through targeted staff hires, training, business line rotation programs, and outsourcing arrangements. The internal audit function should have an effective staff training program to advance professional development and should have a process to evaluate and monitor the quality and appropriateness of training provided to each auditor. Internal auditors generally receive a minimum of forty hours of training in a given year.

Objectivity and ethics. Internal auditors should be objective, which means performing assignments free from bias and interference. A major characteristic of objectivity is that the CAE and all internal audit professional staff avoid any conflicts of interest.[7] For their first year in the internal audit function, internally recruited internal auditors should not audit activities for which they were previously responsible. Moreover, compensation schemes should not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit

5. More recently, this title is used to refer to the person in charge of the internal audit function. An institution may not have a person at the management level of CAE and instead may have an internal audit manager.

6. This is defined as the combined total assets of U.S. operations, net of all intercompany assets and claims on U.S.-domiciled affiliates.

7. IIA standards define conflict of interest as a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult for the individual to fulfill his or her duties impartially.

function.[8] While an internal auditor may recommend internal control standards or review management's procedures before implementation, objectivity requires that the internal auditor not be responsible for the design, installation, procedures development, or operations of the institution's internal control systems.

An institution's internal audit function should have a code of ethics that emphasizes the principles of objectivity, competence, confidentiality, and integrity, consistent with professional internal audit guidance such as the code of ethics established by the IIA.

Internal audit charter. Each institution should have an internal audit charter that describes the purpose, authority, and responsibility of the internal audit function. An audit charter should include the following critical components:

- The objectives and scope of the internal audit function;
- The internal audit function's management reporting position within the organization, as well as its authority and responsibilities;
- The responsibility and accountability of the CAE; and
- The internal audit function's responsibility to evaluate the effectiveness of the institution's risk management, internal controls, and governance processes.

The charter should be approved by the audit committee of the institution's board of directors. The charter should provide the internal audit function with the authorization to access the institution's records, personnel, and physical properties relevant to the performance of internal audit procedures, including the authority to examine any activities or entities. Periodically, the CAE should evaluate whether the charter continues to be adequate, requesting the approval of the audit committee for any revisions. The charter should define the criteria for when and how the internal audit function may outsource some of its work to external experts.

8. IIA standards have additional examples of "conflict of interest" for consideration.

2060.07.1.2.2 Corporate Governance Considerations

Board of directors and senior management responsibilities. The board of directors and senior management are responsible for ensuring that the institution has an effective system of internal controls. As indicated in the 2003 Policy Statement, this responsibility cannot be delegated to others within the institution or to external parties. Further, the board of directors and senior management are responsible for ensuring that internal controls are operating effectively.

Audit committee responsibilities. An institution's audit committee is responsible for establishing an appropriate internal audit function and ensuring that it operates adequately and effectively. The audit committee should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. Moreover, the audit committee is expected to retain oversight responsibility for any aspects of the internal audit function that are outsourced to a third party.

The audit committee should provide oversight to the internal audit function. Audit committee meetings should be on a frequency that facilitates this oversight and generally should be held four times a year at a minimum, with additional meetings held by audit committees of larger financial institutions. Annually, the audit committee should review and approve internal audit's charter, budget and staffing levels, and the audit plan and overall risk-assessment methodology. The committee approves the CAE's hiring, annual performance evaluation, and compensation.

The audit committee and its chairperson should have ongoing interaction with the CAE separate from formally scheduled meetings to remain current on any internal audit department, organizational, or industry concerns. In addition, the audit committee should have executive sessions with the CAE without members of senior management present as needed.

The audit committee should receive appropriate levels of management information to fulfill its oversight responsibilities. At a minimum, the audit committee should receive the following data with respect to internal audit:

- Audit results with a focus on areas rated less than satisfactory;
- Audit plan completion status and compliance with report issuance timeframes;

- Audit plan changes, including the rationale for significant changes;
- Audit issue information, including aging, past-due status, root-cause analysis, and thematic trends;
- Information on higher-risk issues indicating the potential impact, root cause, and remediation status;
- Results of internal and external quality assurance reviews;
- Information on significant industry and institution trends in risks and controls;
- Reporting of significant changes in audit staffing levels;
- Significant changes in internal audit processes, including a periodic review of key internal audit policies and procedures;
- Budgeted audit hours versus actual audit hours;
- Information on major projects; and
- Opinion on the adequacy of risk-management processes, including effectiveness of management's self-assessment and remediation of identified issues (at least annually).

Role of the chief audit executive. In addition to communicating and reporting to the audit committee on audit-related matters, the CAE is responsible for developing and maintaining a quality assurance and improvement program that covers all aspects of internal audit activity, and for continuously monitoring the effectiveness of the audit function. The CAE and/or senior staff should effectively manage and monitor all aspects of audit work on an ongoing basis, including any audit work that is outsourced.[9]

2060.07.1.2.3 The Adequacy of the Internal Audit Function's Processes

Internal audit should have an understanding of the institution's strategy and operating processes as well as the potential impact of current market and macroeconomic conditions on the financial institution. Internal audit's risk-assessment methodology is an integral part of the evaluation of overall policies, procedures, and controls at the institution and the development of a plan to test those processes.

Audit methodology. Internal audit should ensure that it has a well-developed risk-assessment methodology that drives its risk-assessment process. The methodology should include an analysis of cross-institutional risk and thematic control issues and address its processes and procedures for evaluating the effectiveness of risk management, control, and governance processes. The methodology should also address the role of continuous monitoring in determining and evaluating risk, as well as internal audit's process for incorporating other risk identification techniques that the institution's management utilizes such as a risk and control self-assessment (RCSA). The components of an effective methodology should support the internal audit function's assessment of the control environment, beginning with an evaluation of the audit universe.

Audit universe. Internal audit should have effective processes to identify all auditable entities within the audit universe. The number of auditable entities will depend upon whether entities are captured at individual department levels or at other aggregated organizational levels. Internal audit should use its knowledge of the institution to determine whether it has identified all auditable entities and may use the general ledger, cost centers, new product approval processes, organization charts, department listings, knowledge of the institution's products and services, major operating and application systems, significant laws and regulations, or other data. The audit universe should be documented and reviewed periodically as significant organizational changes occur or at least during the annual audit planning process.

Internal audit risk assessment. A risk assessment should document the internal audit staff's understanding of the institution's significant business activities and the associated risks. These assessments typically analyze the risks inherent in a given business line or process, the mitigating control processes, and the resulting residual risk exposure to the institution.

A comprehensive risk assessment should effectively analyze the key risks (and the critical risk-management functions) within the institution and prioritize audit entities within the audit universe. The risk-assessment process should be well documented and dynamic, reflecting changes to the system of internal controls, infrastructure, work processes, and new or changed

9. The ongoing review of audit work should include risk assessments of audit entities and elements, scope documents, audit programs, detailed audit procedures and steps (including sampling methodologies), audit work papers, audit findings, and monitoring of the timely and effective resolution of audit issues.

business lines or laws and regulations. The risk assessments should also consider thematic control issues, risk tolerance, and governance within the institution. Risk assessments should be revised in light of changing market conditions or laws and regulations and updated during the year as changes are identified in the business activities of the institution or observed in the markets in which the institution operates, but no less than annually. When the risk assessment indicates a change in risk, the audit plan should be reviewed to determine whether the planned audit coverage should be increased or decreased to address the revised assessment of risk.

Risk assessments should be formally documented and supported with written analysis of the risks.[10] There should be risk assessments for critical risk-management functions within the institution. Risk assessments may be quantitative or qualitative and may include factors such as the date of the last audit, prior audit results, the impact and likelihood of an event occurring, and the status of external vendor relationships. A management RCSA, if performed, may be considered by the internal audit function in developing its independent risk assessment. The internal audit risk assessment should also include a specific rationale for the overall auditable entity risk score. The overall disposition of the risk assessment should be summarized with consideration given to key performance or risk indicators and prior audit results. A high-level summary or discussion of the risk-assessment results should be provided to the audit committee and include the most significant risks facing the institution as well as how these risks have been addressed in the internal audit plan.

Internal audit plan. Internal audit should develop and periodically revise its comprehensive audit plan and ensure that audit coverage for all identified, auditable entities within the audit universe is appropriate for the size and complexity of the institution's activities. This should be accomplished either through a multiyear plan approach, with the plan revised annually, or through an approach that utilizes a framework to evaluate risks annually focusing on the most significant risks. In the latter approach, there should be a mechanism in place to identify when a significant risk will not be audited in the specified timeframe and a requirement to notify the audit committee and seek its approval of any exception to the framework. Generally, common practice for institutions with defined audit cycles is to follow either a three- or four-year audit cycle; high-risk areas should be audited at least every twelve to eighteen months.[11]

The internal audit plan should consider the risk assessment and internal audit's approach to audit coverage should be appropriate based on the risk assessment. An effective plan covers individual business areas and risk disciplines as well as cross-functional and cross-institutional areas.

The audit planning process should be dynamic, allowing for change when necessary. The process should include a process for modifying the internal audit plan to incorporate significant changes that are identified either through continuous monitoring or during an audit. Any significant changes should be clearly documented and included in quarterly communications to the audit committee. Critical data to be reported to the audit committee should include deferred or cancelled audits rated high-risk and other significant additions or deletions. Significant changes to audit budgets and timeliness for the completion of audits should be reported to the audit committee with documented rationale.

Internal audit continuous monitoring. Internal audit is encouraged to utilize formal continuous monitoring practices as part of the function's risk-assessment processes to support adjustments to the audit plan or universe as they occur. Continuous monitoring can be conducted by an assigned group or individual internal auditors. An effective continuous monitoring process should include written standards to ensure consistent application of processes throughout the organization.

Continuous monitoring results should be documented through a combination of metrics, management reporting, periodic audit summaries, and updated risk assessments to substantiate that the process is operating as designed. Critical issues identified through the monitoring process should be communicated to the audit committee. Computer-assisted auditing techniques are useful tools to highlight issues that

10. For example, risks include credit, market, operational, liquidity, compliance, IT, fraud, political, legal, regulatory, strategic, and reputational.

11. Regardless of the institution's practice, particular care should be taken to ensure that higher-risk elements are reviewed with an appropriate frequency, and not obscured due to their inclusion in a lower risk-rated audit entity.

warrant further consideration within a continuous monitoring process.

2060.07.1.2.4 Internal Audit Performance and Monitoring Processes

Performance. Detailed guidance related to the performance of an internal audit should be documented in the audit manual[12] and work programs to ensure that audit execution is consistent across the audit function. Internal audit policies and procedures should be designed to ensure that audits are executed in a high-quality manner, their results are appropriately communicated, and issues are monitored and appropriately resolved. In performing internal audit work, an institution should consider the following.

- *Internal audit scope:* During the audit planning process, internal audit should analyze the auditable entity's specific risks, mitigating controls, and level of residual risk. The information gathered during the audit planning phase should be used to determine the scope and specific audit steps that should be performed to test the adequacy of the design and operating effectiveness of control processes.

- *Internal audit work papers:* Work papers document the work performed, observations and analyses made, and support for the conclusions and audit results. The work papers should contain sufficient information regarding any scope or audit program modifications and waiver of issues not included in the final report. Work papers also should document the specific sampling methodology, including minimum sample sizes, and the rationale for such methodology. The work papers should contain information that reflects all phases of the audit process including planning, fieldwork, reporting, and issues tracking and follow-up. On an ongoing basis, a comprehensive supervisory review should be performed on all audit work, including any outsourced internal audit procedures.[13]

- *Audit report:* Internal audit should have effective processes to ensure that issues are communicated throughout the institution and audit issues are addressed in a timely manner. The audit report should include an executive summary that describes the auditable area, audit's conclusions, the rationale for those conclusions, and key issues. Most audit reports also include management's action plans to address audit findings. To ensure that identified issues are addressed in a timely manner, reports should be issued to affected business areas, senior management, and the audit committee within an appropriate timeframe after the completion of field work. Compliance with issuance timeframes should be monitored and reported periodically to the audit committee. At a minimum, internal audit should ensure that management considers the level and significance of the risk when assigning resources to address and remediate issues. Management should appropriately document the action plans either within the audit report or separately.

- *Internal audit issues tracking:* Internal audit should have effective processes in place to track and monitor open audit issues and to follow-up on such issues. The timely remediation of open audit issues is an essential component of an organization's risk reduction efforts. Internal audit and the responsible management should discuss and agree to an appropriate resolution date, based on the level of work necessary to complete remediation processes. When an issue owner indicates that work to close an issue is completed, the internal audit function should perform validation work prior to closing the issue. The level of validation necessary may vary based on the issue's risk level. For higher-risk issues, internal audit should perform and document substantive testing to validate that the issue has been resolved. Issues should be tested over an appropriate period of time to ensure the sustainability of the remediation.

Retrospective review processes. When an adverse event occurs at an institution (for example, fraud or a significant loss), management should conduct a post-mortem and "lessons learned" analysis. In these situations, internal audit should ensure that such a review takes place and appropriate action is taken to remediate identified issues. The internal audit function should evaluate management's analysis of the reasons for the event and whether the adverse

12. To facilitate effective, efficient, and consistent practice within the internal audit department, an institution should develop an audit manual that includes comprehensive policies and procedures and is made available to all internal audit staff. The manual should be updated as needed.

13. An experienced audit manager should perform this review.

event was the result of a control breakdown or failure, and identify the measures that should be put in place to prevent a similar event from occurring in the future. In certain situations, the internal audit function should conduct its own post-mortem and a "lessons learned" analysis outlining the remediation procedures necessary to detect, correct, and/or prevent future internal control breakdowns (including improvements in internal audit processes).

Quality assurance and improvement program. A well-designed, comprehensive quality assurance program should ensure that internal audit activities conform to the IIA's professional standards and the institution's internal audit policies and procedures. The program should include both internal and external quality assessments.

The internal audit function should develop and document its internal assessment program to promote and assess the quality and consistency of audit work across all audit groups with respect to policies, procedures, audit performance, and work papers. The quality assurance review should be performed by someone independent of the audit work being reviewed. Conclusions reached and recommendations for appropriate improvement in internal audit process or staff training should be implemented by the CAE through the quality assurance and improvement program. Action plan progress should be monitored and subsequently closed after a period of sustainability. Each institution should conduct an internal quality assessment annually and the CAE should report the results and status of internal assessments to senior management and the audit committee at least annually.

The IIA recommends that an external quality assessment of internal audit be performed by a qualified independent party at least once every five years. The review should address compliance with the IIA's definition of internal auditing, code of ethics, and standards, as well as with the internal audit function's charter, policies and procedures, and any applicable legislative and regulatory requirements. The CAE should communicate the results, planned actions, and status of remediation efforts to senior management and the audit committee.

2060.07.1.3 Internal Audit Outsourcing Arrangements *(Part II of the 2003 Policy Statement)*

As stated in the 2003 Policy Statement, an institution's board of directors and senior management are charged with the overall responsibility for maintaining an effective system of internal controls. Responsibility for maintaining an effective system of internal controls cannot be delegated to a third party. An institution that chooses to outsource audit work should ensure that the audit committee maintains ownership of the internal audit function. The institution's audit committee and CAE should provide active and effective oversight of outsourced activities. Institutions should carefully consider the oversight responsibilities that are consequential to these types of arrangements in determining appropriate staffing levels.

To distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, which may take the form of an engagement letter or similar services agreement. Contracts between the institution and the vendor should include a provision stating that work papers and any related non-public confidential information and personal information must be handled by the vendor in accordance with applicable laws and regulations. An institution should periodically confirm that the vendor continues to comply with the agreed-upon confidentiality requirements, especially for long-term contracts. The audit committee should approve all significant aspects of outsourcing arrangements and should receive information on audit deficiencies in a manner consistent with that provided by the in-house audit department.

2060.07.1.3.1 Vendor Competence

An institution should have appropriate policies and procedures governing the selection and oversight of internal audit vendors, including whether to continue with an existing outsourced arrangement. The audit committee and the CAE are responsible for the selection and retention of internal audit vendors and should be aware of factors that may impact vendors' competence and ability to deliver high-quality audit services.

2060.07.1.3.2 Contingency Planning

An institution's contingency plan should take into consideration the extent to which the institution relies upon outsourcing arrangements.

When an institution relies significantly on the resources of an internal audit service provider, the institution should have contingency procedures for managing temporary or permanent disruptions in the service in order to ensure that the internal audit function can meet its intended objectives.

2060.07.1.3.3 Quality of Audit Work

The quality of audit work performed by the vendor should be consistent with the institution's standards of work expected to be performed by an in-house internal audit department. Further, information supplied by the vendor should provide the board of directors, its audit committee, and senior management with an accurate report on the control environment, including any changes necessary to enhance controls.

2060.07.1.4 Independence Guidance for the Independent Public Accountant *(Part III of the 2003 Policy Statement)*

The following discussion supplements the discussion in Part III of the 2003 Policy Statement and addresses additional requirements regarding auditor independence for depository institutions subject to section 36 of the FDI Act (as amended in 2009).

2060.07.1.4.1 Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

The July 2009 amendments to section 36 of the FDI Act (applicable to insured depository institutions with total assets of $500 million or more) require an institution's external auditor to follow the more restrictive of the independence rules issued by the AICPA, SEC, and PCAOB. In March 2003, the SEC prohibited a registered public accounting firm that is responsible for furnishing an opinion on the consolidated or separate financial statements of an audit client from providing internal audit services to that same client.[14] Therefore, by following the more restrictive independence rules, a depository institution's external auditor is precluded from performing internal audit services, either on a co-sourced or an outsourced basis, even if the institution is not a public company.

14. See SEC final rule, "Strengthening the Commission's Requirements Regarding Auditor Independence," at 17 CFR parts 210, 240, 249 and 274.

2060.07.1.5 Examination Guidance *(Part IV of the 2003 Policy Statement)*

The following discussion supplements the existing guidance in Part IV of the 2003 Policy Statement on examination guidance and discusses the overall effectiveness of an institution's internal audit function and the examiner's reliance on internal audit.

2060.07.1.5.1 Determining the Overall Effectiveness of Internal Audit

An effective internal audit function is a vehicle to advance an institution's safety and soundness and compliance with consumer laws and regulations and is therefore considered as part of the supervisory review process. Federal Reserve examiners will make an overall determination as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the supervisory review process. If internal audit's overall processes are deemed effective, examiners may be able to rely on the work performed by internal audit depending on the nature and risk of the functions subject to examination.

The supervisory assessment of internal audit and its effectiveness will consider an institution's application of the 2003 Policy Statement and this supplemental guidance. An institution's internal audit function generally would be considered effective if the institution's internal audit function structure and practices are consistent with the 2003 Policy Statement and this guidance.

Conversely, an institution's internal audit function that does not follow the enhanced practices and supplemental guidance outlined in this policy letter generally will be considered ineffective. In such a case, examiners will not rely on the institution's internal audit function.

Examiners will inform the CAE as to whether the function is deemed to be effective or ineffective. Internal audit's overall processes could be deemed effective even though some aspects of the internal audit function may require enhancements or improvements such as additional documentation with respect to specific audit processes (for example, risk assessments or work papers). In these situations, the required enhancements or improvements generally should not be a critical part of the overall internal audit function, or the function should be deemed to be ineffective.

2060.07.1.5.2 Relying on the Work Performed by Internal Audit

Examiners may rely on internal audit at supervised institutions if internal audit was deemed effective at the most recent examination of internal audit. In examining an institution's internal audit function, examiners will supplement their examination procedures through continuous monitoring and an assessment of key elements of internal audit, including (1) the adequacy and independence of the audit committee; (2) the independence, professional competence, and quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk assessment; and (4) the adequacy of audit programs and work paper standards. On at least an annual basis, examiners should review these key elements to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.

Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective and when recent work was performed by internal audit in an area where examiners are performing examination procedures. For example, if an internal audit department performs internal audit work in an area where examiners might also review controls, examiners may evaluate whether they can rely on the work of internal audit (and either eliminate or reduce the testing scheduled as part of the regulatory examination processes). In high-risk areas, examiners will consider whether additional examination work is needed even where internal audit has been deemed effective and its work reliable.

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(End of the January 23, 2013, Supplemental Policy Statement)

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, this section has been revised to incorporate the January 15, 2016 "Interagency Advisory on External Audits of Internationally Active U.S. Financial Institutions." The federal banking agencies issued the interagency advisory to communicate their support for the principles and expectations set forth in parts 1 and 2 of the Basel Committee on Banking Supervision's March 2014 guidance on "External audits of banks." "Internationally Active Banks" is defined in the advisory. Refer to subsection 2060.1.8 and SR-16-2 and its attachment.

2060.1.1 INTERNAL AND EXTERNAL AUDIT PROGRAMS AND ACTIVITIES

Audit is an independent appraisal activity that serves as a managerial control within an organization. The primary responsibility for the maintenance of sound systems of internal controls and an adequate internal audit program rests with the directorate of the bank holding company. Included among the objectives of a comprehensive audit program are the detection of irregularities; the determination of compliance with applicable laws and regulations; and the appraisal of the soundness and adequacy of accounting, operating, and administrative controls designed to ensure prompt and accurate recording of transactions and proper safeguarding of assets. At a minimum, an audit program should ensure that adequate systems of checks and balances are in effect to deter fraud and detect control deficiencies.

The size and complexity of a bank holding company operation are major determinants in the scope and extent of the audit program that is developed. In the smaller, less sophisticated organizations, such as holding company shells for small banks, it may not be feasible to employ an auditor or implement an audit program. In some cases, such as those in which banking assets represent virtually all of the parent company's assets and a comprehensive, effective audit program is being implemented in the various subsidiaries, neither an internal nor an external audit program may be necessary at the parent company level.

The development and implementation of an internal audit program should be delegated to a qualified staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor. When evaluating the effectiveness of an internal audit program, the examiner may want to consider the size of audit staffs of banking organizations of a similar size and complexity. To ensure freedom of access to corporate records and complete independence and objectivity in administering the audit program, the auditor should report directly to the directorate or a committee thereof. Administratively, the internal auditor is usually responsible to an officer at a major policymaking level.

To supplement the internal audit activities, external accountants-auditors may be engaged to certify or audit the financial statements or specified activities of the bank holding company and its subsidiaries. Each top-tier bank holding company with total consolidated assets of $500 million or more must engage independent public accountants to perform audits and report on its annual financial statements in accordance with generally accepted accounting principles. The scope of the audit engagement must be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. Bank holding companies do not have to submit audited financial statements as part of the requirements for the FR Y-6 annual report. The Federal Reserve may request audited consolidated financial statements from any bank holding company with total consolidated assets of less than $500 million if deemed warranted for supervisory purposes.

The internal and external auditors should work together in establishing the scope and frequency of audits to be performed. In addition to performing some of the basic functions of the internal auditor, the external auditor should review the internal auditing program to assess its scope and adequacy. When a bank holding company is perhaps too small to employ an internal audit staff, but when the complexities and activities of the organization suggest the need for an audit, the holding company should consider hiring an external auditor. Independence and objectivity are mandatory in any audit program, and these are difficult to maintain if the audit function is a part-time responsibility. When external auditors are employed to perform the internal audit function, they should be permitted to establish the scope of their audits and schedule surprise audits. They also should be given responsibility for suggesting systems and organizational duty assignments for maximum control consistent with the size of the organization.

2060.1.2 EXTERNAL AUDITORS AND THE RELEASE OF REQUIRED INFORMATION

The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) on August 9, 1989, requires that FDIC-insured depository institutions that are being audited provide their independent auditors with information concerning their financial condition and any supervisory actions being taken against them. Specifically, section 36(h)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831m(h)(1)) (the FDI Act) requires an insured depository institution that has engaged the services of an independent auditor to perform an audit within the past two years to provide the auditor with—

1. a copy of the most recent report of condition made by the institution (pursuant to the FDI Act or any other provision of law) and a copy of the most recent report of examination received by the institution;
2. a copy of any supervisory memorandum of understanding with such institution and any written agreement between a federal or state banking agency and the depository institution that is in effect during the period covered by the audit; and
3. a report of any action initiated or taken by a federal banking agency during the period covered by the audit under subsection (a), (b), (c), (e), (g), (i), (s), or (t) of section 8 of the FDI Act or of any similar action taken by a state banking agency under state law, or any other civil money penalty assessed under any other provision of law with respect to the depository institution or any affiliated party.

External auditors who are serving as agents of a bank holding company may, with the approval of the organization, review examination or inspection reports and supervisory correspondence received and communicate with examiners. Examiners should remind external auditors of their responsibility to maintain the confidentiality of the reports and other supervisory communications reviewed as part of their engagement. See also the Board's rules on the release of confidential supervisory information (12 C.F.R. 261, subpart C).

2060.1.3 EXTERNAL AUDITOR INQUIRIES

In some situations, examiners may not be able to fully respond to external auditors' inquiries on certain matters relating to examinations still in progress. The examiners' findings may be incomplete or may be under review by higher supervisory authorities within the Federal Reserve System. In addition, as a general practice, examiners will normally only discuss with external auditors issues and inspection findings that have been presented to the bank holding company's management. These situations relate primarily to the timing of the auditors' inquiries in relation to the stage of inspection work and, thus, should not automatically preclude an auditor from expressing an opinion on the organization's financial statements.

2060.1.4 UNSAFE AND UNSOUND USE OF LIMITATION-OF-LIABILITY PROVISIONS IN EXTERNAL AUDIT ENGAGEMENT LETTERS

On February 9, 2006, the Federal Reserve and the other financial institution regulatory agencies (the agencies)[1] issued an interagency advisory (the advisory) to address safety-and-soundness concerns that may arise when financial institutions enter into external audit contracts (typically referred to as *engagement letters*) that limit the auditors' liability for audit services.[2] The advisory informs financial institutions'[3] boards of directors, audit committees, management, and external auditors of the safety-and-soundness implications that may arise when the financial institution enters into engagement letters that contain provisions to limit the auditors' liability.

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

2. The advisory is effective for audit engagement letters issued on or after February 9, 2006.

3. As used in this advisory, the term *financial institutions* includes bank holding companies, banks, savings associations, and savings and loan holding companies.

The advisory does not apply to previously executed engagement letters. However, any financial institution subject to a multiyear audit engagement letter containing unsafe and unsound limitation-of-liability provisions should seek an amendment to its engagement letter to be consistent with the advisory for periods ending in 2007 or later. (See SR-06-4.)

Limits on external auditors' liability may weaken the external auditors' objectivity, impartiality, and performance and, thus, reduce the agencies' ability to rely on audits. Therefore, certain limitation-of-liability provisions (described in the advisory and its appendix A; see section 2060.1.4.7) are unsafe and unsound. In addition, such provisions may not be consistent with the auditor-independence standards of the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA).

2060.1.4.1 Scope of the Advisory on Engagement Letters

The advisory applies to engagement letters between financial institutions and external auditors with respect to financial-statement audits, audits of internal control over financial reporting, and attestations on management's assessment of internal control over financial reporting (collectively, *audit* or *audits*).

The advisory does not apply to—

1. nonaudit services that may be performed by financial institutions' external auditors,
2. audits of financial institutions' 401(k) plans, pension plans, and other similar audits,
3. services performed by accountants who are not engaged to perform financial institutions' audits (e.g., outsourced internal audits or loan reviews), and
4. other service providers (e.g., software consultants or legal advisers).

While the agencies have observed several types of limitation-of-liability provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to audits in an unsafe and unsound manner.

2060.1.4.2 External Audits and Their Engagement Letters

A properly conducted audit provides an independent and objective view of the reliability of a financial institution's financial statements. The external auditor's objective in an audit is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. In addition, certain financial institutions are required to file audited financial statements and internal control audit or attestation reports with one or more of the agencies. The agencies encourage financial institutions not subject to mandatory audit requirements to voluntarily obtain audits of their financial statements. The FFIEC's September 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations[4] notes, "[a]n institution's internal and external audit programs are critical to its safety and soundness." The policy also states that an effective external auditing program "can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the FDIC."

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the financial institution's audit. The engagement letter commonly describes the objective of the audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (for example, fees and billing). Boards of directors, audit committees, and management are encouraged to closely review all of the provisions in the audit engagement letter before agreeing to sign. As with all agreements that affect a financial institution's legal rights, the financial institution's legal counsel should carefully review audit engagement letters to help ensure that those charged with engaging the external auditor make a fully informed decision.

The advisory describes the types of objectionable limitation-of-liability provisions and pro-

4. See 64 Fed. Reg. 52,319 (September 28, 1999).

vides examples.[5] Financial institutions' boards of directors, audit committees, and management should also be aware that certain insurance policies (such as error and omission policies and directors' and officers' liability policies) might not cover losses arising from claims.

2060.1.4.3 Limitation-of-Liability Provisions

The provisions of an external audit engagement letter that the agencies deem to be unsafe and unsound can be generally categorized as follows: a provision within an agreement between a client financial institution and its external auditor that effectively—

1. indemnifies the external auditor against claims made by third parties;
2. holds harmless or releases the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, other than claims for punitive damages; or
3. limits the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in this advisory as *limitation-of-liability provisions.*

Provisions that waive the right of financial institutions to seek punitive damages from their external auditor are not treated as unsafe and unsound under the advisory. Nevertheless, agreements by clients to indemnify their auditors against any third-party damage awards, including punitive damages, are deemed unsafe and unsound under the advisory. To enhance transparency and market discipline, public financial institutions that agree to waive claims for punitive damages against their external auditors may want to disclose annually the nature of these arrangements in their proxy statements or other public reports.

5. In the majority of external audit engagement letters reviewed, the agencies did not observe provisions that limited an external auditor's liability. However, for those reviewed external audit engagement letters that did have external auditor limited-liability provisions, the agencies noted a significant increase in the types and frequency of the provisions. The provisions took many forms, which made it impractical for the agencies to provide an all-inclusive list. Examples of auditor limitation-of-liability provisions are illustrated in the advisory's appendix A. See section 2060.1.4.7.

Many financial institutions are required to have their financial statements audited, while others voluntarily choose to undergo such audits. For example, federally insured banks with $500 million or more in total assets are required to have annual independent audits.[6] Furthermore, financial institutions that are public companies[7] must have annual independent audits. Certain savings associations (for example, those with a CAMELS rating of 3, 4, or 5) and savings and loan holding companies are also required by OTS's regulations to have annual independent audits.[8] The agencies rely on the results of audits as part of their assessment of a financial institution's safety and soundness.

For audits to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary procedures to comply with auditing and attestation standards established by either the AICPA or, if applicable, the PCAOB. When financial institutions execute agreements that limit the external auditors' liability, the external auditors' objectivity, impartiality, and performance may be weakened or compromised, and the usefulness of the audits for safety-and-soundness purposes may be diminished.

By their very nature, limitation-of-liability provisions can remove or greatly weaken external auditors' objective and unbiased consideration of problems encountered in audit engagements and may diminish auditors' adherence to the standards of objectivity and impartiality required in the performance of audits. The existence of such provisions in external audit engagement letters may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the reliability of audits. Accordingly, financial institutions should not enter into external audit arrangements that include unsafe and unsound limitation-of-liability provisions identified in the advisory, regardless of (1) the size of the financial institution, (2) whether the financial institution is public or not, or (3) whether the external audit is required or voluntary.

6. For banks and savings associations, see section 36 of the FDI Act (12 U.S.C. 1831m) and part 363 of the FDIC's regulations (12 C.F.R. 363).

7. Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

8. See OTS regulation at 12 C.F.R. 563.4.

2060.1.4.4 Auditor Independence

Currently, auditor-independence standard-setters include the SEC, PCAOB, and AICPA. Depending on the audit client, an external auditor is subject to the independence standards issued by one or more of these standard-setters. For all nonpublic financial institutions that are not required to have annual independent audits, the FDIC's rules, pursuant to part 363 (or section 562.4 of the OTS's regulations) require only that an external auditor meet the AICPA independence standards. The rules do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in part 363 of the FDIC's regulations (or in section 562.4 of the OTS regulations), the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the independence requirements and interpretations of the SEC and its staff.[9] In this regard, in a December 13, 2004, frequently asked question (FAQ) on the application of the SEC's auditor-independence rules, the SEC staff reiterated its long-standing position that when an accountant and his or her client enter into an agreement that seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The SEC's FAQ also stated that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence. The FAQ is consistent with the SEC's Codification of Financial Reporting Policies, section 602.02.f.i, "Indemnification by Client." (See section 2060.1.4.8.)

On the basis of the SEC guidance and the agencies' existing regulations, certain limits on auditors' liability are already inappropriate in audit engagement letters entered into by—

1. public financial institutions that file reports with the SEC or with the agencies,
2. financial institutions subject to part 363,[10] and
3. certain other financial institutions that are required to have annual independent audits.

In addition, certain of these limits on auditors' liability may violate the AICPA independence standards. Notwithstanding the potential applicability of auditor-independence standards, the limitation-of-liability provisions discussed in the advisory present safety-and-soundness concerns for all financial institution audits.

2060.1.4.5 Alternative Dispute-Resolution Agreements and Jury-Trial Waivers

The agencies observed that a review of the engagement letters of some financial institutions revealed that they had agreed to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, *mandatory ADR*) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, financial institutions may waive the right to full discovery, limit appellate review, or limit or waive other rights and protections available in ordinary litigation proceedings.

Mandatory ADR procedures and jury-trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. Accordingly, the agencies believe that mandatory ADR or waiver of jury-trial provisions in external audit engagement letters do not present safety-and-soundness concerns, provided that the engagement letters do not also incorporate limitation-of-liability provisions. Institutions are encouraged to carefully review mandatory ADR and jury-trial provisions in engagement letters, as well as review any agreements regarding rules of procedure, and to fully comprehend the ramifications of any agreement to waive any available remedies. Financial institutions should ensure that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—

1. apply equally to all parties,
2. provide a fair process (for example, neutral decision makers and appropriate hearing procedures), and
3. are not imposed in a coercive manner.

9. See part 363 of the FDIC's regulation (12 C.F.R. 363), *Appendix A—Guidelines and Interpretations, Guideline 14, "Role of the Independent Public Accountant-Independence."*
10. See also the OTS's regulation (12 C.F.R. 562.4).

2060.1.4.6 The Advisory's Conclusion

Financial institutions' boards of directors, audit committees, and management should not enter into any agreement that incorporates limitation-of-liability provisions with respect to audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that limit their legal rights.

The inclusion of limitation-of-liability provisions in external audit engagement letters and other agreements that are inconsistent with the advisory will generally be considered an unsafe and unsound practice. Examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities raises any safety-and-soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards. The agencies may take appropriate supervisory action if unsafe and unsound limitation-of-liability provisions are included in external audit engagement letters or other agreements related to audits that are executed (accepted or agreed to by the financial institution).

2060.1.4.7 Examples of Unsafe and Unsound Limitation-of-Liability Provisions

The following information was contained in appendix A of the February 9, 2006, interagency advisory.

Presented below are some of the types of limitation-of-liability provisions (with an illustrative example of each type) that the agencies observed in financial institutions' external audit engagement letters. The inclusion in external audit engagement letters or agreements related to audits of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is considered an unsafe and unsound practice.

1. "Release from Liability for Auditor Negligence" Provision

In this type of provision, the financial institution agrees not to hold the audit firm liable for *any* damages, *except* to the extent determined to have resulted from willful misconduct or fraudulent behavior by the audit firm.

Example: In no event shall [the audit firm] be liable to the financial institution, whether a claim be in tort, contract or otherwise, for any consequential, indirect, lost profit, or similar damages relating to [the audit firm's] services provided under this engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of [the audit firm] relating to such services.

2. "No Damages" Provision

In this type of provision, the financial institution agrees that in no event will the external audit firm's liability include responsibility for any compensatory (incidental or consequential) damages claimed by the financial institution.

Example: In no event will [the audit firm's] liability under the terms of this agreement include responsibility for any claimed incidental or consequential damages.

3. "Limitation of Period to File Claim" Provision

In this type of provision, the financial institution agrees that *no* claim will be asserted after a fixed period of time that is shorter than the applicable statute of limitations, effectively agreeing to limit the financial institution's rights in filing a claim.

Example: It is agreed by the financial institution and [the audit firm] or any successors in interest that no claim arising out of services rendered pursuant to this agreement by, or on behalf of, the financial institution shall be asserted more than two years after the date of the last audit report issued by [the audit firm].

4. "Losses Occurring During Periods Audited" Provision

In this type of provision, the financial institution agrees that the external audit firm's liability will be limited to any losses occurring during periods covered by the external audit, and will not include any losses occurring in later periods for which the external audit firm is not engaged. This provision may not only preclude the collection of consequential damages for harm in later years, but could preclude any recovery at all. It appears that no claim of liability could be brought against the external audit firm until the external audit report is actually delivered. Under such a clause, any claim for liability thereafter might be precluded because the losses did not occur during the period covered by the external audit. In other words, it might limit the external audit firm's liability to a period before there could be any liability. Read more broadly, the external audit firm might be liable for losses that arise in subsequent years only if the firm continues to be engaged to audit the client's financial statements in those years.

Example: In the event the financial institution is dissatisfied with [the audit firm's] services, it is understood that [the audit firm's] liability, if any, arising from this engagement will be limited to any losses occurring during the periods covered by [the audit firm's] audit, and shall not include any losses occurring in later periods for which is not engaged as auditors.

5. *"No Assignment or Transfer" Provision*

In this type of provision, the financial institution agrees that it will not assign or transfer any claim against the external audit firm to another party. This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or a line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage.

Example: The financial institution agrees that it will not, directly or indirectly, agree to assign or transfer any claim against [the audit firm] arising out of this engagement to anyone.

6. *"Knowing Misrepresentations by Management" Provision*

In this type of provision, the financial institution releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentation by management.

Example: Because of the importance of oral and written management representations to an effective audit, the financial institution releases and indemnifies [the audit firm] and its personnel from any and all claims, liabilities, costs, and expenses attributable to any knowing misrepresentation by management.

7. *"Indemnification for Management Negligence" Provision*

In this type of provision, the financial institution agrees to protect the external auditor from third-party claims arising from the external audit firm's failure to discover negligent conduct by management. It would also reinforce the defense of contributory negligence in cases in which the financial institution brings an action against its external auditor. In either case, the contractual defense would insulate the external audit firm from claims for damages even if the reason the external auditor failed to discover the negligent conduct was a failure to conduct the external audit in accordance with generally accepted auditing standards or other applicable professional standards.

Example: The financial institution shall indemnify, hold harmless, and defend and its authorized agents, partners, and employees from and against any and all claims, damages, demands, actions, costs, and charges arising out of, or by reason of, the financial institution's negligent acts or failure to act hereunder.

8. *"Damages Not to Exceed Fees Paid" Provision*

In this type of provision, the financial institution agrees to limit the external auditor's liability to the amount of audit fees the financial institution paid the external auditor, regardless of the extent of damages. This may result in a substantial unrecoverable loss or cost to the financial institution.

Example: [The audit firm] shall not be liable for any claim for damages arising out of or in connection with any services provided herein to the financial institution in an amount greater than the amount of fees actually paid to [the audit firm] with respect to the services directly relating to and forming the basis of such claim.[11]

2060.1.4.8 Frequently Asked Questions on the Application of the SEC's Auditor-Independence Rules

The following information is contained in appendix B of the February 9, 2006, interagency advisory. The information is derived from the SEC's Office of Chief Accountant's Codification of Financial Reporting Policies.

Question[12]

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at ′common law,' other than for their willful misstatements or omissions."

Answer

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. *Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.*

Question

Has there been any change in the commission's long-standing view (Financial Reporting Policies—Section 600—602.02.f.i., "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

Answer

No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity that seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, *the accountant is not independent.* Further, including in engagement letters a clause that a registrant would release, indemnify, or hold harmless from any liability and costs resulting from *knowing misrepresentations by management would also impair the firm's independence.*

2060.1.3 INSPECTION OBJECTIVES

1. To review the operations of the bank holding company to determine if an audit program exits.
2. To determine the independence and competence of those who administer and provide the internal and external audit function.

11. The agencies also observed a similar provision that limited damages to a predetermined amount not related to fees paid.
12. The subtitles in this section have been revised for this manual.

3. To determine the adequacy of the scope and frequency of the audit program.
4. To determine with reasonable assurance that the bank holding company has adequate internal audit and external audit functions that ensure efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
5. To ascertain if the bank holding company's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the bank holding company's management process—the control environment, risk assessment, control activities, information and communication, and monitoring activities.
6. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor under the standards established by the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.
7. To consider the policies, processes, and personnel surrounding the bank holding company's external auditing program and to determine the existence of any unsafe and unsound practices or conditions, including whether—
   a. any engagement letter or other agreement related to external audit activities (1) provides any assurances of indemnification to the bank's external auditors that relieves them of liability for their own negligent acts (including any losses, claims, damages, or other liabilities) or (2) raises any other safety-and-soundness concerns; and
   b. the external auditors have not maintained appropriate independence in their relationships with the bank holding company, in accordance with relevant professional standards.
8. To determine, based on the criteria above, if the work performed by internal and external auditors is reliable.

2060.1.6 INSPECTION PROCEDURES

The primary thrust of the inspection should be directed toward the audit activities that relate to the parent company and all subsidiaries. An assessment of the audit function as it pertains to the bank (or banks) is primarily the responsibility of the regulatory agency that examines that particular bank. The examiner should review the latest bank examination reports to note comments and deficiencies cited concerning internal controls and the audit function. In addition to providing an input into the overall assessment of the audit function, review of the bank examination reports may provide a basis for determining areas of investigation during the inspection. Further, if matters cited in the latest bank examination report are deemed to be significant and indications are that corrective action has not been taken, the examiner should mention the facts to senior management of the bank holding company and note the details in the inspection report.

To judge the adequacy of the audit program, including its scope and frequency, the following procedures, with equal emphasis being placed on the parent, bank, and nonbank subsidiaries, are recommended as minimum guidelines for the inspection.

1. Review the parent company and nonbank operations and the audit comments in the bank examination reports to ascertain the adequacy of the existing audit program or the need for developing such a program, if the organization currently lacks one.
2. Review the scope of the audit function to ensure that procedures are in place to cover adequately those areas that may be susceptible to exposure. When reviewing the audit scope, determine whether the auditor was able to perform all the procedures necessary to complete the audit. If not—
   a. establish whether the scope limitations were imposed by the directorship or management and
   b. determine whether the auditor established and documented the reasons why the scope limitations were imposed.
      (1) Was the auditor able to quantify the effects of the scope limitation on the financial statements and the audit results, and, if not pervasive, was a qualified opinion or disclaimer of opinion issued?
      (2) Did the auditor evaluate all possible effects on his ability to express an opinion on the financial statements?
      (3) Were there any external circumstances that imposed limitations on the audit's scope?
      (4) Were alternative procedures used to accomplish the same audit objectives? If so, did the use of the alternative procedures justify issuance of an unqualified opinion?

3. Review the audit schedule to determine that the audits are satisfactorily spaced and that all functions are audited with adequate frequency.
4. Review audit workpapers and reports on a test-check basis for adequacy of content, satisfactory maintenance, and conformance to audit guidelines outlined by the board of directors.
5. Determine the qualifications and background of the auditor and others participating in the audit function.
6. To establish that the auditor has a direct communication line to the board of directors and freedom of access to all records for audit purposes, review audit reports and minutes of meetings held by directors or a committee thereof.
7. Determine the entity responsible for maintaining the audit function. If a bank provides audit services to affiliates, indicate the manner in which the bank is reimbursed for the cost of such services.
8. Determine whether audit reports are submitted on a timely basis to—
   a. the directors and senior management and
   b. management in the area being audited.
9. Review responses to exceptions and recommendations noted in audit reports.
10. Check on the relationship between the internal and any external auditors to determine whether their activities are coordinated in a manner that effects comprehensive coverage of the organization and at the same time avoids duplication of effort.
11. Review the letter addressed to management by the external auditor and determine that steps have been taken to correct any deficiencies noted. If no deficiencies were noted in the letter, inquire as to whether such comments were communicated to management by any other means.
12. Ascertain that the audit program is annually reviewed and approved by the directors.
13. If the BHC has engaged any external audit firms to conduct audits of its financial statements (including their certification), audits of internal control over financial reporting, attestations on management's assessment of internal control, appraisals of the BHC's audit function, or any internal audit or audit function or operational review, the examiner should:
    a. Review the engagement letters (including past or pending engagement letters) and any agreements between the board of directors (and the audit committee) and the external auditor, noting any qualifications that are contained therein.
    b. Review any correspondence exchanged between the BHC and the external auditor, including any letters requesting opinions from external auditors. Determine if BHC management influenced any of the opinions.
    c. Ascertain if any of the engagement letters restricted the scope of the audit in any way, including whether the letters limited the degree of reliance to be placed on the work of the internal audit staff.
14. Determine if the audit engagement letters or other agreements include possible unsafe and unsound provisions or practices that—
    a. indemnify the external auditor against all claims made by third parties;
    b. hold harmless, release, or indemnify the external auditor from liability for claims or potential claims that the BHC may assert, thus providing relief from liability for the auditors' own negligent acts, including any losses, claims, damages, or other liabilities, (other than claims for punitive damages); or
    c. limit the remedies available to the BHC (other than punitive damages).
15. Find out whether the BHC's board of directors, audit committee, and senior management closely review all of the provisions of audit engagement letters or other agreements for providing external auditing services for the bank before agreeing to sign, thus indicating the BHC's approval and financial commitment.
16. Verify that the BHC has documented its business rationale for any engagement letter or other agreement provisions with external audit firms that limit or impair the BHC's legal rights.
17. If new external auditors have been engaged, ascertain the reasons for such change.
18. Determine if the parent company or nonbank subsidiaries have reported any defalcations. If so, determine if adequate controls have been initiated to lessen any further risk and exposure.
19. Determine if the BHC's external auditors received copies of the subsidiary FDIC-insured institution's examination and other designated supervisory reports and correspondence required by section 36(h)(1) of the FDI Act.

20. Determine the degree of independence of the external audit firm by reviewing any financial ties between the BHC, audit firm, and any of its partners or employees. Also review any other relationships or potential conflicts of interest that may exist.[13]

The independence of the internal auditor should be evaluated by ascertaining whether the following conditions exist: (1) reports are distributed directly to the board or a committee thereof or, less desirably, to an officer not connected with the area being reviewed; (2) there are no relationships within the organization that are incompatible with the internal audit function; and (3) severe restrictions are not placed on the program or its scheduling by management. In order to maintain the degree of objectivity essential to the audit function, the examiner should establish that the internal auditor does not install procedures, originate and approve entries, or otherwise engage in any activity that would be subject to audit review and appraisal.

The examiner should consider meeting with the audit committee and the auditor and, subsequently, with senior bank holding company management to communicate conclusions concerning the adequacy of the scope and frequency of the audit program. During the discussions, the examiner should concentrate on detailing criticisms or deficiencies noted. The auditor and senior bank holding com-pany management should be made fully cognizant of the examiner's analyses and the comments concerning the audit function that will appear on the relevant pages in the inspection report.

13. The Securities and Exchange Commission (SEC) has also released guidance relating to the independence of auditors for public institutions. According to SEC Rule 101, the independence of an auditor would be impaired if there are financial, employment, or business relationships between auditors and audit clients, or if there are relationships between auditors and audit clients in which the auditors provide certain nonaudit services to their audit clients. Much of the language found in the SEC's independence rules is incorporated in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing. (See section 2060.05.)

2060.1.7 (reserved for future use)

2060.1.8 OVERVIEW: INTERAGENCY ADVISORY ON EXTERNAL AUDITS OF INTERNATIONALLY ACTIVE U.S. FINANCIAL INSTITUTIONS

The federal banking agencies (the agencies)[14] issued this interagency advisory to communicate the agencies' support for the principles and expectations set forth in parts 1 and 2, respectively, of the Basel Committee on Banking Supervision's (the BCBS or the Committee) March 2014 guidance on "External audits of banks" (hereafter, referred to as "the BCBS external audit guidance").[15]

In supporting these principles and expectations, the agencies acknowledge that the existing standards and practices in the United States are broadly consistent with the BCBS external audit guidance. However, because of the legal and regulatory framework in the United States, certain differences exist between the standards and practices followed in the United States and the principles and expectations in the BCBS external audit guidance. These differences are addressed in this advisory, which also describes the agencies' supervisory expectations for U.S. financial institutions within the scope of this advisory for incorporating the principles and expectations in the BCBS external audit guidance into their practices. This advisory also outlines examiner responsibilities related to these supervisory expectations.

The BCBS external audit guidance is intended for "internationally active banks" and is relevant for the management, audit committees, external auditors, and prudential supervisors of such financial institutions. The agencies define "internationally active banks" in the advisory. (Refer to SR-16-2 and its attachment.)

14. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

15. See www.bis.org/publ/bcbs280.pdf.

2060.1.8.1 Appendix A—Interagency Advisory on External Audits of Internationally Active U.S. Financial Institutions

Scope

The BCBS external audit guidance is intended for "internationally active banks" and is relevant for the management, audit committees, external auditors, and prudential supervisors of such financial institutions. For purposes of this advisory, the agencies are defining "internationally active banks" as:

- Insured depository institutions that meet either of the following two criteria: (1) consolidated total assets of $250 billion or more; or (2) consolidated total on-balance sheet foreign exposure of $10 billion or more (referred to as "core banks"); and
- U.S. depository institution holding companies that meet any of the following three criteria: (1) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of $250 billion or more; (2) consolidated total on-balance sheet foreign exposure of $10 billion or more; or (3) have a subsidiary depository institution that is a core bank.

In the United States, core banks are subject to 12 CFR 363, the Federal Deposit Insurance Corporation's (FDIC) regulation on Annual Independent Audits and Reporting Requirements.[16] Core banks typically comply with 12 CFR 363 requirements at a holding company level. In addition, these holding companies generally are public companies that are required to file annual, quarterly, and other periodic reports with the U.S. Securities and Exchange Commission (SEC). The Public Company Accounting Oversight Board (PCAOB) regulates the external auditors of these public companies.

Background

In March 2014, the Committee published the BCBS external audit guidance to improve the external audit quality of banks and enhance the effectiveness of prudential supervision, which contributes to financial stability. The BCBS external audit guidance elaborates on Core Principle 27, *Financial Reporting and External Audit,* of the Committee's Core Principles for Effective Banking Supervision[17] by providing guidance related to bank audit committees' responsibilities in overseeing the external audit function. This guidance also discusses prudential supervisors' relationships with external auditors of banks and audit oversight bodies. Additionally, the BCBS external audit guidance includes information relevant to external audits of financial statements that the Committee believes will enhance the quality of these external audits.

The BCBS external audit guidance has two parts:

- Part 1 provides guidance (principles) on the roles and responsibilities of audit committees relevant to external audits and the engagement of bank supervisors with external auditors and external auditors' regulators.
- Part 2 of the document (expectations) emphasizes the proper application of existing internationally accepted auditing standards. The BCBS external audit guidance also provides recommendations for procedures that external auditors could perform in the execution of bank audits to enhance audit quality.[18]

Supervisory Expectations Regarding the Differences Between U.S. Standards and Practices and the BCBS External Audit Guidance

The BCBS external audit guidance builds upon internationally accepted auditing standards and sets expectations for institutions and their external auditors. In the United States, financial institutions within the scope of this advisory are directly or indirectly subject to the audit requirements of 12 CFR 363[19] and supervisory guid-

16. 12 CFR 363 applies to any insured depository institution with respect to any fiscal year in which its consolidated total assets as of the beginning of such fiscal year are $500 million or more.

17. The Committee's Core Principles are available at www.bis.org/publ/bcbs230.pdf. In particular, Core Principle 27 states, "The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function."

18. The BCBS external audit guidance acknowledges that the Committee does not have the authority to set professional standards for external auditors.

19. 12 CFR 363.3(f) requires external auditors to comply

ance related to audits of financial institutions.[20] In order for a core bank to comply with the audited financial statements requirement of 12 CFR 363 at a public holding company level, the audit must be performed in accordance with PCAOB standards. The 12 CFR 363 audit requirements, supervisory guidance, and PCAOB standards, collectively, are generally consistent with the BCBS external audit guidance, except for the differences noted below. This advisory discusses the agencies' supervisory expectations regarding these differences with reference to the corresponding principles from part 1 and expectations from part 2 of the BCBS external audit guidance.

Part 1, Principle 2: The audit committee should monitor and assess the independence of the external auditor.

Paragraph 49 of the BCBS external audit guidance indicates that an institution's audit committee should have a policy in place that stipulates the criteria for "tendering," i.e., putting its external audit contract out for bid. This paragraph further states that the policy also should call for the audit committee to periodically consider whether to put the external audit contract out for bid. Consistent with 12 CFR 363, the banking agencies encourage audit committees to establish policies and procedures addressing the retention and remuneration of the external auditor (independent public accountant).[21] In addition, the external auditors of insured depository institutions subject to 12 CFR 363 must comply with the SEC's rules regarding audit partner rotation. Audit committees are encouraged to consider whether their policies should explicitly address the criteria for tendering the audit contract and whether the contract should periodically be put out for bid.

Part 1, Principle 6: The supervisor and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities.

and

Part 1, Principle 7: The supervisor should require the external auditor to report to it directly on matters arising from an audit that are likely to be of material significance to the functions of the supervisor.

Paragraphs 95 and 96 of the BCBS external audit guidance indicate that the auditor may share information about the external audit of an institution that may be of interest to the depository institution's supervisor (e.g., significant risks of material misstatements, significant or unusual transactions, evidence of management bias, significant deficiencies or material weaknesses in internal control over financial reporting, and actual or suspected breaches of regulations or laws[22]), either (1) directly with the supervisor when a safe harbor exists or (2) indirectly through the institution to the supervisor when a legal safe harbor does not exist. Paragraph 99 of the BCBS external audit guidance provides that the external auditor should communicate matters arising from the audit that may be of material significance to the supervisor when required by the legal or regulatory framework or by a formal agreement or protocol. According to the BCBS external audit guidance, "[a] matter or group of matters is normally of material significance ... when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator."[23]

There is no generally applicable legal or regulatory requirement in the United States for external auditors of banks and holding companies to report directly to the institution's primary federal (and, if applicable, state) supervisor matters arising from the audit that may be of material significance, nor is there a legal safe harbor to do so. Insured depository institutions subject to 12 CFR 363 are required to file with appropriate federal and state supervisors copies of reports and other written communications issued by the external auditor to the institution in connection with the external audit services provided to the institution. Consistent with interagency policy

with the independence standards and interpretations of the American Institute of Certified Public Accountants, the SEC, and the PCAOB.

20. For example, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners* (July 23, 1992).

21. 12 CFR 363.5(a) states, "The duties of the audit committee shall include the appointment, compensation, and oversight of the independent public accountant who performs services required under this part, and reviewing with management and the independent public accountant the basis for the reports issued under this part."

22. See also paragraphs 90-94 of the BCBS external audit guidance.

23. See footnote 9 in the BCBS external audit guidance.

statements[24] and practices, the agencies continue to encourage open and candid communication between an institution's external auditor and the institution's supervisors.

Part 2, Expectation 5: The external auditor of a bank should identify and assess the risks of material misstatement in the bank's financial statements, taking into consideration the complexities of the bank's activities and the effectiveness of its internal control environment.

and

Part 2, Expectation 6: The external auditor of a bank should respond appropriately to the significant risks of material misstatement in the bank's financial statements.

Paragraphs 157 and 168 of the BCBS external audit guidance set forth the Committee's expectations for external auditors to (1) consider regulatory ratios in the determination of materiality for the audit, and (2) evaluate any identified audit differences, errors, and adjustments and their effect on regulatory capital or regulatory capital ratios. PCAOB standards[25] and SEC Staff Accounting Bulletin Topic 1.M, Materiality, indicate external auditors should consider qualitative factors (which include regulatory capital, ratios, and disclosures) in determining materiality and when evaluating the effect of audit differences, errors, and adjustments. Therefore, the agencies expect institutions' audit committees will ensure that their external auditors consider regulatory capital ratios in planning and performing the audit. In this regard, audit committees are encouraged to inquire as to how the external auditors factored these ratios into their materiality assessments.

Additionally, paragraph 166 of the BCBS external audit guidance recommends that the external auditor provide written feedback about the audit engagement team's relations with the institution's internal audit function, including its observations on the adequacy of the work of internal audit, to those charged with governance of the bank. PCAOB Auditing Standard No. 16, *Communications with Audit Committees,* requires the external auditor, as part of communicating the overall audit strategy, to explain the extent to which the auditor plans to use the work of internal audit in an audit of the financial statements or an audit of internal control over financial reporting. However, PCAOB standards do not require the external auditor to provide written feedback about the audit engagement team's relations with the institution's internal audit function, including its observations on the adequacy of the work of internal audit. The agencies encourage audit committees to consider requesting their external auditor to provide written feedback about the audit engagement team's relations with internal audit, including its observations on the adequacy of the work of internal audit, as it relates to the audit of the financial statements or the audit of internal control over financial reporting.

Furthermore, consistent with the March 2003 *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing,* an institution's audit committee should consider whether the institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *International Professional Practices Framework* (previously known as the *Standards for the Professional Practice of Internal Auditing).* Audit committees may look to the IIA's Framework for guidance for both internal and external assessments of the internal audit function.

Examiner Responsibilities

Examiners should evaluate any actions taken by institutions within the scope of this advisory and their audit committees to ensure such actions are consistent with the objectives of this advisory and the BCBS external audit guidance. Where there are differences between the BCBS external audit guidance and U.S. standards, examiners should encourage institutions' audit committees to follow the practices identified in this advisory.

Conclusion

External auditors play an important role in contributing to financial stability when they deliver quality audits, which foster market confidence in institutions' financial statements. Quality audits are also a valuable complement to the supervisory process. The agencies support the principles and expectations set forth in the BCBS external audit guidance because

24. See footnote 6 of this advisory.
25. See PCAOB Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, paragraph 6, and PCAOB Auditing Standard No. 14, Evaluating Audit Results, appendix B, paragraph B2.

enhanced audit quality is an important factor in ensuring the safety and soundness of U.S. institutions. Institutions and their external auditors are expected to comply with existing laws, regulations, and professional standards, as applicable, including those referenced in this advisory.

An assessment of management's strategic plans and its success in meeting previously established budgetary goals is one of the factors considered in evaluating a BHC's management, operations, financial condition, and prospects.[1] Through review of the budget figures, insight can be gained concerning an organization's future plans and other matters such as capital adequacy, liquidity, sources and applications of funds, level and quality of earnings, and performance of management.

The budget is a coordinated financial plan used to estimate and control all or a few of the activities of the various divisions or subsidiaries in a bank holding company. Based on an assessment of future economic developments and conditions, management formulates a plan of action and indicates anticipated changes in the balance-sheet accounts and profitability (predicated on implementation of the plan). The budget is a significant management tool in that it projects expected results and also serves as an important check on management decisions and performance by providing a basis for comparison and corrective action on a timely basis. The comparison of actual performance to budget allows management to give careful attention to various possible courses of action and to choose the course which should result in the greatest benefit. Budgeting is also useful in measuring the performance of individuals and the departments they manage. Further, the comparison of budget totals to actual changes in activities such as loans, investments, and deposits assists in decision making and can promote coordination and cooperation among affiliates. The variance indicated by the comparison process may be construed as a measure of management's performance and planning record and its relationship to the organization's goals and objectives. It should be noted that some significant variances may be caused by factors beyond management's control or factors that could not reasonably be anticipated.

1. The *stragetic planning process* focuses on intermediate and long-term strategic goals and is the vehicle used to determine the overall direction and focus of the organization. The *budgeting process* refers to the tactical decisions required to meet goals and objectives. The budget is a subset of the strategic plan. While smaller bank holding company organizations may not always have formal written budgets, all organizations should have a strategic planning process, which determines overall corporate direction, general resource allocation, and balance-sheet relationships with respect to capital needs, growth, asset mix, and risk.

While various individuals may be responsible for input to the budget process, the chief executive officer typically has the ultimate responsibility for preparation and implementation of the formal budget. The time period covered by a budget typically encompasses one year, although it often covers longer periods in the larger, more sophisticated bank holding companies. The longer the budget period, the greater are the prospects for increased variances from original budget figures. In some cases in which four- or five-year projections are made, bank holding companies may formulate several forecasts based on different sets of assumptions. In such instances, the examiner should work with the "most likely" situation that may evolve based on economic trends, history, and experience of the organization, but should also give serious consideration to the "worst-case" projections.

Many bank holding companies, particularly the smaller organizations, may not have formal written budgets or plans. In small shell companies, while it is not essential to have a formal budget, budgeting procedures should be encouraged where appropriate. Budgeting at the parent level could be appropriately limited to debt-servicing and dividend considerations.

2060.2.1 INSPECTION OBJECTIVES

1. To determine the extent of an organization's financial planning and budget program.
2. To indicate to management of organizations that are without formal planning procedures the advantages of adopting a budget.
3. To understand the institution's decision-making process as it relates to the budget.
4. To determine the causes of significant variances between the budget and actual performance.
5. To assess the reasonableness of projected figures, including controls over the data throughout the budgeting process.
6. To assess the impact of the budget on the present condition and future prospects of the bank holding company.
7. To determine whether the plan outlined in the budget is supported by the financial and managerial resources of the holding company.

2060.2.2 INSPECTION PROCEDURES

1. Familiarity with a bank holding company's financial condition and results of operations should begin before the start of the inspection with a review of the annual report to shareholders, financial reports submitted to the Federal Reserve System, and other financial documentation contained in the files. The more significant accounts, statistical data, and pertinent ratios should be compared on a period-to-period basis to highlight significant changes and discern trends.

2. The examiner also should become familiar with current and projected economic conditions, both nationally and locally, including general industry conditions.

3. Based on a review of the aforementioned data, the examiner should be in a position to substantiate the reasonableness of budgeted figures without a systematic examination of all of the transactions affecting the figures presented. Further, such an analysis provides a better understanding of the operation and highlights matters of interest and potential problem areas to be investigated during the inspection.

4. Throughout the review process, the examiner must maintain a sense of perspective to avoid spending excessive time on relatively immaterial amounts.

5. The examiner should meet with the officer responsible for the preparation of the budget to determine the scope of the organization's financial plans. The extent of senior management's and the board of directors' involvement in the strategic planning and budgeting process should also be ascertained in this preliminary meeting.

6. Workpapers which document or illustrate the rationale for the budget data should be reviewed and discussed with budget personnel, including the existence and extent of internal controls over the data.

7. The examiner should evaluate plans, projections, and forecasts in light of market-area characteristics and the present condition and history of the organization.

8. The examiner should determine whether the accounting principles of major importance have been applied consistently and, if not, the impact of the alternative accounting treatment on the budget totals.

9. The sources of input for the budget should be reviewed and the frequency and procedures for effecting revision should be ascertained.

10. When there are significant budget variances, the examiner should seek documented explanations. Review any such documentation to determine if management policy or factors beyond management control were responsible for the variances.

11. A final summary discussion should be held with management to discuss goals which the examiner believes may be unattainable and to communicate conclusions concerning the budget. Due consideration should be given to management's views, whether or not in concurrence with the examiner's conclusions. If management indicates future changes which could have a significant impact on the organization, the matter should be noted in the inspection report. Further, management's assessment of the effect of contemplated action on the operations and financial condition of the bank holding company should be noted.

12. For those bank holding companies that do not have formal written plans, the examiner should obtain from senior management information on their plans for matters such as growth and expansion, capital injections, debt retirement, and changes in sources of funding. Except for small, shell companies, the examiner should recommend adoption of a budget program and emphasize the need for strategic planning by indicating how management methods may be improved as a result of a logically conceived and properly operated budget. Budgets and planning are especially important in cases in which a bank holding company is losing its share of the market or in which inefficiencies are depressing profitability.

Adequate and accurate records and financial statements are an integral part of a sound bank holding company operation. Records should be maintained to allow preparation of financial statements in accordance with generally accepted accounting principles and to ensure proper accountability for all assets, liabilities, income, and expenses. Generally, an independently certified statement inspires greater confidence than a statement prepared internally. Moreover, an unqualified, independently certified statement may act as a check on management recordkeeping policies and procedures, and provide more assurance that transactions are being properly recorded and that books accurately reflect overall financial condition.

Management may exercise reasonable discretion in selecting and adopting the type of books and records it uses and in formulating accounting systems and bookkeeping procedures. From the examiner's viewpoint, the test of a bank holding company's records is one of adequacy, consistency, and accuracy. The financial statements of every bank holding company must accurately reflect financial condition and operating results. This principle is applicable whether a bank holding company is small and has a relatively simple bookkeeping system or whether it is a larger institution with a fully automated system. A recordkeeping system that is capable of generating a wide variety of pertinent internal data and other information facilitates problem solving and decision making and, thus, contributes to the efficiency of a bank holding company's operations. Further, such a system serves as a convenient tool to provide directors, stockholders, and other interested parties with information on conditions in a bank holding company.

2060.3.1 INSPECTION OBJECTIVES

1. To determine whether financial statements are prepared in accordance with generally accepted accounting principles and are sufficiently detailed to accurately portray the company's financial condition.
2. To determine that sufficient records are maintained to provide detail on material balance-sheet items, income-statement items, and various contingent liabilities and off-balance-sheet risks that permit the preparation of appropriate financial information.
3. To recommend corrective action when policies and procedures employed have resulted in inadequate or inaccurate records and financial statements.

2060.3.2 INSPECTION PROCEDURES

1. The examiner should review the sections relating to audit and records in the prior inspection report and the latest examination reports of the subsidiary banks to note any comments or deficiencies cited concerning records, including any MIS deficiencies. In addition to providing an input into the overall assessment of the quality of records, the review may provide a basis for determining areas of emphasis and follow-up during the inspection.
2. The examiner should discuss recommendations and criticisms contained in such reports with an appropriate officer to ascertain what changes, if any, have taken place.
3. The examiner should review the external auditing firm's management letter, giving particular attention to comments concerning recordkeeping. Determine if any corrective actions were recommended by the external auditors and the extent to which the cited items have been corrected.
4. In those situations when it appears that records are deficient or financial statements are inaccurate, a thorough investigation of applicable transactions may be required. The purpose of the investigation is to obtain information needed in outlining improved controls over MIS, accounting methods, and records so that the financial data presented are in accordance with generally accepted accounting principles. Thus, information is provided which will better serve bank holding company management. The investigation should not necessarily involve a review of every transaction, but should involve a check of a sufficient number of transactions to ensure the examiner that the records, as checked, reflect an accurate financial condition. The extent of the review will depend largely on the procedures and controls over MIS and the condition and adequacy of the books and underlying records. During the investigative process, the examiner should be careful to distinguish between documented facts and statements of intent or interpretations set forth by company representatives.

The directorate and management of bank holding companies have a responsibility to contribute to the health and growth of the organization they serve. To carry out this responsibility effectively, they must be kept fully informed of conditions throughout the organization and trends within the banking industry. Reporting is the process of developing and communicating information internally to directors and management and externally to shareholders and regulatory authorities. Management and the board of directors must recognize that as a company develops and grows, its environment, strategic goals, and information needs change. The guidelines and requirements for reports flowing to management and the board of directors should be established and allow for change, recognizing the fact that informational needs can vary, including those at different levels of the organization.

Informational needs will also be dictated by the particular type of management structure in place—centralized, decentralized, legal entity, or business line. The ultimate decision-making responsibility rests with the corporation's board of directors, and the responsibility for implementing their decisions rests with designated board committees, executive management, or other designated management committees or individuals. As such, examiners should make an assessment of the qualifications of the persons on the board of directors, executive management staff, and the board and executive management committees to ensure that they have the necessary knowledge, experience, and expertise to understand the information presented and to act on it constructively. The assessment should include a review of reporting lines to identify information flows and the various decision-making levels involved or needed.

All reports flowing to executive management, board committees, and the board of directors should be analyzed for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. A review of board and committee minutes should reveal if participants had any questions or whether there were any uncertainties as to the meaning of the data presented.

Each bank holding company prepares various reports for submission to its management and directors; an effective internal reporting system facilitates their ability to analyze a situation and to make informed decisions. Although such reports may vary in content from company to company, emphasis is generally placed on the financial data generated. The important consideration is whether each company is providing sufficient data to keep the interested parties informed of the financial condition and performance of all the divisions or entities. The frequency of the reporting and the detail of information provided can be categorized as being on a need-to-know basis. The form of reports ranges from consultations and meetings to submission of printed material for study and review. The scope and size of the operations will have an effect on the frequency and detail of the information submitted. In the larger, more sophisticated companies, frequent meetings and consultations are held to discuss the performance of various entities, the impact of performance on the organization's goals and objectives, and policies and strategies to be followed. Written reports outlining important matters and summarizing various financial data are typically reviewed and discussed regularly.

The number and variety of reports depends on the size and sophistication of the bank holding company operation. For smaller bank holding companies, the extent of their reports may be limited to annual statements, as more frequent periodic reports may not be necessary under normal conditions. The larger holding companies normally prepare monthly comparative balance sheets and income statements covering similar periods for two consecutive years. Thus, any significant deviation from the prior year's data can be readily detected. Generally, reports detailing the extent of delinquent and nonaccrual loans are prepared monthly. Facts and figures pertaining to the adequacy of the loan-loss provision are presented periodically. Additional reports containing information on budgets, cash flow, liquidity, and capital adequacy are prepared to assist management in assessing the organization's overall financial condition and performance. Summaries of internal audit reports and reports of examinations of subsidiary banks are brought to management's attention. Data relative to other bank holding companies or banks in the same peer groups are assembled, when available, so that comparisons with similarly sized organizations are possible. All of the aforementioned information may be prepared for directors, although not necessarily in as much detail as that submitted to management. On occasion, key management personnel of the holding company attend directors' meetings to expand on the topics being discussed.

Reports to shareholders usually consist of quarterly and annual reports which detail the company's financial condition and results of operations. Additional information may include the chief executive officer's overall assessment of the company, future plans, and other financial and analytical data. The financial information is used for public disclosure and enables investors, depositors, and creditors to make informed judgments concerning the financial condition of the bank holding company. Bank holding companies whose securities have been registered pursuant to the Securities and Exchange Act of 1934 are required to prepare various reports containing specific financial information.

2060.4.1 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, including board and executive management committees.
2. To determine whether the bank holding company has written policies and procedures, and internal controls covering the types of reports required to be submitted to management and the directors.
3. To determine that the required reports are adequate to accurately reflect the financial condition and performance within the organization's divisions and units and whether the reporting systems and reports are adequate to monitor the risks therein.
4. To evaluate whether the reports and reporting systems are adequate to measure and reflect the company's financial position and performance in all areas, to measure the company's progress in meeting its financial and business goals, and to monitor inherent risks.
5. To determine that the contents of the reports are complete and submitted on a timely basis.
6. To recommend corrective action when reporting practices, policies, or procedures are deficient.
7. To evaluate management's procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by reporting systems, and to evaluate the system's ability to adapt to change caused by regulatory and accounting issues or other market conditions.

2060.4.2 INSPECTION PROCEDURES

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls.
2. Ascertain whether any corporate policies address risk managment or internal reporting requirements and determine:
   a. the types of reports required to be submitted and
   b. the adequacy of such reporting requirements in light of a company's particular circumstances.

   Comment: In a holding company with a decentralized system of control over subsidiaries, the existence of written policies and procedures is important since each subsidiary operates as a relatively autonomous unit.
3. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors (including packages for the board of directors and executive committees).
4. Randomly sample, based on a material risk focus, the individual as well as the various types of management reports and determine whether they are adequately prepared in accordance with established policies and procedures and submitted to the appropriate individuals on a timely basis. Determine whether the management reports are sufficient to measure the company's progress in achieving its financial and business goals and forecasts.
5. Identify and document management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Also evaluate the ability of the information system to handle regulatory and accounting issues and to adapt to change.
6. At the conclusion of the review process, the examiner should discuss with management, as appropriate, topics such as—
   a. the lack of established policies and procedures and internal controls,
   b. inadequate reporting requirements, and
   c. noncompliance with reporting requirements and/or the untimely submission of reports.

2060.4.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Registration, reports, and examinations or inspections		225.5		
Reporting requirements emanating from the Securities Exchange Act of 1934	15 USC 78a et seq.			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2060.5.1 INTRODUCTION

In establishing an insurance program, a bank holding company should be aware of where it is exposed to loss, the extent to which insurance is available to cover potential losses and the cost of such insurance. These various factors should be weighed to determine how much risk the bank holding company will assume directly. In assessing the extent of risk an organization is willing to assume, it is important to analyze the impact of an uninsured loss not only on the entity where the loss occurs, but also on the affiliates and the parent. Once appropriate coverage has been acquired, procedures should be established for the periodic review of the program to assure the continuing adequacy of the coverage. Particularly for larger BHCs, these procedures should include at least an annual review of the program by the board of directors of the parent organization.

Insurance is a highly specialized field and no attempt is made here to discuss all the various types and forms of insurance coverage that are available to financial institutions. Examiners are not expected to be insurance experts; however, examiners should recognize that a financial organization's primary defenses against loss include adequate internal controls and procedures and that insurance is intended to complement, not replace, an effective system of internal controls. Thus, an overall appraisal of the control environment becomes a significant consideration in assessing the adequacy of the insurance program. To the extent controls are lacking, the need for additional coverage increases.

2060.5.2 BANKER'S BLANKET BOND

The most important and comprehensive insurance coverage available is the bankers' blanket bond which is usually extended to encompass all the entities in a bank holding company structure. Generally, the scope of the blanket bond contract is intended to cover risks of loss due to criminal acts, such as embezzlement, burglary, robbery, theft, larceny, forgery, etc., but in addition it provides indemnity for loss of property through damage, destruction, misplacement and mysterious, unexplainable disappearance. The most important item of protection under the bond, however, is the blanket fidelity coverage for officers and employees.

2060.5.3 TYPES OF BLANKET BONDS

While there are several similar forms of blanket bonds in use, those commonly found are the Financial Institutions Bond Standard Form No. 24, the Bankers Blanket Bond Standard Form No. 2, and Lloyd's Banks' and Trust Companies' Policy HAN Form (C). Under these blanket forms, every employee is usually covered for the total amount of the bond. Typically, new employees and new offices are automatically covered and no notice is required for an increase in the number of employees or in the number of offices established, unless such increases result from a merger or consolidation with another institution. The word "blanket," however, refers to the over-all amount that applies to the several specified risks covered under the bond and is not intended to mean "all risks" coverage. A most important feature of the bankers' blanket bond is the "discovery rider." The rider, which converts the blanket bond from a "loss sustained basis" to a "discovery basis," provides indemnity against any loss sustained by the insured entity at any time but discovered after the effective date of the bond and prior to the termination or cancellation of the bond, even though lower amounts of insurance and more restrictive coverage may have been carried when the loss was actually sustained.

2060.5.4 DETERMINING THE COVERAGE NEEDED

One of the most difficult insurance problems management faces is the determination of the amount of blanket bond coverage that should be maintained. An estimate of the maximum amount of money and securities that may be lost through burglary or robbery can be calculated with reasonable accuracy, but the potential loss resulting from dishonest acts of officers and employees is not easily measured. The Insurance and Protective Committee of the American Bankers Association has conducted several studies of the problems of determining adequate coverage and has concluded that total deposits represent the most appropriate item in bank financial statements upon which to base an estimate of a reasonable or suitable amount of blanket bond coverage.

In a bank holding company structure, the amount of blanket bond coverage is generally determined by the deposits of the largest bank and the amount of suggested coverage in the ABA's schedule. Such an amount is considered to be a minimum and other factors such as a rapidly expanding operation, excessive cash on hand, or inferior audit and control practices may suggest the need for larger coverage. Since coverages are generally extended to include the nonbank subsidiaries and such subsidiaries usually operate on a smaller scale than their affiliated banks, the question concerning the adequacy of the amount of the blanket bond coverage for a nonbank subsidiary is more easily addressed and is typically a function of the parent's and the bank's coverage.

2060.5.5 NOTIFICATION OF LOSS

When submitting a claim, most blanket bonds have provisions which require a report to be submitted within a specified period after a reportable item comes to the attention of management. Occasionally, items are not reported to the bonding company because of uncertainty as to whether the incident constitutes a reportable item. Failure to report in a timely manner could invalidate the claim and jeopardize existing coverages. Thus, it should be emphasized to management that any questionable items should be reported.

2060.5.6 DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance (''DOL Insurance'') insures the Directors and Officers against *personal* liability resulting from claims of alleged negligence, wrongful acts, errors and omissions, etc. This insurance is not included in the blanket bond or other standard fidelity coverage.

2060.5.7 INSPECTION OBJECTIVES

1. To determine the scope and extent of insurance coverages for the various entities in the organization.
2. To determine the adequacy of insurance coverage after giving due consideration to the overall control environment and factors such as the organization's claim experience and costs associated with various coverages.
3. To ascertain that a comprehensive review of the insurance program is conducted periodically by management and at least annually by the board of directors and entered into the minutes.
4. To determine the entity(ies) responsible for paying the premiums and the manner in which such payments are allocated among the affiliates that receive the coverage benefits.
5. To determine if procedures are in place to assure that claims are filed promptly.

2060.5.8 INSPECTION PROCEDURES

1. The prior year's inspection report should be reviewed for comments relative to controls and insurance. The examiner should note the types and extent of coverages, comments concerning the control environment and any deficiencies related to the administration of the insurance program and the coverages in force.
2. A similar review encompassing the latest examination reports of all major affiliated banks should be conducted. The review process is intended to provide a basis for determining areas of emphasis and follow-up during the inspection. The examiner need not re-examine the insurance program or the controls in force in the individual banks.
3. The examiner should meet with the officer responsible for maintaining the insurance policies and related documentation and ascertain the location of such policies and documentation. Review any independent review of coverages and any deficiencies that may have been cited by the internal or external auditors.
4. Review the manner and frequency of presentations to the board of directors of the insurance coverage.

2065.1.1 INTRODUCTION

Loan workouts with borrowers who are experiencing financial difficulties may take many forms, including a renewal or extension of terms, extension of additional credit, or a restructuring with or without concessions. Such actions, if done in a way that is consistent with prudent lending principles and safety-and-soundness standards, can improve the prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for reporting these actions that may alleviate a lender's concerns about working constructively with borrowers who are experiencing financial difficulties.

2065.1.2 TYPES OF LOAN ACCOMMODATIONS AND WORKOUTS

Short-term loan accommodations. These accommodations typically occur when financial institutions work proactively and prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress. Such actions may entail loan accommodations that are generally short-term or temporary in nature and occur before a loan reaches a workout scenario. These actions can mitigate long-term adverse effects on borrowers by allowing them time to address the issues affecting repayment.

Loan workout programs. When short-term accommodation measures are not sufficient or have not been successful in addressing a borrower's problems, financial institutions could proceed into longer-term or more complex loan arrangements with borrowers under a formal workout program. Such workouts are often in the best interest of the financial institution and its borrower. Loan workout arrangements can take many forms, including, but not limited to

- renewing or extending loan terms,
- granting additional credit to improve prospects for overall repayment, or
- restructuring the loan with or without concessions.[1]

Typically, financial institutions consider longer-term loan workout arrangements after analyzing a borrower's repayment ability, evaluating the support provided by guarantors, and assessing the value of any collateral pledged. Proactive engagement by the financial institution with the borrower often plays a key role in the success of the workout. Consistent with safety-and-soundness standards, examiners will not criticize a financial institution for engaging in loan workout arrangements, even though such loans may be adversely classified, as long as the institution has developed a well-conceived and prudent workout plan supplemented with appropriate analysis of the borrower's willingness and ability to repay. For more information, see SR-23-5, "Prudent Commercial Real Estate Loan Accommodations and Workouts."

2065.1.3 LOAN MODIFICATIONS TO BORROWERS EXPERIENCING FINANCIAL DIFFICULTY

In March 2022, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2022-02, "Financial Instruments - Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures," which amended Accounting Standards Codification (ASC) Topic 326, Financial Instruments – Credit Losses.[2] This guidance eliminated the recognition and measurement accounting guidance for troubled debt restructurings (TDRs) by creditors in subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Under ASU 2022-02, a holding company must evaluate whether a loan modification to a borrower experiencing financial difficulty represents a new loan or a continuation of an existing loan consistent with ASC section 310-20-35, Receivables—Nonrefundable Fees and Other Costs—Subsequent Measurement.

Prior to the adoption of ASU 2022-02, under GAAP, financial institutions, including holding

1. SR-23-5, "Prudent Commercial Real Estate Loan Accommodations and Workouts," states that a loan restructuring involves a formal, legally enforceable modification in the loan's terms.

2. For additional information on ASU 2022-02, holding companies should refer to the FASB's website at www.fasb.org (Accounting Standards Updates Issued), which includes a link to the accounting standard update.

companies, were required to recognize and disclose modified loans where the financial institution has granted a concession for economic or legal reasons, related to the borrower's financial difficulty as TDRs.

As noted in the supplemental instructions for the Consolidated Financial Statements for Holding Companies (FR Y-9C), holding companies that have adopted ASU 2022-02 should report all loans modified since adoption of the new standard to borrowers experiencing financial difficulty who are performing in accordance with their modified terms on Schedule HC-C, Part I, Memorandum items 1.a. through 1.g.[3] If a loan is not performing in accordance with its modified terms, it should be reported on Schedule HC-N, Memorandum items 1.a through 1.g. TDRs should no longer be reported in these Memorandum items. For the detailed breakout of Memorandum item 1.f on both Schedule HC-C and HC-N, holding companies should calculate the 10 percent threshold for loan modifications to borrowers experiencing financial difficulty. For more information, see the instructions for completing the FR Y-9C, which contains instructions for institutions transitioning to the previously described accounting standards.

2065.1.4 NONACCRUAL ASSETS

The instructions for completing the FR Y-9C contain more information about nonaccrual assets and the restoration of nonaccrual assets to accrual status. As explained in the FR Y-9C instructions, holding companies on an accrual basis of reporting shall not accrue interest or discount on any asset:

(1) which is maintained on a cash-basis because of deterioration in the financial position of the borrower;
(2) for which payment in full of interest or principal is not expected; or
(3) upon which principal or interest has been in default for a period of 90 days or more, unless it is both *well secured* and *in the process of collection*.[4]

3. See the Supplemental FR Y-9C Instructions from December 2023.

4. For exceptions to this general rule, see the instructions to the FR Y-9C.

An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guaranty of a financially responsible party.

An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or (2) in appropriate circumstances, through collection efforts not involving legal action, which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

For determining when to place an asset on nonaccrual status, an institution uses the date on which an asset reaches nonaccrual status determined by its contractual terms. If the principal or interest on an asset becomes due and unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due, and it should remain in nonaccrual status until it meets the criteria for restoration to accrual status.

2065.1.5 CASH-BASIS INCOME RECOGNITION ON NONACCRUAL ASSETS

Current regulatory reporting requirements do not preclude the cash-basis recognition of income on nonaccrual assets (including loans that have been partially charged off), if the remaining book balance of the loan is deemed fully collectible. Interest income recognized on a cash basis should be limited to that which would have been accrued on the recorded asset at the contractual rate. Any cash payments received over this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

The recognition of interest income on a cash basis should be handled in accordance with GAAP. Acceptable practices under GAAP include allocating the cash payment to interest income (i.e., the contractual interest payment); reducing the recorded asset balance; or applying the cash payment to amortized cost of the asset, as applicable, or to the recovery of prior charge-offs. The method used for accounting for cash payments needs to be consistent with the holding company's accounting policies for its financial reporting.

2065.1.6 RETURNING AN ASSET TO ACCRUAL STATUS

As a general rule, a nonaccrual asset may be restored to accrual status when

(1) none of its principal and interest is due and unpaid, and the holding company expects repayment of the remaining contractual principal and interest, or
(2) when it otherwise becomes well secured and in the process of collection.

For purposes of meeting the first test for restoring an asset to accrual status, the holding company must have received repayment of the past due principal and interest unless

(1) the asset has been formally restructured and qualifies for accrual status, as discussed below;
(2) the asset is a purchased credit-impaired loan, pool of loans, or debt security accounted for in accordance with ASC Subtopic 310-30, and it meets the criteria for accrual of income under the interest method specified in that subtopic; or
(3) the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments on a loan that is past due and in nonaccrual status, even though the loan has not been brought fully current, and certain criteria are met.

An important element to return an asset to accrual status is demonstrating that the payment performance by the borrower is sustained for a reasonable time. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

2065.1.6.1 Loan Performance Considerations

A period of sustained performance is very important in determining whether there is reasonable assurance of repayment and performance.

One perspective on loan performance is based upon an assessment as to whether the borrower is contractually current on principal or interest payments. For many loans, the assessment of payment status is sufficient to arrive at a loan's classification. In other cases, being contractually current on payments can be misleading as to the credit risk embedded in the loan. This may occur when the loan's underwriting structure or the liberal use of extensions and renewals masks credit weaknesses and may obscure an assessment of a borrower's ability to meet reasonable repayment terms.

A second perspective for assessing a loan's classification is to consider the borrower's expected performance and ability to meet its obligations in accordance with the modified terms over the remaining life of the loan. Therefore, the loan classification is meant to measure risk over the term of the loan rather than just reflecting the loan's payment history. As a borrower's expected performance is dependent upon future events, examiners' credit analyses should focus on

- the borrower's financial strength as reflected by its historical and projected balance sheet and income statements and
- the prospects for the sale or use of a commercial real estate property considering events and market conditions that reasonably may occur during the term of the loan.

2065.1.7 ACQUISITION OF FINANCIAL ASSETS THAT ARE EXPERIENCING MORE-THAN-INSIGNIFICANT DETERIORATION IN CREDIT QUALITY

For purchase credit deteriorated (PCD) assets that have experienced more-than-insignificant deterioration in credit quality since origination, accounting standards require an entity to record as the amortized cost basis the sum of the purchase price and the entity's estimate of credit losses as of the date of acquisition. The recognition of income on PCD assets is dependent on having a reasonable expectation about the amount expected to be collected over the life of the asset. When an entity can no longer reasonably estimate the amount expected to be collected, it should place the PCD asset on nonaccrual status.

2065.1.8 TREATMENT OF NONACCRUAL LOANS WITH PARTIAL CHARGE-OFFS

Considering all relevant factors, a loan with well-defined weaknesses that jeopardize collection in full of all amounts contractually due may result in a partial charge-off as part of a restructuring. When well-defined weaknesses exist and a partial charge-off has been taken, the remaining recorded balance for the restructured loan generally should be classified no more severely than "substandard." A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined. Such situations may occur when significant remaining risk exposures are identified but are not quantified, such as a borrower's bankruptcy or a loan collateralized by a property with potential environmental concerns.

As a general principle, whether to place an asset in nonaccrual status should be determined by the bank's assessment of the individual asset's collectibility. One loan to a borrower being placed in nonaccrual status does not automatically have to result in all other extensions of credit to that borrower being placed in nonaccrual status. When a single borrower has multiple extensions of credits and one meets the criteria for nonaccrual status, the lender should evaluate the other loans to determine whether one or more of them should also be placed in nonaccrual status.

A restructuring may involve a multiple note structure in which, for example, a loan is restructured into two notes (referred to as Note A and Note B). Lenders may separate a portion of the current outstanding debt into a new, legally enforceable note (Note A) that is reasonably assured of repayment and performance according to prudently modified terms. When restructuring a collateral-dependent loan using a multiple note structure, the amount of Note A should be determined using the fair value of the collateral. This note may be placed back in accrual status in certain situations. In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account. Additionally, a properly structured and performing Note A generally would not be adversely classified by examiners. The portion of the debt that is unlikely to be repaid or collected and therefore is deemed uncollectible (Note B) would be adversely classified "loss" and must be charged off.

In contrast, the loan should remain on, or be placed in, nonaccrual status if the financial institution does not split the loan into separate notes, but internally recognizes a partial charge-off. A partial charge-off would indicate that the financial institution does not expect full repayment of the amounts contractually due. If facts change after the charge-off is taken such that the full amounts contractually due, including the amount charged off, are expected to be collected and the loan has been brought contractually current, the remaining balance of the loan may be returned to accrual status without having to first receive payment of the charged-off amount.[5] In these cases, examiners should assess whether the financial institution has well-documented support for its credit assessment of the borrower's financial condition and the prospects for full repayment.

2065.1.9 IN-SUBSTANCE FORECLOSURES

Loans should be recategorized on the balance sheet as "other real estate owned" (OREO) when a holding company has taken physical possession of the collateral. Physical possession is determined by the type of collateral, as outlined below:

- *real estate loan collateralized by property other than a consumer's residential property*—when a holding company, as creditor, has received physical possession of a borrower's assets, regardless of whether a formal foreclosure proceeding has taken place.
- *residential real estate property collateralizing a consumer mortgage*—when a holding company, as creditor, is considered to have received physical possession of the property upon the occurrence of either of the following:
  - The holding company obtains legal title to the residential real estate property upon completion of a foreclosure even if the borrower has redemption rights, whereby they have a legal right for a period of time after a

5. The charged-off amount should not be reversed or re-booked, under any condition, to increase the recorded investment in the loan or its amortized cost, as applicable, when the loan is returned to accrual status. However, expected recoveries, prior to collection, are a component of management's estimate of the net amount expected to be collected for a loan under ASC Topic 326. Refer to relevant regulatory reporting instructions for supervisory guidance on returning a loan to accrual status.

foreclosure to reclaim the real estate property by paying certain amounts specified by law.
- The borrower conveys all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The deed in lieu of foreclosure or similar legal agreement is completed when agreed-upon terms and conditions have been satisfied by both the borrower and the creditor.

When a holding company receives a long-lived asset, such as real estate, from a borrower in full satisfaction of a loan, the long-lived asset is rebuttably presumed to be held for sale and the holding company shall initially measure this asset at its fair value less cost to sell.[6]

2065.1.10 LIQUIDATION VALUES OF REAL ESTATE LOANS

Examiners should evaluate real estate loans based on the borrower's ability to pay over time, rather than on a presumption of immediate liquidation of the real estate (i.e., a forced sale of the property).[7] Loans may be reported at fair value in certain situations including when firm management has an intent to sell the loans, has elected to account for the loans under the fair value option election, or when repayment is expected to be provided substantially through the operation or sale of the collateral.

2065.1.11 KEY MANAGEMENT RESPONSIBILITIES

Financial institution management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements. Management is also responsible for establishing and maintaining an appropriate governance and internal control structure over the preparation of regulatory reports. An effective governance and control structure commonly includes policies and procedures that provide clear guidance on accounting matters.

Accurate regulatory reports are critical to the transparency of a financial institution's financial position and risk profile and are imperative for effective supervision. Decisions related to loan workout arrangements may affect regulatory reporting, particularly interest accruals and loan loss estimates. Therefore, a firm's loan workout staff have an important role in communicating with the firm's accounting and regulatory reporting staff to ensure that the firm's loan restructurings are presented accurately in regulatory reports.

A firm needs to consider whether a loan that was accruing interest prior to the loan restructuring should be placed in nonaccrual status at the time of modification to ensure that income is not materially overstated. Consistent with regulatory report instructions, a loan that has been restructured so as to be reasonably assured of repayment and performance according to prudent modified terms need not be placed in nonaccrual status. Therefore, for a loan to remain in accrual status, the restructuring and any charge-off taken on the loan must be supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must be placed in nonaccrual status. While an appropriately designed restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule, it does not relieve the financial institution from the responsibility to promptly charge off all identified losses.

2065.1.12 SUPERVISORY CONSIDERATIONS

In evaluating credit risk-management processes and validating the accuracy of internal loan grades, examiners are responsible for reviewing management's processes related to accounting and regulatory reporting. While similar data are used for loan risk monitoring, accounting, and reporting systems, this information does not necessarily produce identical outcomes. For example, loss classifications may not be equivalent to the associated allowance measurements.

Examiners need to have a clear understanding of the differences between credit risk management and accounting and regulatory reporting concepts (such as accrual status and the allowance) when assessing the adequacy of the financial institution's reporting practices for on- and off-balance sheet credit exposures. Examiners should also refer to appropriate regulatory reporting instructions as well as applicable accounting standards for further information.

6. Long-lived assets are described in greater detail in ASC Topic 360, Property, Plant, and Equipment.

7. See the *Bank Holding Company Supervision Manual*, section 2231.0, "Real Estate Appraisals and Evaluations," for more information on liquidation value.

2065.2.1 PURPOSE OF THE ALLOWANCE FOR LOAN LEASE LOSSES

The allowance for loan and lease losses (ALLL) reflects estimated credit losses within a holding company's portfolio of loans and leases. Estimated credit losses are estimates of the current amount of loans that are probable that the holding company will be unable to collect given the facts and circumstances since the evaluation date (generally the date of the holding company's balance sheet). That is, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans as of the evaluation date.

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), a holding company maintains an ALLL at a level that is appropriate to cover estimated credit losses associated with its loan and lease portfolio, that is, loans and leases that the holding company has intent and ability to hold for the foreseeable future or until maturity or payoff. The ALLL is presented on an institution's balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet. Each holding company should also maintain, as a separate liability account, an ALLL at a level that is appropriate to cover estimated credit losses associated with off-balance sheet credit instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees. The FR-Y9C report instructions provide more ALLL reporting information for holding companies.

The ALLL also is a component for calculating tier 2 capital, as set forth in Regulation Q (12 CFR 217.20(d)). Tier 2 capital includes surplus related to the issuance of tier 2 capital instruments; limited amounts of total capital minority interest not included in an institution's tier 1 capital; and limited amounts of the ALLL, or adjusted allowances for credit losses (AACL), as applicable, less applicable regulatory adjustments and deductions.[1] An institution calculating its total capital ratio using the standardized approach may include in tier 2 capital the amount of ALLL or AACL that does not exceed 1.25 percent of its standardized total risk-weighted assets.

2065.2.2 DETERMINING AN ADEQUATE LEVEL FOR THE ALLL

In determining the adequacy of an institution's ALLL (including amounts based on an analysis of the commercial real estate portfolio), examiners will consider an institution's process for conducting the analysis and whether management consistently applies this process to the loan and lease portfolio.[2] The determination of the adequacy of the ALLL should be based on management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient, without further analysis, to produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should consider factors such as

- changes in the nature and volume of the portfolio;
- the experience, ability, and depth of relevant staff;
- changes in credit standards;
- collection policies and historical collection experience;
- concentrations of credit risk;
- trends in the volume and severity of past-due and classified loans; and
- trends in the volume of nonaccrual loans, specific problem loans, and commitments.

1. ALLL means valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables, or other extensions of credit as determined in accordance with GAAP. ALLL excludes "allocated transfer risk reserves." For purposes of Regulation Q, ALLL includes allowances that have been established through a charge against earnings to cover estimated credit losses associated with off-balance-sheet credit exposures as determined in accordance with GAAP.

2. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb overall credit losses originating from the loan and lease portfolio. The balance of the ALLL is management's estimation of potential credit losses, synonymous with its determination as to the adequacy of the overall ALLL.

In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset-quality problems. Further, management should consider external factors such as local and national economic conditions and developments, competition, and legal and regulatory requirements, as well as reasonably foreseeable events that are likely to affect the performance of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Management should maintain reasonable records to support evaluating the adequacy the ALLL. Further, each institution is responsible for ensuring that controls are in place to consistently determine the allowance for loan and lease losses in accordance with GAAP (including ASC Subtopic 450-20, Contingencies – Loss Contingencies, and ASC Topic 310, Receivables), the institution's policies and procedures, management's best judgment, and relevant supervisory guidance.

2065.2.3 OVERVIEW OF THE 2006 ALLL POLICY STATEMENT

In 2006, the Federal Reserve and the other banking agencies issued a policy statement (2006 policy statement) regarding the ALLL that discusses

- its nature and purpose;
- the responsibilities of boards of directors, the institution's management, and the examiners of institutions; and
- factors to be considered in the estimation of the ALLL.[3]

The 2006 policy statement applies to all depository institutions supervised by the banking agencies, except for U.S. branches and agencies of foreign banks.[4] In addition, the Federal Reserve believes the guidance is broadly applicable to bank holding companies as well as savings and loan holding companies.[5] Accordingly, examiners should apply the policy, as appropriate, during inspections of holding companies and their nonbank subsidiaries, in addition to the examination of state member banks.

The 2006 policy statement indicates that it is the responsibility of an institution's board of directors and management to maintain the ALLL at an appropriate level. Each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. To fulfill this responsibility, an institution should have controls to consistently determine the ALLL in accordance with GAAP, the institution's policies and procedures, management's best judgment, and relevant supervisory guidance. The 2006 policy statement also discusses the analysis of the loan and lease portfolio, factors to consider in estimating credit losses, and the characteristics of an effective loan-review system.[6]

The 2006 policy statement reiterates the policy that Federal Reserve examiners will generally accept management's estimates in their assessment of the appropriateness of the ALLL when management has (1) maintained effective loan review systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner; (3) established an acceptable ALLL-evaluation process for both individual loans and groups of loans that meets the objectives for an appropriate ALLL; and (4) incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

The 2006 policy statement emphasizes that an institution should provide reasonable support

3. For the entire text of the 2006 policy statement, see SR-06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses."

4. See SR-95-42, "Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations," and SR-95-4, "Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations."

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

6. Attachment 1, "Loan Review Systems," of the 2006 policy statement has been superseded. For more guidance on effective credit risk review systems. See 85 Fed. Reg. 33,278 (June 1, 2020); SR-20-13, "Interagency Guidance on Credit Risk Review Systems;" and the *Commercial Bank Examination Manual*'s section entitled, "Credit Risk Review Systems."

and documentation of its ALLL estimates, including adjustments to the allowance for qualitative or environmental factors and unallocated portions of the allowance. This emphasis on support and documentation supplements, but does not replace, the guidance in the 2001 Interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (see SR-01-17).

Additionally, an institution-specific loss estimate generally should not be based solely on a "standard percentage" of loans. While peer group or other benchmark averages are an appropriate tool to evaluate the reasonableness of the allowance, an institution should analyze the collectibility of the loan portfolio to estimate the allowance and not assume a set percentage for loss estimates (that is, 15 percent for loans classified as substandard and 50 percent for loans classified as doubtful).

The 2006 policy statement also includes accounting guidance covering the acceptable methods to measure impairment. Lastly, the 2006 policy statement reminds institutions that allowances related to off-balance-sheet financial instruments such as loan commitments or letters of credit should not be reported as part of the ALLL. Any allowance for these types of instruments is recorded as an "other liability."

2065.2.4 ALLL METHODOLOGIES AND DOCUMENTATION

In 2001, the Federal Financial Institutions Examination Council issued the "Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions" (2001 policy statement).[7] The 2001 policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, this statement emphasizes the need for an institution to have appropriate ALLL policies and procedures, including an effective loan-review system. The guidance also provides examples of appropriate supporting documentation. While the 2001 policy statement was intended for insured depository institutions, the Federal Reserve believes this guidance is broadly applicable to bank holding companies and to savings and loan holding companies.[8] Accordingly, examiners should consider this policy statement in their inspection of holding companies and their nonbank subsidiaries.

As discussed in the 2001 policy statement, an institution needs to establish its ALLL methodology in accordance with GAAP. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated periodically and modified to incorporate new events or findings, as needed. Under the direction of the board of directors, an institution's management should implement appropriate procedures and controls to promote compliance with the institution's ALLL policies and procedures. Institution management should (1) segment the portfolio to evaluate credit risks; (2) select loss rates that best reflect the probable loss; and (3) be responsive to changes in the institution, the economy, or the lending environment by changing the methodology, when appropriate.

An institution's determination of an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses.

2065.2.5 ALLL ESTIMATION PRACTICES FOR LOANS SECURED BY JUNIOR LIENS

In January 2012, the Federal Reserve and the other federal banking agencies issued, "Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1–4 Family Residential Properties." (See SR-12-3.)

An institution should consider all credit quality indicators relevant to their junior liens. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien has been modified. Further, institutions should ensure that during the ALLL estimation process, sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios. As discussed in the

7. For the entire text of the 2001 policy statement, see SR-01-17, "Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions." See also 66 Fed. Reg. 35,629 (July 6, 2001).

8. See SR-14-9.

guidance, an institution should refer to GAAP for recognizing ALLL.

The guidance states that an institution should use reasonably available tools to determine the payment status of senior liens associated with its junior liens, such as credit reports, third-party services, or, in certain cases, a proxy. Typically, large, complex institutions with significant home equity lending activity would find most tools reasonably available and would use proxies in limited circumstances.

More information on risk-management principles for junior-lien loans and home equity lines of credit is available in the May 2005 "Interagency Credit Risk Management Guidance for Home Equity Lending." (See SR-05-11 and section 2010.2.4 of this manual.)

2065.2.6 SUPERVISORY CONSIDERATIONS FOR ASSESSING ALLL

Examiners should assess the credit quality of an institution's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of its ALLL. The Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency issued interagency guidance on credit risk review systems for supervised institutions in 2020.[9] The credit risk review guidance discusses sound management of an institution's credit risk; a system of independent, ongoing credit review; and appropriate communication regarding the performance of the institution's loan portfolio to its management and board of directors. In addition, the *Commercial Bank Examination Manual* provides specific examination objectives and procedures to assist examiners in reviewing the appropriateness of an institution's ALLL.

In their review and classification or grading of the loan portfolio, examiners consider significant factors that affect the collectibility of the loan portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should:

- Consider the effectiveness of board oversight as well as the quality of the institution's loan review system and its management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's loan review function and credit grading system. Typically, examiners will test a sample of the institution's loans.[10]
- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. In making these evaluations, examiners should ensure that the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and the other factors previously discussed) have been appropriately considered and that management has appropriately applied GAAP.
- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances, this may include a quantitative analysis (for example, using the types of ratio analysis previously discussed) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.
- Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance

9. See SR-20-13.

10. An institution may have a credit risk rating framework that differs from the framework for loan classifications used by the federal banking agencies. Such institutions should maintain documentation that translates their risk ratings into the regulatory classification framework used by the federal banking agencies. This documentation will enable examiners to reconcile the totals for the various loan classifications or risk ratings under the institution's system to the federal banking agencies' categories contained in the Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions Attachment 1 — Classification Definitions (SR-13-18). See also SR-20-13 for more information.

reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.
- Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
- Review the interest and fee income accounts associated with the lending process to ensure that the institution's net income is not materially misstated.

When assessing the appropriateness of the ALLL, examiners should evaluate an institution's related process, methodology, and underlying assumptions that require a substantial degree of management judgment. Even when an institution maintains sound loan administration and collection procedures and an effective loan review system and controls, examiners should not use an institution's estimate of credit losses as a single precise amount due to the wide range of qualitative or environmental factors that should be considered.

An institution's ability to estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners should generally accept management's estimates when they assess the appropriateness of the institution's ALLL, and not seek adjustments to the ALLL, when management has

- maintained effective loan review systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner.
- analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner.
- established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL.
- incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

If the examiner concludes that the level of ALLL is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, the examiner should include recommendations for correcting these deficiencies in their communications to the institution and its board of directors. Additional supervisory action may be necessary to address the weaknesses in the ALLL process, including the materiality of errors in the institution's reported ALLL.

2065.2.6.1 ALLL Level Reflected in Regulatory Reports

When the reported amount of an institution's ALLL is not appropriate, examiners will require an institution to adjust its ALLL by an amount sufficient to bring the ALLL reported on its regulatory reports to an appropriate level as of the balance sheet's evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

2065.3.1 BACKGROUND ON CURRENT EXPECTED CREDIT LOSSES METHODOLOGY

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016–13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, as well as amendments since June 2016. These updates are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments—Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 introduces the current expected credit losses methodology (CECL), which replaces the incurred loss methodology for financial assets measured at amortized cost; introduces the term "purchased credit-deteriorated (PCD) assets," which replaces the term "purchased credit-impaired (PCI) assets"; and modifies the treatment of credit losses on available-for-sale (AFS) debt securities.

The allowance for credit losses or ACL is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term of the assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL, unless there is a reasonable expectation of executing a troubled debt restructuring or the renewal and extension options are part of the original or modified contract and are cancellable by the institution based on the contractual terms in the loan agreement.

In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets. FASB ASC Topic 326 requires management to use relevant forward-looking information and expectations drawn from reasonable and supportable forecasts when estimating expected credit losses.

As of the end of each quarter, or more frequently if warranted, each holding company should evaluate the collectibility of its financial assets measured at amortized cost, including, if applicable, any recorded accrued interest receivable (that is, not already reversed or charged off, as applicable), and make adjusting entries to maintain the appropriate balance of each of the separate ACLs reported on the balance sheet. A holding company should measure expected credit losses on a collective or pool basis when financial assets share similar risk characteristics. If a financial asset does not share similar risk characteristics with other assets, expected credit losses for that asset should be evaluated individually. Individually evaluated assets should not be included in a collective assessment of expected credit losses. If a financial asset ceases to share similar risk characteristics with other assets in its pool, the asset should be moved to a different pool with assets sharing similar risk characteristics, if such a pool exists. For more information on ACLs, see the glossary to the Consolidated Financial Statements for Holding Companies (FR Y-9C).

The ACL also is a component for calculating tier 2 capital, as set forth in Regulation Q (12 CFR 217.20(d)). Tier 2 capital includes surplus related to the issuance of tier 2 capital instruments; limited amounts of total capital minority interest not included in a banking organization's tier 1 capital; and limited amounts of the allowance for loan and lease losses (ALLL), or adjusted allowances for credit losses (AACL), as applicable, less applicable regulatory adjustments and deductions. A banking organization calculating its total capital ratio using the standardized approach may include in tier 2 capital the amount of ALLL or AACL that does not exceed 1.25 percent of its standardized total risk-weighted assets.

2065.3.2 APPLICABILITY

FASB ASC Topic 326 applies to all banks, savings associations, credit unions, and financial institution holding companies, regardless of size, that file regulatory reports for which the reporting requirements conform to U.S. generally accepted accounting principles (GAAP).[1]

Further, FASB ASC Topic 326 applies to all financial assets carried at amortized cost (including loans held for investment (HFI) and held-to-maturity (HTM) debt securities, as well as trade

1. See section 37(a) of the Federal Deposit Insurance Act. Under these statutory provisions, the accounting principles are applicable to reports or statements required to be filed by all insured depository institutions with the federal banking agencies (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation).

Table 1. Summary Scope of CECL

Financial assets within the scope of CECL	The CECL methodology does *not* apply to the following financial assets
• Financing receivables such as loans held-for-investment • Overdrawn deposit accounts (i.e., overdrafts) that are reclassified as held-for-investment loans • Held-to-maturity debt securities • Receivables that result from revenue transactions within the scope of Topic 606 on revenue from contracts with customers and Topic 610 on other income, which applies, for example, to the sale of foreclosed real estate • Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance • Receivables related to repurchase agreements and securities lending agreements within the scope of Topic 860 on transfers and servicing • Net investments in leases recognized by a lessor in accordance with Topic 842 on leases • Off-balance-sheet credit exposures including off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments except for those within the scope of Topic 815 on derivatives and hedging	• Financial assets measured at fair value through net income, including those assets for which the fair value option has been elected • Available-for-sale debt securities • Loans held-for-sale • Policy loan receivables of an insurance entity • Loans and receivables between entities under common control • Receivables arising from operating leases.

receivables, reinsurance recoverables, and receivables that relate to repurchase agreements and securities lending agreements), a lessor's net investments in leases, and off-balance-sheet credit exposures not accounted for as insurance or as derivatives, including loan commitments, standby letters of credit, and financial guarantees.

FASB ASC Topic 326 does not apply to trading assets, loans held for sale, financial assets for which the fair value option has been elected, or loans and receivables between entities under common control. Table 1 provides a high-level overview of the scope of key financial assets covered and excluded from CECL.

2065.3.3 KEY ELEMENTS OF THE ACCOUNTING STANDARD

ASU 2016–13 and subsequent amendments revise U.S. GAAP and, consequently, affect regulatory reports based on U.S. GAAP. CECL differs from the incurred loss methodology in several key respects. First, for financial assets measured at amortized cost, CECL requires institutions to recognize lifetime expected credit losses, not just credit losses incurred as of the reporting date. CECL requires the incorporation of reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses, while also maintaining the current requirement that institutions consider past events and current conditions. Furthermore, the probable threshold for recognition of allowances in accordance with the incurred loss methodology is removed under CECL. Taken together, estimating expected credit losses over the life of an asset under CECL, including consideration of reasonable and supportable forecasts but without applying the probable threshold that exists under the incurred loss methodology, results in earlier recognition of credit losses.

CECL replaces multiple impairment approaches in existing U.S. GAAP. CECL allowances generally cover a broader range of financial assets than the ALLL under the incurred loss methodology. Under the incurred loss methodology, ALLL generally covers credit losses on loans held for investment and lease financing receivables, with additional allowances for certain other extensions of credit and allowances for credit losses on certain off-balance-sheet credit exposures (with the latter allowances presented as liabilities).[2] These exposures will be within the scope of CECL.

As previously mentioned, FASB ASC Topic 326 introduces the term PCD assets, which replaces the term PCI assets. The PCD asset definition covers a broader range of assets than the PCI asset definition. CECL requires institutions to estimate and record a credit loss allowance for a PCD asset at the time of purchase. This credit loss allowance is then added to the purchase price to determine the purchase date amortized cost basis of the asset for financial reporting purposes. Post-acquisition changes in credit loss allowances on PCD assets will be established through earnings. This is different from the treatment of PCI assets, for which institutions are not permitted to estimate and recognize credit loss allowances at the time of purchase. Rather, institutions generally estimate credit loss allowances for PCI assets subsequent to the purchase only if there is deterioration in the expected cash flows from such assets.

FASB ASC Topic 326 also introduces new requirements for AFS debt securities. The accounting standard requires that an institution recognize credit losses on individual AFS debt securities through credit loss allowances, rather than through direct write-downs, as was required under U.S. GAAP prior to the adoption of FASB ASC Topic 326. AFS debt securities continue to be measured at fair value, with changes in fair value not related to credit losses recognized in other comprehensive income. Credit loss allowances on an AFS debt security are limited to the amount by which the security's fair value is less than its amortized cost.

2065.3.4 INTERAGENCY POLICY STATEMENT ON ALLOWANCES FOR CREDIT LOSSES

In June 2020, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the agencies) issued an interagency policy statement on allowances for credit losses (ACLs).[3] The agencies issued the policy statement in response to changes to U.S. GAAP as promulgated by the FASB in FASB ASC Topic 326.

The interagency policy statement on ACLs describes

- the measurement of expected credit losses under the CECL methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326;
- the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes;
- the maintenance of appropriate ACLs;
- the responsibilities of boards of directors and management; and
- examiner reviews of ACLs.

The interagency policy statement becomes applicable to an institution upon that institution's adoption of FASB ASC Topic 326. The following policy statements are no longer effective for an institution upon its adoption of FASB ASC Topic 326: the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses;[4] and the July 2001 Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.[5] The agencies will rescind the ALLL Policy Statements once FASB ASC Topic 326 is effective for all institutions.

2065.3.5 TRANSITION FROM ALLOWANCE FOR LOAN LEASE LOSSES

For all holding companies, early application of the credit losses standard is permitted for fiscal years beginning after December 15, 2018,

2. "Other extensions of credit" includes trade and reinsurance receivables, and receivables that relate to repurchase agreements and securities lending agreements. "Off-balance-sheet credit exposures" includes off-balance-sheet credit exposures not accounted for as insurance, such as loan commitments, standby letters of credit, and financial guarantees. Credit losses for off-balance-sheet credit exposures that are unconditionally cancellable by the issuer are not recognized under CECL.

3. The policy statement in its entirety is available at 85 Fed. Reg. 32,991 (June 1, 2020) and SR-20-12, "Interagency Policy Statement on Allowances for Credit Losses."

4. See SR-06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)." The final policy statement attached to SR-20-12 does not affect Attachment 1 to SR-06-17. Attachment 1 has been revised through a separate interagency notice published at 85 Fed. Reg. 33,278 (June 1, 2020). See also SR-20-13, "Interagency Guidance on Credit Risk Review Systems."

5. See SR-01-17, "Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions."

including interim financial reporting periods within that fiscal year. On November 15, 2019, the FASB issued ASU No. 2019-10 to defer the effective dates of ASU 2016-13 for certain holding companies. Under this ASU, for holding companies that are Securities and Exchange Commission (SEC) filers, excluding those that are eligible to be "smaller reporting companies" as defined in the SEC's rules, FASB ASC Topic 326 continues to be effective for fiscal years beginning after December 15, 2019, including interim financial reporting periods within those fiscal years (that is, January 1, 2020, for such entities with calendar year fiscal years). For all other holding companies, including those SEC filers that are eligible to be smaller reporting holding companies, FASB Topic 326 will take effect for fiscal years beginning after December 15, 2022, including interim financial reporting periods within those fiscal years (that is, January 1, 2023, for such entities with calendar year fiscal years).

Holding companies must apply FASB ASC Topic 326 for completing the FR Y-9C in accordance with the U.S. GAAP effective dates. A holding company that early adopts FASB ASC Topic 326 for U.S. GAAP financial reporting purposes should also early adopt the standard in the same period for FR Y-9 purposes. Section 4014 of the CARES Act, as amended by section 540 of the Consolidated Appropriations Act, 2021, allows a holding company to delay the adoption of ASC Topic 326 until the earlier of (1) January 1, 2022, or (2) the first day of the institution's fiscal year that begins after the date of the termination of the national emergency concerning the coronavirus outbreak declared by the President on March 13, 2020, under the National Emergencies Act.

The agencies have adopted rules providing institutions the option to phase in the day-one adverse effects on regulatory capital that may result from the adoption of the CECL accounting standard.[6] For institutions that are phasing in the capital impact of implementing the CECL accounting standard, the denominator for concentration calculations is tier 1 capital plus allowance for loan and lease losses or allowance for credit losses adjusted for the amount of CECL phase-in capital included in both allowance and tier 1 capital.[7]

For purposes of determining whether an institution phasing in the capital impact of implementing the CECL methodology is in compliance with its regulatory capital requirements (including capital buffer and prompt corrective action requirements, which apply to state member banks), the agencies will use the institution's regulatory capital ratios as adjusted by the CECL transition provision.[8] Through the supervisory process, the agencies will continue to examine institutions' credit loss estimates and allowance balances regardless of whether the institution has elected to use the CECL transition provision. In addition, the agencies may examine whether the electing institution will have adequate amounts of capital at the expiration of their CECL transition provision period. After all institutions have adopted the CECL methodology and have exited their CECL transition provision periods, it will no longer be necessary to adjust for the amount of CECL phase-in capital included in both the allowance and tier 1 capital.

For the purposes of measuring concentrations at institutions that are phasing in the adoption of the CECL accounting standard, examiners should evaluate the appropriateness of the amounts included in the denominator for the tier 1 capital calculation and confirm that the CECL transitioned amounts, if elected, plus the allowance for credit losses related to loans and leases have been excluded. To calculate the amount to be excluded from tier 1 capital, examiners should use the difference between "retained earnings" as reported on item 26.a of Schedule HC to the Y-9C Report and "retained earnings" as reported on item 2 Schedule HC-R, Part I, to the Y-9C. This resulting difference is the amount of retained earnings that should have been used to calculate tier 1 capital for purposes of measuring concentrations and should equal the retained earnings on the institution's balance sheet.

2065.3.6 SUPERVISORY CONSIDERATIONS FOR ASSESSING ACL

Examiners are expected to assess the appropriateness of management's loss estimation pro-

6. See 84 Fed. Reg. 4222 (February 14, 2019); 85 Fed. Reg. 17,723 (March 31, 2020); and 85 Fed. Reg. 61,577 (September 30, 2020).

7. For more information, see SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach."

8. See 84 Fed. Reg. 4222 (February 14, 2019).

cesses and the appropriateness of the institution's ACL balances as part of their supervisory activities. The review of ACLs, including the depth of the examiner's assessment, should be commensurate with the institution's size, complexity, and risk profile. As part of their supervisory activities, examiners generally assess the credit quality and credit risk of an institution's financial asset portfolios, the adequacy of the institution's credit loss estimation processes, the adequacy of supporting documentation, and the appropriateness of the reported ACLs and provisions for credit losses in the institution's regulatory reports and financial statements, if applicable. Examiners may consider the significant factors that affect collectibility, including the value of collateral securing financial assets and any other repayment sources. Supervisory activities may include evaluating management's effectiveness in assessing credit risk for debt securities (both prior to purchase and on an on-going basis). The *Commercial Bank Examination Manual* provides specific examination objectives and procedures to assist examiners in reviewing the appropriateness of an institution's ACL.

Incentive compensation practices in the financial industry were one of many factors that contributed to the financial crisis that began in mid-2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.[1] These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well-being and safety and soundness of their organizations. This section provides guidance on sound incentive compensation practices to banking organizations supervised by the Federal Reserve (also the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies")).[2] This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes.[3]

Alignment of incentives provided to employees with the interests of shareholders of the organization often also benefits safety and soundness. However, aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness concerns. Because of the presence of the federal safety net, (including the ability of insured depository institutions to raise insured deposits and access the discount window and payment services of the Federal Reserve), shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Accordingly, the Federal Reserve expects banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

To be consistent with safety and soundness, incentive compensation arrangements[4] at a banking organization should:

1. Provide employees incentives that appropriately balance risk and reward;
2. Be compatible with effective controls and risk-management; and
3. Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with them, are discussed later in this guidance.

The Federal Reserve expects banking organizations to regularly review their incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk-management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in this guidance and that they do not encourage employees to expose the organization to imprudent risks that may pose a threat to the safety and soundness of the organization.

1. Examples of risks that may present a threat to the organization's safety and soundness include credit, market, liquidity, operational, legal, compliance, and reputational risks.

2. As used in this guidance, the term "banking organization" includes national banks, state member banks, state nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs) with a branch, agency, or commercial lending company in the United States. If the Federal Reserve is referenced, the reference is intended to also include the other supervisory Agencies.

3. This guidance (see 75 *Fed. Reg.* 36395, June 25, 2010, for the entire text) and the principles reflected herein are consistent with the *Principles for Sound Compensation Practices* issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's *Implementation Standards* for those principles, issued in September 2009.

4. In this guidance, the term "incentive compensation" refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary). In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

The Federal Reserve recognizes that incentive compensation arrangements often seek to serve several important and worthy objectives. For example, incentive compensation arrangements may be used to help attract skilled staff, induce better organization-wide and employee performance, promote employee retention, provide retirement security to employees, or allow compensation expenses to vary with revenue on an organization-wide basis. Moreover, the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization. The resources required will depend upon the complexity of the firm and its use of incentive compensation arrangements. For some, the task of designing and implementing compensation arrangements that properly offer incentives for executive and non-executive employees to pursue the organization's long-term well-being and that do not encourage imprudent risk-taking is a complex task that will require the commitment of adequate resources.

While issues related to designing and implementing incentive compensation arrangements are complex, the Federal Reserve is committed to ensuring that banking organizations move forward in incorporating the principles described in this guidance into their incentive compensation practices.[5]

As discussed further below, because of the size and complexity of their operations, Large complex banking organizations (LCBOs)[6] should have and adhere to systematic and formalized policies, procedures, and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards. In several places, this guidance specifically highlights the types of policies, procedures, and systems that LCBOs should have and maintain, but that generally are not expected of smaller, less complex organizations. LCBOs warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system. The Federal Reserve will work with LCBOs as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization.

The policies, procedures, and systems of smaller banking organizations that use incentive compensation arrangements[7] are expected to be less extensive, formalized, and detailed than those of LCBOs. Supervisory reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted by the Federal Reserve as part of the evaluation of those organizations' risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. These reviews will be tailored to reflect the scope and complexity of an organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for smaller banking organizations that do not use, to a significant extent, incentive compensation arrangements.[8]

For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organiza-

5. In December 2009 the Federal Reserve, working with the other Agencies, initiated a special horizontal review of incentive compensation arrangements and related risk-management, control, and corporate governance practices of large banking organizations (LBOs). This initiative was designed to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.

6. For supervisory purposes, the Federal Reserve (as well as the other federal bank regulatory agencies) segments the organizations it supervises into different supervisory portfolios based on, among other things, size, complexity, and risk profile. For purposes of this guidance, the LBOs referred to in the guidance are identified in this section as large complex banking organizations to be consistent with the Federal Reserve's other supervisory policies. LBOs are designated by (1) the OCC as the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (2) the FDIC, large, complex insured depository institutions (IDIs); and (3) the OTS, the largest and most complex savings associations and savings and loan holding companies.

7. This guidance does not apply to banking organizations that do not use incentive compensation.

8. To facilitate these reviews, where appropriate, a smaller banking organization should review its compensation arrangements to determine whether it uses incentive compensation arrangements to a significant extent in its business operations. A smaller banking organization will not be considered a significant user of incentive compensation arrangements simply because the organization has a firm-wide profit-sharing or bonus plan that is based on the bank's profitability, even if the plan covers all or most of the organization's employees.

tion's rating component(s) and subcomponent(s) relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

The Federal Reserve (or the organization's appropriate federal supervisor) may take enforcement action against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization, particularly when the organization is not taking prompt and effective measures to correct the deficiencies. For example, the appropriate federal supervisor may take an enforcement action if material deficiencies are found to exist in the organization's incentive compensation arrangements or related risk-management, control, or governance processes, or the organization fails to promptly develop, submit, or adhere to an effective plan designed to ensure that its incentive compensation arrangements do not encourage imprudent risk-taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to take affirmative action, such as developing a corrective action plan that is acceptable to the appropriate federal supervisor to rectify safety-and-soundness deficiencies in its incentive compensation arrangements or related processes. Where warranted, the appropriate federal supervisor may require the organization to take additional affirmative action to correct or remedy deficiencies related to the organization's incentive compensation practices.

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Federal Reserve will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

2068.0.1 SCOPE OF APPLICATION

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.[9] Incentive compensation arrangements for executive officers as well as for non-executive personnel who have the ability to expose a banking organization to material amounts of risk may, if not properly structured, pose a threat to the organization's safety and soundness. Accordingly, this guidance applies to incentive compensation arrangements for:

1. Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;[10]
2. Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization's overall risk tolerance); and
3. Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

For ease of reference, these executive and non-executive employees are collectively referred to hereafter as "covered employees" or "employees." Depending on the facts and circumstances of the individual organization, the types of employees or categories of employees that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks would likely include, for example, tellers, bookkeepers, couriers, or data processing personnel.

In determining whether an employee, or group of employees, may expose a banking organization to material risk, the organization

9. In the case of the U.S. operations of FBOs, the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls. In addition, the policies for the U.S. operations of FBOs should be consistent with this guidance.

10. Senior executives include, at a minimum, "executive officers" within the meaning of the Federal Reserve's Regulation O (see 12 CFR 215.2(e)(1)) and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (see 17 CFR 229.402(a)(3)). Savings associations should also refer to OTS's rule on loans by saving associations to their executive officers, directors, and principal shareholders. (12 CFR 563.43).

should consider the full range of inherent risks arising from, or generated by, the employee's activities, even if the organization uses risk-management processes or controls to limit the risks such activities ultimately may pose to the organization. Moreover, risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization.[11]

For purposes of illustration, assume that a banking organization has a structured-finance unit that is material to the organization. A group of employees within that unit who originate structured-finance transactions that may expose the unit to material risks should be considered "covered employees" for purposes of this guidance even if those transactions must be approved by an independent risk function prior to consummation, or the organization uses other processes or methods to limit the risk that such transactions may present to the organization.

Strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations. However, irrespective of the quality of these functions, poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk-management and internal control functions of even well-managed organizations.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken or circumvent the organization's risk-management or internal control functions, such as by providing inaccurate or incomplete information to these functions, to boost the employee's personal compensation. Accordingly, sound compensation practices are an integral part of strong risk-management and internal control functions. A key goal of this guidance is to encourage banking organizations to incorporate the risks related to incentive compensation into their broader risk-management framework. Risk-management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

11. Thus, risks may be material to an organization even if they are not large enough themselves to threaten the solvency of the organization.

2068.0.2 PRINCIPLES OF A SOUND INCENTIVE COMPENSATION SYSTEM

2068.0.2.1 Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the organization. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the organization to more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage imprudent risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the business generated, the potential for the arrangement to encourage imprudent risk-taking may be quite strong. Similarly, traders who work with positions that close at year-end could have an incentive to take large risks toward the end of a year if there is no mechanism for factoring how such positions perform over a longer period of time. The same result could ensue if the performance measures themselves lack integrity or can be manipulated inappropriately by the employees receiving incentive compensation.

On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (e.g., for most employees, organization-wide profit), the potential for the arrangement to encourage the employee to take imprudent risks on behalf of the organization may be weak. For this reason, plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid activities with substantial risk.

- *Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.*

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance risk associated with subprime loans versus prime loans).[12] In addition, some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of covered employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes ("quantitative measures"), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.

Large complex banking organizations. In designing and modifying incentive compensation arrangements, LCBOs should assess in advance of implementation whether such

12. Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.

arrangements are likely to provide balanced risk-taking incentives. Simulation analysis of incentive compensation arrangements is one way of doing so. Such analysis uses forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This type of analysis, or other analysis that results in assessments of likely effectiveness, can help an LCBO assess whether incentive compensation awards and payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

- *An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.*

If an incentive compensation arrangement may encourage employees to expose their banking organization to imprudent risks, the organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four methods are often used to make compensation more sensitive to risk. These methods are:

1. *Risk Adjustment of Awards:* The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.
2. *Deferral of Payment:* The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.[13] Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, subject to appropriate oversight. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.
3. *Longer Performance Periods:* The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.
4. *Reduced Sensitivity to Short-Term Performance:* The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives. This method also can include improving the quality and reliability of performance measures in taking into account both short-term and long-term risks, for example improving the reliability and accuracy of estimates of revenues and long-term profits upon which performance measures depend.[14]

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for imprudent risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become more evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities

13. The deferral-of-payment method is sometimes referred to in the industry as a "clawback." The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement.

14. Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take imprudent risk in order to reach performance targets that are aggressive, but potentially achievable.

or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced.

The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance. Thus, for example, risk adjustments used to counteract a materially unbalanced compensation arrangement should have a similarly material impact on the incentive compensation paid under the arrangement. Further, improvements in the quality and reliability of performance measures themselves, for example improving the reliability and accuracy of estimates of revenues and profits upon which performance measures depend, can significantly improve the degree of balance in risk-taking incentives.

Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking. For example, if a banking organization relies to a significant degree on the judgment of one or more managers to ensure that the incentive compensation awards to employees are appropriately risk-adjusted, the organization should have policies and procedures that describe how managers are expected to exercise that judgment to achieve balance and that provide for the manager(s) to receive appropriate available information about the employee's risk-taking activities to make informed judgments.

Large complex banking organizations. Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. LCBOs should actively monitor developments in the field and should incorporate into their incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well-being and safety and soundness.

- *The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.*

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, activities, risks, and incentive compensation practices may differ materially among banking organizations based on, among other things, the scope or complexity of activities conducted and the business strategies pursued by the organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in imprudent risk-taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

Moreover, the risks associated with the activities of one group of non-executive employees (e.g., loan originators) within a banking organization may differ significantly from those of another group of non-executive employees (e.g., spot foreign exchange traders) within the organization. In addition, reliable quantitative measures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large, complex organization. This factor can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on an organization-wide basis solely through use of the risk-adjustment-of-award method.

Furthermore, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level covered employees (particularly at large organizations) to take risks because such employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.[15]

Large complex banking organizations. Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LCBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period.

The portion of the incentive compensation of other covered employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the organization and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

- *Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.*

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes can provide the employee significant incentives to expose the organization to undue risk. For example, an arrangement that provides an employee with a guaranteed payout upon departure from an organization, regardless of performance, may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.

Banking organizations should carefully review any such existing or proposed arrangements (sometimes called "golden parachutes") and the potential impact of such arrangements on the organization's safety and soundness. In appropriate circumstances an organization should consider including balancing features—such as risk adjustment or deferral requirements that extend past the employee's departure—in the arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking. In all cases, a banking organization should ensure that the structure and terms of any golden parachute arrangement entered into by the organization do not encourage imprudent risk-taking in light of the other features of the employee's incentive compensation arrangements.

Large complex banking organizations. Provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of the deferral arrangement if the departing employee is able to negotiate a "golden handshake" arrangement with the new employer.[16] This weakening effect can be particularly significant for senior executives or other skilled employees at LCBOs whose services are in high demand within the market.

Golden handshake arrangements present special issues for LCBOs and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure

15. For example, spreading payouts of incentive compensation awards over a standard three-year period may not appropriately reflect the differences in the type and time horizon of risk associated with the activities of different groups of employees, and may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.

16. Golden handshakes are arrangements that compensate an employee for some or all of the estimated, non-adjusted value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment.

(subject to any clawback or malus[17]), these changes could reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and create conflicts of interest. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. LCBOs should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Federal Reserve will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

- *Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.*

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees need to understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

17. A malus arrangement permits the employer to prevent vesting of all or part of the amount of a deferred remuneration award. Malus provisions are invoked when risk outcomes are worse than expected or when the information upon which the award was based turns out to have been incorrect. Loss of unvested compensation due to the employee voluntarily leaving the firm is not an example of malus as the term is used in this guidance.

2068.0.2.2 Principle 2: Compatibility with Effective Controls and Risk-Management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation arrangement may seek to influence, in ways designed to increase the employee's pay, the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk.

Such actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting imprudent risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk-management, internal control, or financial purposes. In such cases, the employee's actions may weaken not only the balance of the organization's incentive compensation arrangements, but also the risk-management, internal controls, and other functions that are supposed to act as a separate check on risk-taking. For this reason, traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced. Rather, a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- *Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.*

To help prevent damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. Banking organizations should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements. Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).

Large complex banking organizations. LCBOs should have and maintain policies and procedures that (1) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (2) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (3) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

An LCBO also should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An LCBO's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

- *Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.*

Developing incentive compensation arrangements that provide balanced risk-taking incentives and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking.[18] Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to

1. reviewing the types of risks associated with the activities of covered employees;
2. approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and
3. analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance functions, also play an important role in helping ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

- *Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.*

The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by covered employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk-management or internal controls. The compensation arrangements for employees in risk-management and control functions thus should be sufficient to attract and retain qualified per-

18. Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

sonnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (e.g., adherence to internal controls).

- *Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.*

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Results should be reported to appropriate levels of management, including the board of directors where warranted and consistent with Principle 3 below. The monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. Thus, for example, a small, noncomplex organization that uses incentive compensation only to a limited extent may find that it can appropriately monitor its arrangements through normal management processes.

A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take imprudent risks.

2068.0.2.3 Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.[19] The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements.

Large complex banking organizations and organizations that are significant users of incentive compensation. The board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors of such an organization should review and approve the overall goals and purposes of the organization's incentive compensation system. In addition, the board should provide clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that

19. As used in this guidance, the term "board of directors" is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system. In the case of FBOs, the term refers to the relevant oversight body for the firm's U.S. operations, consistent with the FBO's overall corporate and management structure.

achieves balance and is consistent with safety and soundness.

The board of directors of such an organization also should ensure that steps are taken so that the incentive compensation system—including performance measures and targets—is designed and operated in a manner that will achieve balance.

• *The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.*

To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements.

The board of directors of a banking organization should closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

The board of directors of a banking organization should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace as well as developments in academic research and regulatory advice regarding incentive compensation policies. However, the board should recognize that organizations, activities, and practices within the industry are not identical. Incentive compensation arrangements at one organization may not be suitable for use at another organization because of differences in the risks, controls, structure, and management among organizations. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the organization's ability to manage effectively, regardless of the practices employed by other organizations.

Large complex banking organizations and organizations that are significant users of incentive compensation. The board of an LCBO or other organization that uses incentive compensation to a significant extent should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may increase the potential for imprudent risk-taking.

The board of such an organization also should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting imprudent risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

• *The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.*

The board of directors of a banking organization should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise may be present collectively among the members of the board, may come from formal training or from experience in addressing these issues, including as a director, or may be obtained through advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. The board of directors of an organization with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require special board expertise or to retain and use outside experts in this area.

In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

Large complex banking organizations and organizations that are significant users of incentive compensation. If a separate compensation committee is not already in place or required by other authorities,[20] the board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should consider establishing such a committee—reporting to the full board—that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

- *A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.*

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.[21] To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes that encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.[22]

- *Large complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.*

At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

1. Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include
   a. senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
   b. individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and
   c. groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk;
2. Identify the types and time horizons of risks to the organization from the activities of these employees;
3. Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take imprudent risks;

20. See New York Stock Exchange Listed Company Manual Section 303A.05(a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

21. On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness.

22. A banking organization also should comply with the incentive compensation disclosure requirements of the federal securities law and other laws as applicable. See, for example, Proxy Disclosure Enhancements, SEC Release Nos. 33-9089, 34-61175, 74 F.R. 68334 (Dec. 23, 2009) (to be codified at 17 C.F.R. 229 and 249).

4. Include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;
5. Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
6. Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

2068.0.3 CONCLUSION ON SOUND INCENTIVE COMPENSATION

Banking organizations are responsible for ensuring that their incentive compensation arrangements do not encourage imprudent risk-taking behavior and are consistent with the safety and soundness of the organization. The Federal Reserve expects banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes.

The Federal Reserve intends to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Federal Reserve will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Federal Reserve also will update this guidance as appropriate to incorporate best practices as they develop over time.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2014, this section is revised to include a June 13, 2014, interagency Addendum to the 1998 "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure" (Addendum). The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (Agencies) announced the issuance of the Addendum to ensure that insured depository institutions (IDIs) in a consolidated group maintain an appropriate relationship regarding the payment of taxes and treatment of tax refunds. The purpose of the Addendum is to ensure that tax allocation agreements expressly acknowledge an agency relationship between a holding company[1] and its subsidiary IDI to protect the IDI's ownership rights in tax refunds. State member banks and holding companies should implement the guidance as soon as reasonably possible, which the Agency expect would not be later than October 31, 2014. This Addendum clarifies and supplements but does not replace the 1998 Interagency Policy Statement. (Refer to SR-14-6.)

A holding company and its depository institution subsidiaries may generally file a consolidated group income tax return. For bank regulatory purposes, however, each depository institution is viewed as, and reports as, a separate legal and accounting entity. Each holding company subsidiary that participates in filing a consolidated tax return should record its tax expenses or tax benefits as though it had filed a tax return as a separate entity. The amount and timing of any intercompany payments or refunds to the subsidiary that result from its being a part of the consolidated return group should be no more favorable than if the subsidiary was a separate taxpayer. A consolidated return permits the parent's and other subsidiaries' taxable losses to be offset against other subsidiaries' taxable income, with the parent most often providing the principal loss. This can be illustrated with the following example:

1. For the purpose of this guidance, the term, "holding company" refers to a bank holding company or a savings and loan holding company.

	Parent Only	*Bank*	*Non-bank A*	*Non-bank B*	*Consolidated*
Contribution to consolidated net taxable income (loss):	$(100)	$2,000	$500	$(50)	$2,350
Assumed tax rate	40%	40%	40%	40%	40%
Tax payment/ (benefit)	$(40)	$ 800	$200	$(20)	$ 940

In this example, the parent, as the representative of the consolidated group to the Internal Revenue Service, would collect $800 from the bank subsidiary and $200 from Nonbank Subsidiary A, and pay $20 to Nonbank Subsidiary B. In return, the parent would remit to the tax authorities $940, resulting in a net cash retention of $40 by the parent.

Bank holding companies employ numerous methods to determine the amount of estimated payments to be received from their subsidiaries. Although the tax-accounting methods to be used by bank holding companies are not prescribed by the Federal Reserve System, the method employed must afford subsidiaries equitable treatment compared with filing separate returns. In general terms, tax transactions between any subsidiary and its parent should be conducted as though the subsidiary was dealing directly with state or federal taxing authorities.

The tax structure of holding companies becomes more complicated when deferred taxes are considered in the intercorporate tax settlements.[2] Deferred taxes occur when taxable income, for financial reporting purposes, differs from taxable income as reported to the taxing authorities. This difference is due to timing differences between financial-statement income and tax income for loan-loss provisions and other items, such as foreign tax credits. In addition, differences result from the use of the cash basis of accounting for tax purposes, as opposed to the accrual basis of accounting used in finan-

2. The issue becomes more complex because of GAAP-based tax expenses versus actual taxes paid under relevant tax laws (the difference between the two expenses is either a deferred tax liability or asset on the balance sheet). If the sharing agreement is based on the tax expense on the statement of income, more funds may be transferred to the paying agent than are required to settle the actual taxes owed.

cial reporting. The different bases are chosen by management.

An example of deferred income taxes follows, using an estimated tax rate of 40 percent.

	Financial Reporting	*Tax Return*
Pre-tax income	$200	$150
Currently payable	60	60
Deferred portion	20	—
TOTAL	80	60
Net income	$120	$90

The deferred portion represents the tax effect of delaying the recognition of income or taking more of a deduction for tax-return purposes (40% x $50). This is a temporary difference since over the "life" of the holding company, income and deductions should theoretically equalize for both book and tax purposes.

Financial Accounting Standards Board Accounting Standards Codification 740-10 Statement No. 109 (FAS 109), "Accounting for Income Taxes," provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax liabilities and assets. FAS 109 describes how a bank holding company should record (1) taxes payable or refundable for the current year and (2) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the banking organization's financial statements or tax returns.

Generally, all bank and other holding companies file annual income tax returns. The holding company pays the entire amount of tax (that is, the amount still due after estimated tax payments) on or before the due date for filing, or it can elect to pay by the extension deadline if one is granted. Bank holding companies may receive extensions from taxing authorities to file their returns later. For the federal tax return, a six-month extension may be granted.

Bank holding companies generally pay estimated taxes throughout the year. The most common payment dates will be as follows (assuming calendar period):

April 15 —first estimate (25%)
June 15 —second estimate (25%)
September 15 —third estimate (25%)
December 15 —fourth estimate (25%)
March 15 —Due date for income tax return for U.S. corporations or foreign corporations with offices in the United States. Last day for filing for the automatic six-month extension.
September 15 —Due date of return if six-month extensions were granted.

Bank holding companies have engaged in intercorporate income tax settlements that have the effect of transferring assets and income from a bank subsidiary to the parent company. The Board will apply appropriate supervisory remedies to situations that are considered inequitable or improper. These remedies may include, under certain circumstances, the Board's cease-and-desist powers.

On occasion, bank holding companies have used deferred tax assets as a vehicle to transfer cash or other earning assets of subsidiaries, principally from the bank, into the parent company. The Board's opinion is that each deferred tax asset or liability must remain on the books of the subsidiary. If deferred tax assets have been transferred to the parent, regardless of when the transfer may have occurred, immediate arrangements must be made to return the asset to the appropriate subsidiary. Instances of transferring deferred tax assets to the parent are worthy of inclusion in the Examiner's Comments and Matters Requiring Special Board Attention section or page of the inspection report.

2070.0.1 INTERAGENCY POLICY STATEMENT ON INCOME TAX ALLOCATION IN A HOLDING COMPANY STRUCTURE

In 1998, the federal bank and savings association's regulatory agencies (the agencies) issued the following policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its subsidiaries will often file a consolidated group income tax return. However, for bank regulatory purposes, each depository institution of the consolidated group is viewed as, and reports as, a separate legal and accounting entity. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed as a separate tax-paying entity.[3] The amount and timing of payments or refunds should be no less favorable to a subsidiary than if it was a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action. See SR-98-38.

2070.0.1.1 Tax-Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written comprehensive tax-allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax-allocation agreements usually address certain issues common to consolidated groups.

Therefore, such an agreement should—

1. require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate-entity basis;
2. discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
3. discuss reimbursements to an institution when it has a loss for tax purposes; and
4. prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

2070.0.1.2 Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of the federally supervised bank Consolidated Reports of Condition and Income, and other guidance issued by the agencies require depository institutions to account for their current and deferred tax liability or benefit.

When the depository-institution members of a consolidated group prepare separate bank regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate-entity basis, regardless of the consolidated group's tax-paying or -refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate-entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

2070.0.1.3 Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate-entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[4] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

3. Throughout the policy statement, the terms "separate entity" and "separate taxpayer" are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate-entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

4. These restrictions include the prompt-corrective-action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR 325, subpart B; for national banks, 12 CFR section 6.6; for savings associations, 12 CFR 565; and for state member banks, 12 CFR 208.45.

2070.0.1.4 Tax Refunds from the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the refund amount it is due on a separate-entity basis. Provided the institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carry-back benefits available on a separate-entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carry-forward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[5] Accordingly, an organization's tax-allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

5. See 26 CFR 1.1502-77(a).

2070.0.1.5 Income-Tax-Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate-entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by "forgiving" some or all of the subsidiary's deferred tax liability. Transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because each member of the consolidated group is jointly and severally liable for the group's potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

2070.0.1.6 Appendix — 2014 Addendum to 1998 Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

Since the issuance of the 1998 Interagency Policy Statement, courts have reached varying conclusions regarding whether tax allocation agreements create a debtor-creditor relationship between a holding company and its IDI.[6] Some courts have found that the tax refunds in question were the property of the holding company in bankruptcy (rather than property of the sub-

6. Case law on this issue is mixed. *Compare Zucker v. FDIC, as Receiver for BankUnited,* 727 F.3d 1100, 1108-09 (11th Cir. Aug. 15, 2013) ("The relationship between the Holding Company and the Bank is not a debtor-creditor relationship. When the Holding Company received the tax refunds it held the funds intact—as if in escrow—for the benefit of the Bank and thus the remaining members of the Consolidated Group.") with *F.D.I.C. v. Siegel (In re IndyMac Bancorp, Inc.),* F. ____ App'x ____ , 2014 WL 1568759, *2 (9th Cir. Apr. 21, 2014) *(per curiam)* ("The TSA does not create a trust relationship. The absence of language creating a trust relationship is explicitly an indication of a debtor-creditor relationship in California").

sidiary IDI) and held by the holding company as the IDI's debtor.[7]

On June 13, 2014, an Addendum to the 1998 Interagency Policy Statement (Addendum) was issued by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (Agencies). It explains that Consolidated Groups should review their tax allocation agreements to ensure the agreements achieve the objectives of the Interagency Policy Statement. This Addendum also clarifies how certain of the requirements of sections 23A and 23B of the Federal Reserve Act (FRA) apply to tax allocation agreements between IDIs and their affiliates.

In reviewing their tax allocation agreements, Consolidated Groups should ensure the agreements: (1) clearly acknowledge that an agency relationship exists between the holding company and its subsidiary IDIs with respect to tax refunds, and (2) do not contain other language to suggest a contrary intent.[8] In addition, all Consolidated Groups should amend their tax allocation agreements to include the following paragraph or substantially similar language:

The [holding company] is an agent for the [IDI and its subsidiaries] (the "Institution") with respect to all matters related to consolidated tax returns and refund claims, and nothing in this agreement shall be construed to alter or modify this agency relationship. If the [holding company] receives a tax refund from a taxing authority, these funds are obtained as agent for the Institution. Any tax refund attributable to income earned, taxes paid, and losses incurred by the Institution is the property of and owned by the Institution, and shall be held in trust by the [holding company] for the benefit of the Institution. The [holding company] shall forward promptly the amounts held in trust to the Institution. Nothing in this agreement is intended to be or should be construed to provide the [holding company] with an ownership interest in a tax refund that is attributable to income earned, taxes paid, and losses incurred by the Institution. The [holding company] hereby agrees that this tax sharing agreement does not give it an ownership interest in a tax refund generated by the tax attributes of the Institution.

Going forward, the Agencies generally will deem tax allocation agreements that contain this or similar language to acknowledge that an agency relationship exists for purposes of the Interagency Policy Statement, this Addendum, and sections 23A and 23B of the FRA.

All tax allocation agreements are subject to the requirements of section 23B of the FRA, and tax allocation agreements that do not clearly acknowledge that an agency relationship exists may be subject to additional requirements under section 23A of the FRA.[9] In general, section 23B requires affiliate transactions to be made on terms and under circumstances that are substantially the same, or at least as favorable to the IDI, as comparable transactions involving nonaffiliated companies or, in the absence of comparable transactions, on terms and circumstances that would in good faith be offered to nonaffiliated companies.[10] Tax allocation agreements should require the holding company to forward promptly any payment due the IDI under the tax allocation agreement and specify the timing of such payment. Agreements that allow a holding company to hold and not promptly transmit tax refunds received from the taxing authority and owed to an IDI are inconsistent with the requirements of section 23B and subject to supervisory action. However, an Agency's determination of whether such provision, or the tax allocation agreement in total, is consistent with section 23B will be based on the facts and circumstances of the particular tax allocation agreement and any associated refund.

State member banks and holding companies should implement this 2014 Addendum guidance as soon as reasonably possible, which the Agencies expect would not be later than October 31, 2014. See 79 *Fed. Reg.* 35230, June 19, 2014, and SR-14-6, July 15, 2014, "Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure."

7. *See e.g., F.D.I.C. v. Siegel (In re IndyMac Bancorp, Inc.),* F. ____ App'x ____, 2014 WL 1568759 (9th Cir. Apr. 21, 2014) *(per curiam).*

8. This Addendum clarifies and supplements but does not replace the Interagency Policy Statement.

9. Section 23A requires, among other things, that loans and extensions of credit from a bank to its affiliates be properly collateralized. 12 U.S.C. 371c(c).

10. 12 U.S.C. 371c-1(a). Transactions subject to section 23B include the payment of money by a bank to an affiliate under contract, lease, or otherwise and transactions in which the affiliate acts as agent of the bank. *Id.* at § 371c-1(a)(2) & (a)(4).

2070.0.2 Qualifying Subchapter S Corporations

The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code (the code). On October 29, 1996, the FFIEC issued a bulletin notifying all federally insured banks and thrifts of the impact of these changes. Thrift organizations may qualify for Subchapter S corporation[11] status under the code's revisions and could generally receive pass-through tax treatment for federal income tax purposes if certain criteria are met.

The bulletin states that no formal application is required to be filed with the federal bank and thrift regulatory agencies merely as a result of an election by a bank, thrift, or parent holding company to become a Subchapter S corporation. However, if an institution takes certain steps to meet the criteria to qualify for this tax status, particularly the code's limitations on the number and types of shareholders, applications or notices to the agencies may be required.

The FFIEC bulletin also states that any distributions made by the Subchapter S banking organization to its shareholders, including distributions intended to cover shareholders' personal tax liabilities for their shares of the income of the institution, will continue to be regarded as dividends and subject to any limitations under relevant banking law. See SR-96-28.

2070.0.3 Inspection Objectives

1. To determine whether the supervisory and accounting guidance set forth in ASC 740-10 (FASB 109), other tax-accounting standards, and the 1998 interagency policy statement on income tax allocation has been appropriately, equitably, and consistently applied.
2. To verify that the parent's intercorporate tax policy contains a provision requiring the subsidiaries to receive an appropriate refund from the parent when they incur a loss, and that such a refund would have been receivable from the tax authorities if the subsidiary was filing a separate return.
3. To ascertain that tax payments and tax refunds between financial institution subsidiaries and the parent company have been limited to no more than what the institution might have paid to or received from the tax authorities, if it had filed its tax returns on a timely, separate-entity basis.[12]
4. To determine that no deferred tax liability, corresponding asset, or the deferred portion of its applicable income taxes has been transferred from a bank subsidiary to the parent company.
5. To verify that there has been proper accountability for tax-forgiveness transactions between the parent company and its financial institution subsidiaries.
6. To substantiate that corporate practices are consistent with corporate policies.

2070.0.4 Inspection Procedures

1. Obtain and discuss with the holding company's management its intercorporate income tax policies and tax-sharing agreements. Obtain and retain a copy of the intercorporate tax policies and agreements in the workpaper files. Review the written intercorporate tax-settlement policy and ascertain that it includes the following:
   a. a description of the method(s) used in determining the amount of estimated taxes paid by each subsidiary to the parent
   b. an indication of when payments are to be made
   c. a statement that deferred taxes are maintained on the affiliate's general ledger
   d. procedures for handling tax claims and refunds

   Holding companies of depository institutions should also have written tax-sharing agreements with their subsidiaries that specify intercorporate tax-settlement policies. The Board encourages these holding companies to develop such agreements. For tax-sharing agreements, the following inspection procedures should be followed:
   a. Determine whether each subsidiary is required to compute its income taxes (current and deferred) on a separate-entity basis.
   b. Ascertain if the amount and timing of payments for current tax expense, including estimated tax payments, are discussed.
   c. Determine if reimbursements are discussed when an institution has a loss for

11. Subchapter S corporations are corporations that elect to pass corporate income tax losses, deductions, and credit through to their shareholders for federal income tax purposes.

12. The term "separate-entity basis" recognizes that certain adjustments, in particular tax elections in a consolidated return, may, in certain periods, result in higher payments by the depository institution than would have been made if the depository institution was unaffiliated.

tax purposes.
   d. Determine if there is a prohibition on the payment or other transfer of deferred taxes by an institution to another member of the consolidated group.
2. Review briefly the parent's intercompany transaction report; general ledger income tax accounts; cash receipts and disbursements; and, if necessary, tax-return workpapers and other pertinent corporate documents.
   a. Ascertain that the taxes collected by the parent company from each depository institution subsidiary do not exceed the amount that would have been paid if a separate return had been filed.
   b. When depository institution subsidiaries are making their tax payments directly to the taxing authorities, determine whether other subsidiaries are paying their proportionate share.
3. Review the separate regulatory reports for depository institution members of the holding company that are included in the filing of a consolidated tax return.
   a. Verify that each subsidiary institution is recording current and deferred taxes as if it was filing its own tax returns on a separate-entity basis.
   b. Ascertain that any adjustments for statutory tax considerations, arising from filing a consolidated return, are also made to the separate-entity calculations consistently and equitably among the holding company affiliates.
4. Determine if any excess amounts (tax benefits), resulting from the filing of a consolidated return, are consistently and equitably allocated among the members of the consolidated group.
5. Review the tax payments that are made from the bank and the nonbank subsidiaries to the parent company.
   a. Determine that payments, including estimated payments that are being requested, do not significantly precede the time that a consolidated or estimated current tax liability would be due and payable by the parent to the tax authorities.
   b. Verify with management that the tax payments to the parent company were not in excess of the amounts recorded by its depository institution subsidiaries as current tax expense on a separate-entity basis.
   c. Determine that subsidiary institutions are not paying their deferred tax liabilities on the deferred portions of their applicable income taxes to the parent company.
   d. Ascertain that the parent company is not deriving tax monies from depository institution subsidiaries that are used for other operating needs.
6. When a subsidiary incurs a loss, review the tax system to determine that bank and nonbank subsidiaries are receiving an appropriate refund from the parent company, that is, an amount that is no less than what would have been received if the tax return had been filed on a separate-entity basis.
   a. Verify that refunds are received no later than the date the institutions would have filed their own returns and that no refund is characterized as the parent company's property.
   b. If the parent company does not require a subsidiary to pay its full amount of current tax liability, and the parent will not later require the institution to pay the remainder of the current tax liability, ascertain that the amount of the tax liability is recorded as having been paid and that the corresponding credit is recorded as a capital contribution from the parent to the subsidiary.
7. Determine that the deferred tax accounts of each bank subsidiary are maintained on its books and that they are not transferred to the parent organization.
8. Determine if the Internal Revenue Service or other tax authorities have assessed any additional tax payments on the consolidated group, and whether the holding company has provided an additional reserve to cover the assessment.
9. Complete the Other Supervisory Issues page or section of the Report of Bank Holding Company Inspection (FR 1225 or FR 1241).

2070.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure			4-870	1999 FRB 111
2014 Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure				

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The purpose of this Section is to discuss the types of funding ordinarily found in holding companies and to analyze their respective characteristics. It is not intended that this section include an analysis of the inter-relationships of these factors because that will be addressed in the various subsections of Section 4000 of the Manual.

The three major types of funding are short-term debt, long-term debt and equity. The ideal ''hypothetical'' holding company balance sheet would reflect sufficient equity to fund total bank and nonbank capital needs.

The complexity of the debt and/or equity financing will depend greatly upon the size and financial status of the holding company as well as the access to certain capital markets. The small holding company will be limited in the type and/or sophistication of financing instruments available for its use, and probably would look to local sources for its debt and equity needs. This would include sale of equity and debt instruments to owners of the holding company. The medium-sized holding company has access to public markets through investment bankers and occasionally may issue its own corporate notes in the commercial paper market. The large holding company has a wide range of choices depending upon its financial condition and the economic climate at the time of any offering. It also has the ability to place debt privately as an alternate to dealing with public markets. In summary, the type of financing needed by a holding company will vary with the size and nature of its banking and nonbanking operations. The following subsections address those issues.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2010, this section was revised to include a cross reference to section 4066.0 of this manual, which provides the March 17, 2010, interagency policy statement on "Funding and Liquidity Risk Management."

A key principle underlying the Federal Reserve's supervision of bank holding companies (BHCs) is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, BHCs should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

For more information regarding the Federal Reserve's supervisory expectations on liquidity risk management for BHCs, see section 4066.0, "Consolidated (Funding and Liquidity Risk Management)." This section provides the March 17, 2010, interagency policy statement on "Funding and Liquidity Risk Management." (see also SR-10-6 and its attachment.)

2080.05.1 FUNDING AND LIQUIDITY

A principal objective of a parent BHC's funding strategy should be to support capital investments in subsidiaries and long-term assets with capital and long-term sources of funds. Long-term or permanent financing not only reduces funding and liquidity risks, but also provides an organization with investors and lenders that have a long-run commitment to its viability. Long-term financing may take the form of term loans, long-term debt securities, convertible debentures, subordinated debt, and equity.

In general, liquidity can be measured by the ability of an organization to meet its maturing obligations, convert assets into cash with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations. A major determinant of a BHC's liquidity position is the level of liquid assets available to support maturing liabilities. The use of short-term debt, including commercial paper, to fund long-term assets can result in unsafe and unsound banking conditions, especially if a BHC does not have alternative sources of liquidity or other reliable means to refinance or redeem its obligations. In addition, commercial paper proceeds should not be used to fund corporate dividends or pay current expenses. Funding mismatches can exacerbate an otherwise manageable period of financial stress or, in the extreme, undermine public confidence in an organization's viability. For this reason, BHCs, in managing their funding positions, should control liquidity risk by maintaining an adequate cushion of liquid assets to cover short-term liabilities. Holding companies should, at all times, have sufficient liquidity and funding flexibility to handle any runoff, whether anticipated or unforeseen, of commercial paper or other short-term obligations—without having an adverse impact on their subsidiary banks.

This objective can best be achieved by limiting the use of short-term debt to fund assets that can be readily converted to cash without undue loss. It should be emphasized, however, that the simple matching of the maturity of short-term debt with the stated or nominal maturity of assets does not, by itself, adequately ensure an organization's ability to retire its short-term obligations if the condition of the underlying assets precludes their timely sale or liquidation. In this regard, it is particularly important that parent company advances to subsidiaries be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can readily be converted to cash. Consequently, effective procedures to monitor and ensure on an ongoing basis the quality and liquidity of the assets being funded by short-term debt are critical elements of a holding company's overall funding program.

BHCs should establish and maintain reliable funding and contingency plans to meet ongoing liquidity needs and to address any unexpected funding mismatches that could develop over time. Such plans could include reduced reliance on short-term purchased funds, greater use of longer-term financing, appropriate internal limitations on parent company funding of long-term assets, and reliable alternate sources of liquidity. It is particularly important that BHCs have reliable plans or backup facilities to refinance or redeem their short-term debt obligations in the event assets being funded by these obligations cannot be liquidated in a timely manner when the debt must be repaid. In this connection, holding companies relying on backup lines of credit for contingency plan purposes should seek to arrange standby facilities that will be reliable during times of financial stress, rather than facilities that contain clauses which may relieve the lender of the obligation to fund the borrower in the event of a deterioration in the borrower's financial condition.

In developing and carrying out funding programs, BHCs should avoid overreliance or excessive dependence on any single short-term or potentially volatile source of funds, such as commercial paper, or any single maturity range. Prudent internal liquidity policies and practices should include specifying limits for, and monitoring the degree of reliance on, particular maturity ranges and types of short-term funding. Special attention should be given to the use of overnight money since a loss of confidence in the issuing organization could lead to an immediate funding problem. BHCs issuing overnight liabilities should maintain, on an ongoing basis, a cushion of superior quality assets that can be immediately liquidated or converted to cash with minimal loss. The absence of such a cushion or a clear ability to redeem overnight liabilities when they become due should generally be viewed as an unsafe and unsound banking practice.

2080.05.2 ADDITIONAL SUPERVISORY CONSIDERATIONS

BHCs and their nonbank affiliates should maintain sufficient liquidity and capital strength to provide assurance that outstanding debt obligations issued to finance the activities of these entities can be serviced and repaid without adversely affecting the condition of the affiliated bank(s). In this regard, BHCs should maintain strong capital positions to enable them to withstand potential losses that might be incurred in the sale of assets to retire holding company debt obligations. It is particularly important that a BHC not allow its liquidity and funding policies or practices to undermine its ability to act as a source of strength to its affiliated bank(s).

The principles and guidelines outlined above constitute prudent financial practices for BHCs and most businesses in general. Holding company boards of directors should periodically assure themselves that funding plans, policies, and practices are prudent in light of their organizations' overall financial condition. Such plans and policies should be consistent with the principles outlined above, including the need for appropriate internal limits on the level and type of short-term debt outstanding and the need for realistic and reliable contingency plans to meet any unanticipated runoff of short-term liabilities without adversely affecting affiliated banks.

2080.05.3 EXAMINER'S APPLICATION OF PRINCIPLES IN EVALUATING LIQUIDITY AND IN FORMULATING CORRECTIVE ACTION PROGRAMS

Reserve Bank examiners should be guided by these principles in evaluating liquidity and in formulating corrective action programs for BHCs that are experiencing earnings weaknesses or asset-quality problems, or that are otherwise subject to unusual liquidity pressures. In particular, BHCs with less than satisfactory supervisory ratings—composite (C) and the potential impact (I) of the parent company and nondepository entities—(that is, 3 or worse), or any other holding companies subject to potentially serious liquidity or funding pressures, should be asked to prepare a realistic and specific action plan for reducing or redeeming entirely their outstanding short-term obligations without directly or indirectly undermining the condition of their affiliated bank(s).[1] Such contingency plans should be reviewed and evaluated by Reserve Bank supervisory personnel during or subsequent to on-site inspections. Any deficiencies in the plan, if not addressed by management, should be brought to the attention of the organization's board of directors. If the liquidity or funding position of such a company appears likely to worsen significantly, or if the company's financial condition worsens to a sufficient degree, the company should be expected to implement, on a timely basis, its plan to curtail or eliminate its reliance on commercial paper or other volatile, short-term sources of funds. Any decisions or steps taken by Reserve Banks in this regard should be discussed and coordinated with Board staff.

Reference should also be made to other manual sections that address funding, cash flow, or liquidity (for example, 2010.1, 2080.0, 2080.1, 2080.2, 2080.4, 2080.5, 2080.6, 4010.0, 4010.1, 4010.2, 5010.27, and 5010.28).

1. It is important to note that there are securities registration requirements under the Securities Act of 1933 related to the issuance of commercial paper. A BHC should have procedures in place to ensure compliance with all applicable securities and SEC requirements. Refer to manual section 2080.1.

Commercial paper is a generic term that is generally used to describe short-term unsecured promissory notes issued by well-recognized and generally financially sound corporations. The largest commercial paper issuers are finance companies and bank holding companies which use the proceeds as a source of funds in lieu of fixed rate borrowing.

Generally accepted limitations on issuances and uses of commercial paper derive from Section 3(a)(3) of the Securities Act of 1933 (1933 Act). Section 3(a)(3) exempts from the registration requirements of the 1933 Act "any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. . . ." The Securities and Exchange Commission (SEC) has rulemaking authority over the issuance of commercial paper.

The five criteria, as set forth in an SEC interpretation (SA Release #33–4412, September 20, 1961), that are deemed necessary to qualify securities for the commercial paper exemption are that the commercial paper must:

- Be of prime quality and negotiable;
- Be of a type not ordinarily purchased by the general public;
- Be issued to facilitate current operational business requirements;
- Be eligible for discounting by a Federal Reserve Bank;
- Have a maturity not exceeding nine months.

2080.1.1 MEETING THE SEC CRITERIA

The above criteria are discussed below.

2080.1.1.1 Nine-Month Maturity Standard

Although roll-over of commercial paper proceeds on maturity is common, the SEC has stated that obligations that are payable on demand or have provisions for automatic rollover do not satisfy the nine-month maturity standard. However, the SEC staff has issued "no action" letters for commercial paper master note agreements which allow eligible investors to make daily purchases and withdrawals (subject to a minimum amount of $25,000) as long as the note and each investor's interest therein, does not exceed nine months. Such master note agreements may permit prepayment by the issuer, or upon demand of the investor, at any time.

2080.1.1.2 Prime Quality

Most commercial paper is rated by at least one of five nationally recognized statistical rating organizations. The SEC has not clearly articulated the line at which it will regard a specific rating of commercial paper as being "not prime" and, indeed, there is no requirement that a rating be obtained at all in order to qualify. SEC staff has issued a series of "no-action" letters to individual bank holding companies based on specific facts and circumstances even where it does not appear that a rating was obtained. However, where commercial paper is downgraded to below what is generally regarded as "investment quality" (ratings of less than medium grade—refer to the *Commercial Bank Examination Manual*, section 203.1), or a rating is withdrawn, BHCs may not be able to issue commercial paper based on the Section 3(a)(3) exemption, in the absence of a marked significant improvement in the issuer's financial condition.

2080.1.1.3 Current Transactions

There have been considerable interpretative problems arising out of the current transactions concept. The SEC staff has issued a partial laundry list of activities which would not be deemed suitable for investment of commercial paper proceeds, namely:

1. The discharge of existing indebtedness, unless such indebtedness is itself exempt under section 3(a)(3) of the 1933 Act;
2. The purchase or construction of a plant or the purchase of durable machinery or equipment;
3. The funding of commercial real estate development or financing;
4. The purchase of real estate mortgages or other securities;
5. The financing of mobile homes or home improvements; or

6. The purchase or establishment of a business enterprise.

The SEC has opined that commercial paper, which is used as bridge financing by a bank holding company to fund a permanent acquisition within the 270-day maturity period of the paper, will meet the current transactions criterion. The amount of a bank holding company's commercial paper cannot exceed the aggregate amount of "current transactions" of the bank holding company and its subsidiaries *on a consolidated basis*. For this purpose, "current transactions" include dividends, interest, taxes and short-term loan repayments. In summary, in most cases, the "current transactions" requirement will not be a significant limitation on issuances of commercial paper by bank holding companies.

In addition to meeting SEC requirements, a bank holding company must meet funding and liquidity criteria prescribed by the Board. For a detailed discussion on acceptable use of commercial paper in connection with a bank holding company overall funding strategies, see Sections 2080.05 and 2080.6.

2080.1.1.4 Sales to Institutional Investors

Commercial paper is generally marketed only to institutional investors (corporations, pension funds, insurance companies, etc.) although sales to individuals are not prohibited. It is clear, however, from the legislative history of the Section 3(a)(3) exemption that commercial paper was not to be marketed for sale to the general public. Currently, SEC staff will not issue a no-action letter if the minimum denomination of the commercial paper to be issued is less than $25,000. One of the underlying premises of the Section 3(a)(3) exemption is that purchasers of commercial paper have sufficient financial sophistication to make informed investment decisions without the benefit of the information provided by a registration statement. It is, therefore, generally recognized today that any individual purchaser of commercial paper should meet the "accredited investor" criteria of commercial paper set forth in SEC Regulation D (17 C.F.R 230.501(a)). To qualify as an "accredited investor", an individual can meet one of two tests—a net worth test or an income test. To qualify under the net worth test, an individual or an individual and his or her spouse must have a net worth at the time of purchase in excess of $1 million. The alternative test requires $200,000 in income for each of the last two years ($300,000 if the spouse's income is included) and a reasonable expectation of reaching the same income level in the current year.

For additional information on marketing of commercial paper, see the next subsection.

2080.1.2 MARKETING OF COMMERCIAL PAPER

The sale of bank holding company (or nonbank subsidiary) commercial paper by an affiliated bank to depositors or other investors raises a number of supervisory issues. Of particular concern is the possibility that individuals may purchase holding company paper with the misunderstanding that it is an insured deposit or obligation of the subsidiary bank. The probability of this occurring is increased when a bank subsidiary is actively engaged in the marketing of the paper of its holding company or nonbank affiliate, or when the holding company or nonbank affiliate has a name similar to the name of the commercial bank subsidiary.

It is a long-standing policy of the Federal Reserve (refer to letters SR 90–19 and SR–620) that debt obligations of a bank holding company or a nonbank affiliate should not be issued, marketed or sold in a way that conveys the misimpression or misunderstanding that such instruments are either: 1) federally-insured deposits, or 2) obligations of, or guaranteed by, an insured depository institution. The purchase of such holding company obligations by retail depositors of an affiliated depository institution can, in the event of default, result in losses to individuals who believed that they had acquired federally-insured or guaranteed instruments. In addition to the problems created for these individuals, such a situation could impair public confidence in the affiliated depository institution and lead to unexpected withdrawals or liquidity pressures.

Events surrounding the sale of uninsured debt obligations of holding companies to retail customers of affiliated depository institutions have focused attention on the potential for problems in this area. In view of these concerns, the Federal Reserve emphasizes that this policy applies to the sale of both long- and short-term debt obligations of a bank holding company and any nonbank affiliate, as well as to the sale of uninsured debt securities issued by a state member bank or its subsidiaries. Debt obligations covered by this supervisory policy include commercial paper and all other short-term and long-term debt securities, such as thrift notes and subordinated debentures.

Bank holding companies and nondepository affiliates that have issued or plan to issue uninsured obligations or debt securities should not market or sell these instruments in any public area of an insured depository institution where retail deposits are accepted, including any lobby area of the depository institution. Bank holding companies and any affiliates that are engaged in issuing debt obligations should establish appropriate policies and controls over the marketing and sale of the instruments. In particular, internal controls should be established to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of uninsured debt obligations is separated from the retail deposit-taking functions of affiliated depository institutions.

State member banks, including their subsidiaries, may also be engaged in issuing nondeposit debt securities (such as subordinated debt), and it is equally important to ensure that such securities are not marketed or sold in a manner that could give the purchaser the impression that the obligations are federally-insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. Consistent with long-standing Federal Reserve policy, debt obligations of bank holding companies or their nonbank affiliates, including commercial paper and other short- or long-term debt securities, should prominently indicate that: 1) they are not obligations of an insured depository institution; and 2) they are not insured by the Federal Deposit Insurance Corporation. In cases where purchasers do not take physical possession of the obligation, the purchasers should be provided with a printed advice that conveys this information. Employees engaged in the sale of bank holding company debt obligations should be instructed to relate this information verbally to potential purchasers. In addition, with respect to the sale of holding company debt obligations, the instruments or related documentation should not display the name of the affiliated bank in such a way that could create confusion among potential purchasers about the identity of the obligor. State member banks involved in the sale of uninsured nondeposit debt securities of the bank should establish procedures to ensure that potential purchasers understand that the debt security is not federally-insured or guaranteed.

Federal Reserve examiners are responsible for monitoring compliance with this supervisory policy; and, as part of the examination of state member banks and bank holding companies, are expected to continue to review the polices and internal controls relating to the marketing and sale of debt obligations and securities. Examiners should determine whether the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function of the insured depository affiliate.

In determining whether the activities are sufficiently separated, examiners should take into account: 1) whether the sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area[1]; 2) whether advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion; 3) whether similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor; 4) whether retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate; 5) whether information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and 6) whether retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

The Board's policy is that the manner in which commercial paper is sold should not lead bank customers or investors to construe commercial paper as an insured obligation or an instrument which may be higher in yield but equal in risk to insured bank deposits. All purchasers of commercial paper should clearly understand that such paper is an obligation of the parent company or nonbank subsidiary and

1. This policy is not intended to preclude the sale of holding company affiliate obligations from a bank's money market desk, provided that the money market function is separate from any public area where retail deposits are accepted, including any lobby area.

not an obligation of the bank and that the quality of the investment depends on the risks and operating characteristics associated with the overall holding company and its nonbanking activities.

2080.1.3 THRIFT NOTES AND SIMILAR DEBT INSTRUMENTS

In the event a bank holding company or nonbanking affiliate issues thrift notes or other debt obligations which do not fall within the generally accepted definition of commercial paper, examiners should be guided by the Board's 1978 position on the issuance of small denomination debt obligations by bank holding companies and their nonbanking affiliates. At that time, the Board was considering thrift notes issued by a nonbanking subsidiary of a bank holding company and concluded that such obligations should prominently indicate in bold type on their face that the obligations are not obligations of a bank and are not FDIC insured. The Board also stated that the obligations should not be sold on the premises of affiliated banks. Where there is substantial reliance on the sale of thrift notes to fund the operations of a bank holding company or nonbanking subsidiary, other than an industrial bank, a violation of the Glass–Steagall Act may be involved. Such cases should be discussed with Reserve Bank counsel.

2080.1.4 OTHER SHORT-TERM INDEBTEDNESS

A company's access to bank credit is almost universal, and most small to medium-sized companies will reflect this type of debt on their balance sheets. An important point to remember about bank debt is that maturities of the bank notes are usually short-term while the proceeds of the borrowings are often applied to long-term assets, that is, investment in the bank's capital and/or long-term debt accounts. The note may be subject to renewal on an annual basis, and the creditor may have the opportunity to call the note at renewal if the financial condition of the company has deteriorated. Rates of interest on short- term bank notes are usually pegged to the creditor's prime rate plus some fraction thereof. The principal is often repaid over a period of years as the notes are rolled over despite their short-term maturity.

2080.1.5 CURRENT PORTION OF LONG-TERM DEBT

This type of debt has many of the short-term characteristics of bank debt, with possibly one additional important feature. Such debt is usually tied to a written agreement between creditor and debtor, and encompasses certain minimum standards of performance to be adhered to by the company. The examiner must review the agreement to determine that the company is operating within the parameters of the covenants laid out in the agreement. Failure to abide by the covenants can trigger default provisions of the agreement and escalate the repayment of the total loan balance outstanding.

2080.1.6 INSPECTION OBJECTIVES

1. To determine the company's policy and actual practices with respect to the sale of uninsured debt obligations and securities issued by bank holding companies, nonbank affiliates or State member banks. More often than not, an informal policy evolves from practice. It then becomes important to interview senior officers in charge of this function to determine if they are adequately aware of the statutory and regulatory constraints with respect to appropriate usage of commercial paper.
2. To review the company's funding and liquidity strategy with a view to determining whether it has sufficient liquid assets to support maturing liabilities and whether there are any funding mismatches. (See Manual sections 2080.05, 4010.2.3, 4010.2.7, and 5010.24.1)
3. To determine compliance with the Federal Reserve System's supervisory policy with regard to the marketing of commercial paper, thrift notes or similar type debt instruments (refer to Board letter S 2427 dated June 27, 1980, and supervisory letters SR 90–19 and SR 620).
4. To identify potential weaknesses in corporate policy and practices.

2080.1.7 INSPECTION PROCEDURES

1. Review the bank holding company's procedures for authorizing the issuance of commercial paper and other uninsured debt obligations and securities of the holding company and/or its nonbank affiliates.

2. Review the board of directors' resolution authorizing the issuance of commercial paper and other uninsured debt obligations and securities.

3. Determine whether the company has sought a "no action" letter from the SEC. A "no action" letter indicates the SEC has reviewed the company's issuance of commercial paper and plans "no action" to require the registration of the commercial paper as "securities." Some companies rely on the opinion of their own counsel that their paper is not subject to SEC registration requirements. If the company does not have a "no action" letter there should be a legal opinion on file from the holding company's attorney regarding exemption from registration under section 5 of the 1933 Act.

4. Obtain a copy of the holding company's written policy on paper usage to compare with resolution and practice.

5. Review to determine the extent to which the commercial paper and other uninsured debt obligations are supported by back-up lines of credit provided by unaffiliated banks. These lines are established to cover any unexpected run-off of paper at maturity. Commitments for lines of credit should be in writing and have expiration dates. Commitment fees substantiate the enforceability of the commitment whereas compensating balances tend to indicate that the lending commitment is less formal. The examiner should determine whether material adverse change clauses exist in back-up line of credit agreements which may affect their reliability. Comment if it appears that those provisions might be utilized.

Compensating balance arrangements should be disclosed. A company may commit to a compensating balance, but if it relies on its bank subsidiary to provide the funds the bank should be compensated for utilization of its funds.

Reciprocal back-up lines may be established. This may eliminate the need for fees or compensating balances and may provide a certain comfort level for company management.

6. Obtain a listing of commercial paper and other uninsured debt obligation holders from management to the extent known. In the case of larger BHCs, there is a choice between issuing paper on a local level or placing it nationally through the auspices of an investment banking firm. In the latter case, there is likely to be no record of who purchases the paper because the paper is usually sold on a bearer basis. Holding companies looking for a wider market, national recognition, and higher ratings place their paper through an investment banking firm. However, it should be recognized that the market for commercial paper placed in this manner is more sophisticated and knowledgeable and therefore more sensitive to adverse developments than a local market. The smaller company can be content to sell its paper on a local level through its corporate headquarters, knowing its customer profile and limiting the amount to any one paperholder, thereby limiting its exposure to refinancing problems caused by large scale redemptions.

7. Review for potential weaknesses in corporate policy and practices. Any amounts in excess of 10 percent in the hands of one paperholder should be discussed with management and noted in the report. A large paperholder could refuse to purchase new paper at maturity (rollover) and place the company in a liquidity squeeze, requiring sell-off of assets or draw down of back-up lines.

Rollovers are prohibited under the 1933 Act. The instrument must have a definite date of maturity with no automatic provision for reinvestment of proceeds. Companies must abide by the 270-day provision and if the paperholder elects to reinvest the funds, a new instrument should be executed.

8. Request a copy of the commercial paper, thrift note or similar type instrument, and any printed advice to the purchasing customer for review. These documents should be checked for compliance with the standards set forth under the captions "Marketing of Commercial Paper" and "Thrift Notes and Similar Debt Instruments" in this section of the Manual.

9. If a bank sells the commercial paper and/or other uninsured debt obligations of its holding company or nonbanking affiliate, review the procedures to separate their sale from the retail operations of the bank.

This segregation should be reviewed as part of all holding company inspections. Examiner judgment must be relied upon, to a large extent, to determine whether the marketing activities of commercial bank subsidiaries for the bank holding company's commercial paper and other uninsured debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit- taking function. In making this determination, the examiner should consider whether:

a. The sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area;

b. Advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion;

c. Similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor;

d. Retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate;

e. Information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and

f. Retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

In those cases where the bank holding company or nonbanking affiliates issue thrift notes or similar type debt instruments, ascertain that these obligations are not being sold on the premises of affiliated banks.

10. The procedures in Nos. 8 and 9 address the manner in which bank holding companies (or nonbanking subsidiaries) market their commercial paper, thrift notes or similar type debt instruments; consequently, implementation will necessitate review of marketing procedures of all holding companies (or nonbanking subsidiaries), regardless of the type of charter or the identity of the primary supervisor of the subsidiary (affiliate) bank. Exceptions to the policies on the marketing of such paper should be noted on the ''Commercial Paper and Lines of Credit'' pages and discussed on the ''Examiner's Comments'' page of the inspection report. The managements of all bank holding companies must be fully informed of the Federal Reserve's policy with respect to the marketing of holding company debt obligations, as in SR Letter 90–19, and exceptions should be addressed in the supervisory follow-up process.

Long-term debt represents an alternative financing method to short-term debt and equity funds. Before choosing this type of funding the bank holding company will need to determine how the advantages and disadvantages of long-term debt apply to its financial position and funding needs. Interest on long-term debt is an expense item and therefore is tax deductible. The company issuing debt effectively pays approximately ''half-price'' (interest expense net of tax deduction) on debt while the company issuing equity pays the full dividend rate without a tax benefit. Counterbalancing the tax advantage is the fact that long-term debt must be serviced and retired to prevent default and cannot be used as an offset for losses.

The issuance of long-term debt will be relatively advantageous to the holding company whose price/earnings ratio is low and whose stock is selling significantly below book value. In this instance, the cost to the company of equity funding rises proportionately to the drop in the price of the stock since less funds are obtained for an equal number of shares, yet the dividend per share remains the same.

A major factor influencing a bank holding company's decision to issue long-term debt instead of equity is the dilution impact of new equity. Straight debt will not dilute ownership and is typically retired from cash flow, whereas new equity dilutes earnings per share (more so than the impact of the debt's interest expense on earnings).

Preferred stock can be retired through a sinking fund and is sometimes convertible to common shares. Convertible stock adds to the dilution effect when the conversion is exercised and prior to conversion, ''fully diluted'' earnings per share must be reported that assume full conversion. The bank holding company will consider both stockholder and market reaction to any dilution effects of long-term financing. The BHC may view debt financing as the best alternative if it feels that a diluted earnings per share would drive down the market price of its stock and contribute to stockholder discontent.

Inherent in any financing are intangible costs. While it is evident that on the surface debt financing is cheaper than equity financing, it would be hard to quantify the effects of potential missed interest payment or default associated with debt instruments. The bank holding company also will be concerned with its additional ''debt capacity'' if the present issuance of debt pushes the debt/equity ratio beyond acceptable limits.

Theoretically, ''straight debt'' is a direct secured or unsecured obligation requiring repayment at maturity and generally taking a senior position in the claim on assets. Principal is sometimes payable in a lump sum, often through the use of a sinking fund, while interest is paid at stated periods throughout the life of the note.

2080.2.1 CONVERTIBLE SUBORDINATED DEBENTURE

A convertible subordinated debenture is an unsecured debt that is subordinate to other debt and convertible to common stock at a certain date or price. The essential provision of this debt is that it may eventually be retired by equity and inherently has the potential for dilution. With this type of financing, the creditor typically has the right to convert the bond into a stated number of shares of common stock at some future time. Usually the conversion price is 10 to 15 percent above the market price of the stock. This encourages the bondholder to keep the bond until the market price meets or surpasses the conversion price. In many convertible debt agreements, the bank holding company issuing debt will have the option to call the issue when the conversion price equals the market price.

The bank holding company will issue a convertible subordinated debenture when its stock price is depressed. The convertibility provision is added as a ''sweetner'' to the issue and counteracts the negative aspect of its subordinated position. The subordinated nature of this issue will help a bank holding company with prior debt which includes covenants that dictate against additional senior debt.

2080.2.2 CONVERTIBLE PREFERRED DEBENTURE

This debt instrument is similar to straight convertible debt except it is convertible into preferred stock. This alternative is open to the bank holding company which needs to add a ''sweetner'' to this issue in order to market it, but does not want dilution of ''common'' ownership.

2080.2.3 NEGATIVE COVENANTS

The lender will be concerned with the borrower's debt structure when offering financing. If the borrower's debt/equity ratio is approaching an unacceptable level, the lender will try to assure that the bank holding company does not overextend itself. While the lender may demand the right to approve future equity issues, the lender is likely to be more willing to give such approval than to allow more debt because the equity issue adds to the capital base, and this base is a possible source of funds for the payment of debt.

Closely related to the restriction on further debt is the position of the lender in the liquidation of assets. The holder of a straight debt issue will usually demand to be senior to other debt holders. This characteristic is particularly suited to straight debt because straight debt is more vulnerable to default than convertible debt and doesn't have other sweetners such as a conversion right or a right to participate in distributions of earnings. The examiner will want to determine how the covenants affect future debt financing and if the effect is positive or negative.

The lender is likely to seek to insure that neither the structure nor policies of the bank holding company are altered without its approval during the life of the debt. The lender can insure this through other negative covenants attached to the debt. Some common covenants of this type include (1) limitations on capital expenditures and on the sale of assets, (2) restrictions on the BHC's redemption of its own stock, (3) restrictions on investments in general, (4) restrictions on dividend payment without prior approval, and (5) the imposition of loan to capital ratios, deposit to capital ratios and asset to capital ratios.

2080.2.4 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to policies on long-term debt.
2. To review the use of long-term funds.
3. To determine the existence of debt covenants and compliance by the holding company.

2080.2.5 INSPECTION PROCEDURES

1. Review the parent-only balance sheet and income statement for debt and interest expense captions.
2. Review the consolidated balance sheet and income statement for debt and interest expense captions.
3. Review any written policies and procedures available as part of an overall capital plan. If no plan or policies exist, the examiner should encourage management to develop them, and in large BHCs, to put them in writing.
4. Determine that the bank holding company does not finance long-term assets with short-term debt, as this leaves the holding company vulnerable to rising interest rates and the possibility of a credit crunch. On the other hand, it may be beneficial for the holding company to finance short-term assets with long-term debt. This is particularly true during periods of rising interest rates because the bank holding company can get higher yields on loans financed by lower cost long-term debt, than it can with commercial paper that has to be turned over at generally increasing rates. In any event, the bank holding company will need to insure that it has ample capacity to finance additional long-term assets with long-term debt when the opportunity presents itself.
5. Review any sinking fund provisions usually found with straight debt and straight preferred issues if the issue is not going to be refinanced by further debt or by an equity issue. Since payments to the fund will directly drain cash reserves, it is imperative that the bank holding company have adequate annual cash flow to service both the interest and add to the sinking fund. The larger the debt, the more the lender will look for a sinking fund feature as a means of precluding a default when maturity occurs and refinancing is not available. When a sinking fund exists the examiner will need to analyze the parent's cash flow statement to see that payments do not produce an adverse cash drain.

The capacity of the holding company to serve as a source of financial strength to its bank subsidiaries is a major consideration of the Federal Reserve Board in supervising a bank holding company. The cornerstone of this financial strength is capital adequacy.

The financial structure of banking organizations allows for the use of substantial leverage. If capital is large in relation to debt, additional borrowing is relatively inexpensive. However, because of added risk to lenders, the cost of borrowing increases as new obligations are assumed. At some point, therefore, equity financing becomes less costly and may become the only alternative available for needed funds.

Basically, a holding company's financial structure can be viewed in two ways: the ''single entity'' approach, whereby the holding company is considered an integrated entity and financial strength is assessed on the basis of its consolidated totals, and the ''building block'' approach, wherein the holding company is seen as a collection of individual components. In the latter view, the company's financial strength is assessed primarily in terms of the financial structure of each component.

When applying the ''building block'' approach, the liability and capital structure of each subsidiary is compared to the norm of its particular industry. The use of the ''building block'' approach has some advantages:

1. Comparative statistics are usually available to measure the performance and strength of the individual subsidiaries.
2. It permits comparison of capitalization between holding companies engaged in differing activities.
3. It identifies the degree of leveraging within a single subsidiary of a bank holding company.

The parent should maintain a favorable balance of debt and equity so that it will be able to assist its subsidiaries when necessary through contributions of its own capital or through additional funds generated from debt or equity financing.

At times, however, sale of additional stock may not be a viable alternative for capital formation, even when a company can show a favorable debt/equity balance. Reluctance to enter into a new stock offering may stem from a desire to avoid further dilution of existing ownership interest or from an unfavorable market price of outstanding stock in relation to book value. In these instances, long-term quasi-capital funds may sometimes be obtained through other sources, such as convertible securities or subordinated debt.

2080.3.1 PREFERRED STOCK

Preferred stock is becoming a more acceptable alternative due to certain advantages. Through contracted covenants, it is senior to common stock because it usually has no voting voice in management as does common stock. Preferred stock usually carries a fixed dividend rate that is either cumulative or noncumulative. Cumulative preferred provides that unpaid dividends in prior years must be paid to preferred shareholders before common dividends can be paid. A noncumulative feature provides that dividends foregone during lean years are lost permanently. From the viewpoint of the bank holding company, a noncumulative preferred issue is more desirable, while investors would desire a cumulative feature.

Perpetual preferred stock does not have a stated maturity date and it may not be redeemed at the option of the holder. Advantages that preferred stock can offer the bank holding company are (1) avoidance of dilution of earnings per common share and (2) absence of voting rights. On the other hand, dividend payments, particularly cumulative dividends, are expensive since they are not a tax-deductible expense as is interest on debt. Cumulative dividends can be particularly draining on cash when they are declared after several years of suspended dividends and payment is then made in a lump sum.

Preferred stock is usually retired by refinancing with debt or through its own conversion feature. If the bank holding company feels that it can afford an equity issue in the future but not at present, it can issue a convertible preferred debenture to postpone the equity issue until a later date. On the other hand, if debt is the desired method of financing but the present debt/equity ratio is not acceptable, the bank holding company will issue preferred and refinance with debt at a more opportune time. However, the Board has expressed concern that in applications to form a BHC, preferred stock not be used as a debt substitute resulting in circumvention of its debt guidelines. On applications with preferred stock which has debt-like characteristics, such stock may be treated as debt in the financial analysis.

2080.3.2 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to parent company policies on capital adequacy within the subsidiaries and for the consolidated organization.
2. To review the use of proceeds of equity capital financings.
3. To review any debt covenants that pertain to a minimum acceptable capital position.

2080.3.3 INSPECTION PROCEDURES

1. Review any existing BHC policies regarding capital adequacy or capital planning.
2. Request any plans regarding proposed capital issues.

Earnings retention provides the most immediate source of capital formation and growth. Earnings retained after dividend payout can often be sufficient to keep pace with asset growth, thereby preserving the balance or relationship between equity capital and total assets. Often referred to as ‘‘internal funding,’’ earnings retention should be carefully reviewed to assure that the BHC's capital base is keeping pace with asset growth.

Bank earnings retention should be reviewed carefully due to the dividend requirements often imposed on banks by their parent companies. Although a bank's board of directors must approve the declaration and payment of any bank dividend, often the bank's board is actually ratifying a decision determined at the parent level. The need for bank retention of earnings is particularly pronounced either during periods of expansion or periods of declining earnings or losses.

Parent company management may be under pressure from shareholders or ‘‘the market’’ to increase dividends or to maintain dividends at historic levels despite reversals in consolidated earnings trends. Examiners should be careful to point out to management that dividend pressures often serve to the detriment of the bank subsidiary(ies) which is often asked to supply the proceeds via a dividend to the parent company. As a regulator of banks (and bank holding companies), the Federal Reserve System is concerned with the preservation and maintenance of a sound banking system and in particular, soundly capitalized banks. Earnings retention contributes to capital growth and should be encouraged. For additional information on earnings retention and dividends see sections 2020.5.1, 4010.1, 4020.1, and 4060.9. See section 4070.1 of the *Commercial Bank Examination Manual*.

2080.4.1 PAYMENT OF DIVIDENDS BY BANK SUBSIDIARIES

Bank dividends can be determined to be excessive if they exceed the limitations imposed by either section 5199(b) or 5204 (also referred to as sections 56 and 60(b)) of the Revised Statutes and accordingly, should be reviewed with regard to those limitations. The Federal Reserve Board amended Regulation H regarding the payment of dividends by state member banks on December 20, 1990, [12 C.F.R. 208.19(a) and 208.19(b)]. The rule was revised, effective October 1, 1998, and replaced as renumbered section 208.5 (see 12 C.F.R. 208.5), ‘‘Dividends and other distributions.’’ It sets forth the ‘‘Limitation on withdrawal of capital by dividend or otherwise,’’ in subsection 208.5(d). The regulation discusses the elements that are taken into account in determining a state member bank's dividend paying capacity. Two different calculations are performed to measure the amount of dividends that may be paid, a Net Income Test and an Undivided Profits Test.

2080.4.1.1 Net Income Test

The approval of the Federal Reserve is required for dividends declared by a member bank that in any calendar year exceeds the net income of the current year, combined with retained net income for the two preceding years (the ‘‘Net Income Test’’).

2080.4.1.2 Undivided Profits Test

A member bank must receive prior approval of the Federal Reserve, and of at least two-thirds of the shareholders of each class of stock outstanding, before paying dividends in amounts greater than undivided profits.

Holding companies have turned to employee pension plans and, to a lesser degree, stock option plans as ways to provide added capital for holding company operations. While there may be a number of reasons for implementing such programs, one of the by-products is the flow of working capital into the holding company. The program usually involves a pre-tax contribution by the holding company to an employee benefit plan (e.g., profit sharing plan) and the resulting purchase by such plan of common or preferred shares of the holding company's stock. The holding company benefits through the use of the funds for working capital, and the plan provides for retirement benefits for employees as shareholders in the company. Since ESOPs are administered under the Employees Retirement Income Security Act of 1974 (ERISA), the guidelines delineated in SR 85–21 should be followed in determining whether possible ERISA violations exist. Reference should also be made to Manual section 4010.1.1.

2080.5.1 STOCK OPTION PROGRAMS

Employee stock option programs generate a nominal percentage of a holding company's financing needs to reward key employees for service rendered via the reduced price of the company's stock. While such programs constitute one method of available funding for a holding company, they generally may not be expected to add any capital amounts beyond nominal levels.

2080.5.2 EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Employee Stock Ownership Plans (ESOP) are an alternative holding company funding tool. An ESOP is a tax-qualified employee benefit plan which is designed to be invested primarily in employer stock. The concept of an ESOP is to encourage the establishment of employee benefit programs which expand the employees' share in company stock ownership. Participation in an ESOP may also significantly enhance employee motivation. The essential differences between an ESOP and other qualified stock bonus plans are that an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities, and that an employer may receive additional tax credits for amounts contributed to ESOPs. Under limited circumstances, lenders to ESOP's may also receive benefits that result in reduced borrowing costs to the ESOP. As long as ESOP meets the IRS requirements for a qualified employee plan, it may invest up to 100% of its assets in "qualifying" employer securities. It is exempt from some of the self-dealing limitations applicable to most employee benefit plans, as it is viewed as a means of providing stock ownership interests for employees rather than as strictly a retirement plan. Furthermore, an ESOP may purchase the stock either from the employer company or from shareholders. Therefore, in addition to use as a tool of corporate finance, an ESOP may serve as a ready purchaser for outstanding stock, without a corresponding loss of voting control.

ESOPs are in some ways similar to deferred profit sharing plans. ESOPs are authorized under the same section, namely, section 401 of the Internal Revenue Code. Employer contributions (within limits based on a percentage of eligible payroll) are allowable deductions from the employer's pre-tax income. Contributions are held in trust, and benefits when paid out upon an employee's retirement, death, or termination of service, must be paid in company stock. The distinguishing feature of an ESOP lies in the fact that the direct purpose of the plan is to invest employer contributions in the stock of the company.

2080.5.2.1 Accounting Guidelines for Leveraged ESOP Transactions

Newly issued or existing shares of BHC stock are sometimes sold to the ESOP and paid for with money borrowed from a third party; these types of ESOPs are commonly referred to as "leveraged ESOPs." The borrowings are generally serviced with contributions by the employer, which are a tax deductible expense. The borrowing arrangement by the ESOP often includes a guarantee or commitment by the employer (the BHC or the subsidiary bank) to make future contributions to the ESOP sufficient to meet debt service requirements.

When this occurs, questions arise involving the appropriate accounting for the leveraged ESOP transaction. The Accounting Standards Executive Committee of the American Institute of CPAs has issued a Statement of Position

(SOP) 72–3 which discusses ESOP borrowing situations. Since the Federal Reserve applies generally accepted accounting principles, banks and bank holding companies should follow SOP 76–3. The SOP statement covers cases where the employer either guarantees the ESOP loan or commits to make future ESOP contributions sufficient to service the debt. For such cases, the SOP indicates that the employer should credit a liability account for the amount of the ESOP debt and offset that entry by reducing shareholders' equity. The liability recorded by the employer should be reduced as the ESOP makes payments on the debt. This liability is recorded because the guarantee or commitment is in substance the employer's debt. When there is no guarantee, the ESOP is treated like any other shareholder.

In other words, where there is a leveraged ESOP which has purchased BHC stock, and there is a guarantee, commitment, or other arrangement which is in effect a guarantee relative to the debt service of the ESOP, for analytical purposes the amount of ESOP debt will be considered as parent debt and thus parent equity will be reduced accordingly. This will affect debt to equity ratios as well as consolidated capital ratios, where applicable.

2080.5.2.2 Fiduciary Standards under ERISA Pertaining to ESOPs

There are also general fiduciary standards under ERISA pertaining to ESOPs which have been delineated largely through court decisions rather than issuance of regulations. Although exempted from ERISA's asset diversification requirement, ESOP transactions are still required to meet fiduciary standards of prudence, and must be designed and administered for the ''exclusive benefit'' of plan employees. (ERISA §404(a) and 29 CFR 2550.407d–6). Yet, as stated above, ESOPs may have distinct advantages which inure primarily to the sponsoring company, its management and large shareholders. Due to these potential or actual conflicts of interest, it is important that the sponsoring employer and any other fiduciaries of a plan undertake every effort to assure full consideration of the best interests of plan employees.

The safeguarding of the statutory ''exclusive'' interests of plan employees pursuant to ERISA is within the jurisdiction of the IRS and the Department of Labor. The bank regulatory agencies also have some responsibility in their review and examination activities where employee benefit plans such as ESOPs are involved. In this connection, a Uniform Interagency Referral Agreement mandated by statute, has been in effect since 1980 whereby certain possible violations of the provisions of ERISA are referred to the DOL by the Division of Banking Supervision and Regulation, pursuant to delegated authority. SR 81–697 (SA) contains the procedures for making referrals to the Department of Labor. Attached to the SR letter is an exhibit, *ERISA Referral Format,* which lists the information necessary when making referrals. Holding company examiners can expedite the ERISA referral process by including that information in their reports.

2080.5.3 STATUS OF ESOP'S UNDER THE BHC ACT

On August 6, 1985, the Board determined (1985 FRB 804) that an ESOP that controls more than 25 percent of the voting shares of a bank or bank holding company is a bank holding company. The Board determined that the underlying trust which held the shares of the bank holding company is a ''business trust'' as defined in the BHC Act and was thus not excluded from the definition of a ''company'' under the terms of the Act.

2080.5.4 INSPECTION CONSIDERATIONS

Examiners should review unfunded pension liabilities of the BHC to determine their potential impact on the organization. In addition, examiners should review the soundness of any borrowings used to fund ESOP purchases of BHC stock. ESOP borrowings from an affiliated bank used to purchase BHC shares may result in an apparent increase in BHC capital which in fact turns out to have been funded with subsidiary bank funds, a practice considered suitable for in-depth review by examination staff. Section 401 (of the Internal Revenue Code) plan holdings of BHC stock need to be evaluated under the ''content'' provisions of the BHC Act, change in Bank Control Act, and Regulation Y.

When an ESOP is subject to the Change in Bank Control Act, this fact should be brought to the attention of a BHC's management. Section 225.41 of Regulation Y specifies transactions—acquisitions—that would require providing the Board with 60 days prior written notice before acquiring control of a bank holding company (or a state member bank), unless the transaction is exempt under section 225.42 of the Regulation. In addition to the above, a determination should be made as to whether the ESOP is a bank holding company. The examiner may also refer to the Financial Accounting Standards Board's Statement No. 87, ''Employers' Accounting for Pensions.''

A key principle underlying the Federal Reserve's supervision of bank holding companies and savings and loan holding companies (collectively, "holding companies") is that such holding companies should be operated in a way that promotes the safety and soundness of their subsidiary depository institutions. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their depository institutions. Consequently, holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent holding company and its nonbank subsidiaries.

2080.6.1 FUNDING BY SWEEPING DEPOSIT ACCOUNTS

A principal objective of a holding company's funding strategy should be to maintain an adequate degree of liquidity at the parent company and its subsidiaries. Funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in an organization's viability. In developing and carrying out funding programs, holding companies should give special attention to the use of overnight or extremely short-term liabilities since a loss of confidence in the issuing organization could lead to an immediate funding problem. Accordingly, holding companies relying on overnight or extremely short-term funding sources should maintain a level of superior quality assets, namely, assets that can be immediately liquidated or converted to cash with minimal loss, that is at least equal to the amount of those funding sources.

A potential source of funding mismatch arises from deposit sweeps. This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts) which permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent holding company. These obligations include such instruments as commercial paper, program notes, and master notes.

In view of the extremely short-term maturity of most sweep arrangements, firms should exercise great care when investing the proceeds. In general, appropriate uses of the proceeds of deposit sweep arrangements include short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment grade assets that can be disposed of with minimal loss of principal. Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems at the parent holding company that examiners would view as unsafe and unsound. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due would also be viewed as an unsafe and unsound banking activity.

Reserve Bank supervisory and examination personnel should consider the guidance in this section as well as SR-90-31, "Bank Holding Company Funding from Sweep Accounts," in determining whether holding companies engaged in sweep arrangements with their subsidiary banks are doing so in a safe and sound manner.[1]

1. The applicability of the guidance in SR 90-31 was extended to savings and loan holding companies. See SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

This manual presents several sections on control and ownership, which describe the concept of control as it is applied by the Federal Reserve under the relevant banking and/or savings and loan-related statutes.

This section defines control and explains why control is important from a supervisory perspective. Specifically, control is a threshold issue that is used to determine which companies and individuals (whether domestic or foreign) are subject to Federal Reserve regulatory oversight due to their relationships with, including ownership interests in, U.S. federally insured depository institutions. The Federal Reserve is responsible for evaluating the control relationships affecting bank holding companies (BHCs), savings and loan holding companies (SLHCs) (including banks and other subsidiaries), and banks. The following subsections specifically address control as it applies to companies, qualified family partnerships, individuals and certain companies, and BHC formations.[1]

2090.0.1 GOVERNING FRAMEWORK FOR COMPANIES

The Bank Holding Company Act (BHC Act) and the Home Owners' Loan Act (HOLA), and the Board's implementing regulations, Regulation Y (12 CFR part 225) and Regulation LL (12 CFR part 238) set forth the standards for what constitutes "control."[2] The standards are substantially similar under both statutes and their respective implementing regulations. Importantly, these control standards apply only to companies and other legal entities, not to individuals.[3] This section will largely focus on the BHC Act and Regulation Y for BHCs, although a similar set of principles and requirements apply under HOLA and Regulation LL for SLHCs. Therefore, the inspection procedures at the end of this section can be used in inspections of both BHCs and SLHCs.

Key definitions under the BHC Act and Regulation Y:

Company—any corporation, partnership, business trust, association, or similar organization, or any other trust unless by its terms it must terminate either within 25 years, or within 21 years and 10 months after the death of individuals living on the effective date of the trust.[4] "Company" does not include any corporation that is majority owned by the United States or any state, or any qualified family partnership.[5]

Bank holding company or BHC—any company that has control over any bank or over any company that is or becomes a BHC.[6]

Bank—includes an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. § 1813(h)); or an institution organized under certain laws specified by statute, which both (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (2) is engaged in the business of making commercial loans.[7] The statute includes several exceptions from the definition of "bank."[8]

Subsidiary—a bank or other company that is controlled by a BHC.[9]

2090.0.2 IMPORTANCE OF CONTROL

A company that is a BHC is subject to the supervisory and regulatory oversight of the Federal Reserve. Such oversight covers the direct

1. Appendix 1 provides additional information on regulations, interpretations, and orders related to controls and ownership.

2. BHC Act (12 U.S.C. § 1841 et seq.); HOLA (12 U.S.C. § 1467 et seq.).

3. Control is also determined under the Change in Bank Control Act or the CBC Act (see the section of this manual entitled, "Control and Ownership (Change in Control)"). The CBC Act applies to individuals, companies, and other legal entities. The CBC Act's definition of control has elements of the other two statutes, with "control" meaning "the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25 percent or more of any class of voting securities of an insured depository institution." Under the CBC Act, a prior notice generally is required for individuals or companies that seek to control 10 percent or more of a BHC's or SLHC's voting securities. For a bank or thrift that has no parent holding company, the notice is filed with the bank or thrift's primary federal banking regulator. As with the BHC Act and HOLA, exemptions from the prior notice requirements are available under certain circumstances under the CBC Act.

4. The exemption for trusts is narrower for SLHCs due to differences between HOLA and the BHC Act. See 12 CFR 238.2(m)(2)(ii).

5. 12 CFR 225.2(d)1.

6. 12 CFR 225.2(c)(1).

7. 12 U.S.C. § 1841(c)(1); 12 CFR 225.2(b)(1).

8. 12 U.S.C. § 1841(c)(2).

9. 12 CFR 225.2(o).

activities of the BHC, as well as those activities conducted by the BHC through its bank and nonbank subsidiaries. When designated a BHC, various requirements and restrictions come into effect, including examinations and regulatory reporting requirements, capital and liquidity requirements, source of strength obligations, cross-guarantee liability obligations among affiliated insured depository subsidiaries, activity restrictions, and restrictions on certain affiliate transactions involving insured depository subsidiaries.

The Board's authority over BHCs is guided by two key purposes of the BHC Act: (1) to ensure that companies that acquire control of banks (and other insured depository institutions, as under HOLA) have the financial strength and managerial ability to exercise control in a safe and sound manner; and (2) to separate banking from commerce by restricting the nonbanking activities of BHCs and by preventing companies with commercial interests from exercising control over banking organizations.[10]

A company must first obtain the prior approval of the Federal Reserve before becoming a BHC (see section 2090.2 for BHC Formations). In cases where control of a bank is obtained without prior approval of the Federal Reserve (whether intentionally or inadvertently), the controlling company must be brought into conformance with the BHC Act as soon as possible. Such a company will have to apply for BHC status (which may require the company to modify its activities) and/or divest some, or all, of its investment in the acquired bank.

2090.0.3 INVESTMENTS INVOLVING BANKING ORGANIZATIONS

A company (that is not a bank or BHC) can make an investment in a bank or BHC or receive an investment from a bank or BHC. An existing BHC can make an investment in another company, bank, or BHC. Accordingly, investments can be made according to the following scenarios:

Scenario 1: by a company (that is not a bank or BHC) in a bank or BHC,

Scenario 2: by a BHC in a company (that is not a bank or BHC), or

Scenario 3: by a BHC in a bank or BHC.

If the investment is deemed to be a *controlling* investment, then under

Scenario 1: the company (investing company/investor/acquirer) would be required to seek prior Federal Reserve approval to become a BHC,

Scenario 2: the company (investee company/investee/target) would become a subsidiary of a BHC, and

Scenario 3: the target bank or BHC would become a subsidiary of the acquiring BHC.

If the investment is deemed to be a *noncontrolling* investment, then under

Scenario 1: the company (investing company/investor/acquirer) would *not* be required to seek prior Federal Reserve approval to become a BHC,

Scenario 2: the company (investee company/investee/target) would *not* become a subsidiary of a BHC, and

Scenario 3: the target bank or BHC would *not* become a subsidiary of the investing BHC.

Investors and investees often seek to structure their investments in, or by, banks or BHCs in a manner to avoid a determination of control. Otherwise, if control exists, status as a BHC or a subsidiary thereof would result, subjecting the company to the Federal Reserve's oversight, as well as restrictions on certain activities.

An investing company/acquirer that proposes to invest in a bank or BHC often seeks a control determination from the Federal Reserve to understand whether the transaction will result in the company becoming a BHC, and therefore subject to the BHC Act. An existing BHC also may seek a control determination to limit its obligations to the investee company/target in which an investment is being made.

2090.0.4 DEFINITION OF CONTROL

Under section 2(a)(2) of the BHC Act, control is defined by a three-pronged test. A company has "control" of a bank or BHC, if any one of the following three prongs are met:

10. For the purposes of this section, "banking organizations" is a general term that applies to a BHC or an SLHC, and their related subsidiaries.

1. the company directly or indirectly owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or a company that is a BHC;
2. the company controls in any manner the election of a majority of the directors or trustees of a bank or a company that is a BHC; or
3. the company directly or indirectly exercises a controlling influence over the management or policies of a bank or a company that is a BHC.

The first and second prongs of the control test are generally straightforward. The third prong, or the "controlling influence" prong, is largely based on a set of tiered presumptions of control (discussed below).

2090.0.5 BACKGROUND ON CONTROLLING INFLUENCE

Under the BHC Act and HOLA, investing companies that own less than 5 percent are presumed not to control, whereas investing companies that own 25 percent or more, absolutely control for purposes of the statute. As a result, evaluation of the controlling influence prong arises for ownership levels in the range of 5 percent to less than 25 percent.

Typically, large noncontrolling investors seek to protect or enhance their investments through multiple forms of engagement with the target company. This approach provides the investor with an opportunity to monitor and influence the target company.

Based on the review of many individual cases over the years, the Board has developed standards that cover the most common factors or investment features that may give rise to controlling influence concerns. For example, these may include

- the size and structure of a company's voting and total equity investment;
- a company's rights to director representation;
- common management, employees, or directors between companies;
- restrictive covenants;
- business relationships; and
- other indicia of the ability or incentive of a company to exercise a controlling influence over a bank or BHC.[11]

In 2020, the Board issued a rule on Control and Divesture Proceedings (2020 rule),[12] which was subsequently codified in Regulations Y and LL. The 2020 rule sets forth standards for investors to rebut the presumption of control under the controlling influence prong, along with other important control-related items. The Board's 2020 rule expands substantially the number of control presumptions and makes some targeted adjustments from past practices. For example, noncontrolling investors may have a greater number of director representatives at their investee company, and investors can terminate an existing control relationship at greater levels of ownership. In addition, the use of passivity commitments are no longer needed, generally.[13] Overall, the 2020 rule provides the banking industry with greater transparency of the Federal Reserve's application of its control rules. As such, the 2020 rule is intended to facilitate and expedite permissible investments in and by banking organizations. Such investments may raise capital for the banking organization or form some type of strategic alliance.

2090.0.6 PRESUMPTIONS OF CONTROL

The 2020 rule establishes and describes a series of tiered presumptions of control based on voting securities and other important relationships or factors. These tiered presumptions and additional presumptions of control are listed in paragraphs (b) through (j) of section 225.32 of Regulation Y and section 238.22 of Regulation LL. See appendix 2 to this section for a summary of tiered presumptions.

The level of investment and all other aspects of the investor/investee relationship are to be considered in the aggregate when determining whether there is a presumption of control. Different standards apply once a company's level of voting securities exceeds 5 percent, 10 percent, and 15 percent. As an investing company's

11. Some of these standards have been codified in the Board's Regulation Y (see e.g., 12 CFR 225.138 and 12 CFR 225.139). In addition, the Board issued guidance through policy statements (see the section of this manual entitled, "Control and Ownership (Policy Statements on Equity Investments in Banks and Bank Holding Companies))."

12. 85 Fed. Reg. 12,398 (March 2, 2020).

13. Passivity commitments are a set of standardized restrictions that are used to support an absence of controlling influence entered between the investing company and the Board. Federal Reserve staff generally had requested passivity commitments when an investing company proposes to control 10 percent or more of a class of voting securities of a BHC or SLHC.

percentage of voting securities increases, the significance of the other relationships generally must decrease to avoid triggering controlling influence concerns.

The subsections below describe some of these investor/investee relationships and how they can represent a controlling influence over the target company.

2090.0.6.1 Director Representation

A company's level of representation on the board of directors of a target company is an important factor for controlling influence. The second prong of the control test (controlling in any manner the election of the majority of the board of directors of a target company) reinforces the importance that director representation has on determining a controlling influence. In addition to the share of director representatives that one company has on the board of directors of a target company, there may be a controlling influence if a particular director representative has an outsized ability to affect the decisions of the target company. For instance, the chair of the board of directors of a company is generally recognized as a leader of the company and its board of directors. Further, the chair may have additional powers, such as the ability to set the agenda for meetings of the board of directors. Similarly, certain committees of the board of directors may have the power to take actions that bind the company without the need for approval by the full board of directors. In these circumstances, such a committee is nearly equivalent to the full board of directors with respect to those decisions that it is empowered to make unilaterally.

2090.0.6.2 Business Relationships

A company's business relationships with another company provide a mechanism through which the investing company could exercise a controlling influence over the target company. For example, a business relationship between an investor and another company that accounts for a substantial portion of the revenues or expenses of the target company may provide a lever by which the investor could attempt to influence the target company. In addition, if a company can enter into a business relationship with a target company on terms that are not market terms, it is likely that the investing company has a significant level of influence over the target company. Business relationship thresholds generally are based on the size of these relationships as compared to total consolidated annual revenues and expenses. The Board also may consider other factors such as relationships that are difficult to replace and are necessary for core functions.

2090.0.6.3 Senior Management Interlocks

The officers of a company wield significant power over the company because they implement the major policies set by the board of directors, make the ancillary policy decisions necessary for implementation of a policy, and operate the company on a day-to-day basis. In addition, officers often make influential recommendations to the board of directors regarding major policy decisions. As a result of this substantial degree of influence, situations where an agent of a significant investor company serves as a management official of another company may provide a considerable avenue for the first company to exercise a controlling influence over the target company.

2090.0.6.4 Contractual Limits on Major Operational or Policy Decisions

A company that controls a material amount of voting securities of a target company also may have contractual arrangements with the target company, such as investment agreements, debt relationships, service agreements, or agreements related to other business relationships. Contractual rights often raise controlling influence concerns as an investor may have the ability to restrict significantly, directly or indirectly, the discretion of another company over operational or policy decisions, whether such decisions are made by management or by the other company's board of directors. The ability of an investor to significantly restrict an important business decision of a company generally provides the investor with the ability to exercise a significant influence over the company.

2090.0.6.5 Total Equity

The overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. A company is likely to pay heed to its large shareholders in order to maintain stability in its capital base, enhance its ability to raise future equity capital, and to prevent the negative market signal that may be created by the sale of a large block of equity by an unhappy shareholder. Under the Board's Regulation Y, a company will be presumed to control a target company when the first company controls one-third or more of the total equity of the target company.[14]

2090.0.6.6 Divestiture

The Board historically has taken the position that a company that has controlled another company may be able to exert a controlling influence over that company even after a substantial divestiture. The 2020 rule establishes that a company that previously controlled a target company during the preceding two years is presumed to continue to control the target company if the first company owned 15 percent or more of any class of voting securities of the target company. The divestiture presumption does not apply if a majority of each class of voting securities of the target company is controlled by a single unaffiliated individual or company after the divestiture by the investor company. Further, the divestiture presumption generally does not apply in cases where a company sells a subsidiary to a third company and receives stock of the third company as consideration for the sale.

2090.0.7 SUPERVISORY CONSIDERATIONS

The determination of whether an investment, or proposed investment, is a controlling or noncontrolling investment is separate and independent from the analysis of whether the investment raises safety-and-soundness concerns. Examiners should review terms of the investment, including all existing or planned relationships, in connection with the review of the investment. While the table in appendix 2 to this section provides guidance as to what is indicative of control, it can be used as a starting point to understand the details or additional elements surrounding an investment and any related relationships or rights between the investor and investee companies that may raise safety-and-soundness concerns. For example, business relationships may be a cause of concern when one company is dependent on the other for funding, regardless of whether it triggers any presumption of control. Similarly, a bank director or management official appointed by the investor company to serve at the target banking organization potentially could wield significant influence over deliberations and decisions of the target perhaps resulting in misaligned interests or new operational risks.

2090.0.8 INSPECTION OBJECTIVES

1. To confirm all 5 percent or greater shareholders (including the combined ownership interests of related parties) at an existing BHC or SLHC.
2. To determine whether any change in control has resulted in a company becoming a BHC in violation of section 3(a)(1) of the BHC Act (or HOLA for SLHCs), or an individual acquiring significant ownership interests in violation of the Change in Bank Control (CBC) Act.
3. To ascertain whether an existing BHC or SLHC has acquired either directly or indirectly additional banking assets in violation of section 3(a)(3) of the BHC Act (or HOLA for SLHCs).
4. To establish whether a BHC which has purchased its own stock is in compliance with section 225.4(b) of Regulation Y. (See this manual's section entitled, "Control and Ownership (Treasury Stock Redemptions).")

2090.0.9 INSPECTION PROCEDURES

1. Review the holding company's stock records and the company's investment portfolio. Also review the holding company's annual filing of form FR Y-6.
2. To assess compliance with the BHC Act, HOLA, and the CBC Act, review transactions involving an equity investment by a BHC or SLHC or by an individual or other company (investments into a BHC, SLHC, bank, or other company) that result in the investor owning 5 percent or more of the voting securities of the target company. Consider whether any such investments raise any safety-and-soundness concerns for the affected parties.

14. 12 CFR 225.32(c). For SLHCs, a lower standard of 25 percent of total equity applies under HOLA. See 12 U.S.C. § 1467a(a)(2)(B).

3. If the holding company has any subsidiaries that are indirectly owned or controlled, determine whether such shares are held in a trust and, if so, whether the trust agreement contains any provisions that could potentially expose the holding company or any of its subsidiaries to financial or other liabilities.

APPENDIX 1: REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Regulations*[1]	*Interpretations*[2]	*Orders*[3]
Regulation Y	225		
Regulation LL	238		
Direct control voting securities			1978 FRB 121
Indirect control as trustee		Ltr. 1/14/76 to W. Lloyd, Chicago Fed Ltr. 10/16/73 to W. Lloyd, Chicago Fed	
Acting through others			1970 FRB 350 1974 FRB 865 1972 FRB 717 1974 FRB 130 1974 FRB 131
Transfer of shares			1974 FRB 875
Rebuttable presumption of control • nonvoting stock • other indicators of control			1972 FRB 487 136 Fed. Reg. 18,945 (Sept. 24, 1971)
Procedures for determining control		S-2173 (Sept. 17, 1971) (at 4–191.1)	Patogonia vs. BOG 517 F. 2d 803 (9th Cir. 1975)
Nonvoting equity investments by BHCs	225.143	4-172.1	1982 FRB 413
Equity investments in banks and BHCs (2008 Policy Statement)	225.144		

1. 12 CFR, unless specifically stated otherwise.
2. Federal Reserve Regulatory Service reference.
3. Federal Reserve Bulletin (FRB) reference, unless specifically stated otherwise.

APPENDIX 2: SUMMARY OF TIERED PRESUMPTIONS

Presumption of control	*Less than 5% voting*	*5–9.99% voting*	*10–14.99% voting*	*15–24.99% voting*
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms	N/A	N/A	Market terms	Market terms
Officer/ Employee Interlocks	N/A	No more than 1 interlock, never chief executive officer (CEO)	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (Directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less

Note: Presumption triggered if any relationship exceeds the amount in the table.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to include a Board staff interpretation, pertaining to a qualified family partnership (QFP), that was issued on May 10, 2010. The interpretation considered whether a proposed assignment of an economic interest in the partnership interests of a partnership that is a QFP under section 2(o)(10) of the Bank Holding Company Act would cause the partnership to lose its status as a QFP.

2090.05.1 QUALIFIED FAMILY PARTNERSHIP EXEMPTION

Under the Bank Holding Company Act (the Act), any "company" (including a partnership) that controls a bank is considered a bank holding company (BHC).[1] Section 2(o) of the Act (as amended by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996),[2] however, provides a limited exemption from the definition of company for a "qualified family partnership" (QFP), and accordingly, a partnership that qualifies as a QFP is not considered a BHC under the Act.[3] A QFP, under the Act, is able to own and control a BHC without the partnership becoming subject to the registration, source of strength, approval, reporting, and other requirements imposed on a BHC.

In order to qualify for the Act's exemption for a QFP, all the partners of the QFP must be individuals related to each other by blood, marriage, or adoption; or trusts for the primary benefit of those individuals (collectively, "qualified parties"). In addition, the partnership must

- control any bank (its bank investments) through a single registered BHC that remains subject to all of the provisions of the Act;
- control only one registered BHC;
- not engage in any business activity except indirectly through ownership of other business entities (that is, the partnership must be an investment vehicle for the family and may not be an operating company);
- limit its investments to those permitted for a BHC under section 4(c) of the Act; and
- not be obligated on any debt, either directly or as a guarantor.[4]

Any partnership requesting qualification as a QFP must commit (1) to be subject to Federal Reserve Board examination to ensure compliance with the conditions for eligibility and (2) to be treated as a BHC for purposes of enforcement actions by the Board. In addition, while a QFP is exempt from the prior-approval requirements of section 3 of the Act in connection with a bank acquisition, the partnership continues to be subject to the notice provisions of the Change in Bank Control Act.

As noted above, the primary benefits to becoming a QFP are (1) exemption from the capital requirements applicable to BHCs, (2) exemption from the reporting requirements applicable to a BHC, and (3) the freedom to make permissible nonbanking investments without prior Board approval. Because the QFP must use a single registered BHC to hold all of its bank investments, there continues to be a BHC subject to the requirements of the Act in every case. This structure ensures that the cross-guarantee provisions of the Federal Deposit Insurance Act continue to apply to all banks controlled by a QFP.

2090.05.2 ASSIGNMENT OF ECONOMIC PARTNERSHIP INTEREST THAT IS A QFP

Board staff issued a May 10, 2010, interpretation on whether a proposed assignment of an economic interest in the partnership interests of a partnership that is a QFP under section 2(o)(10) of the Act would cause the partnership to lose its status as a QFP.[5] Board staff noted that the QFP exemption does not distinguish between the legal and beneficial ownership of such partnership interest. An assignment of the economic interests in a QFP interest, especially in the case of a limited partnership interest, would effectively give the assignee a beneficial interest in the QFP. Where the assignee is not a family member, Board staff believes that such

1. 12 U.S.C. 1841(a)(1).
2. Pub. L. 104-2089, section 2610; 110 Stat. 3009.
3. 12 U.S.C. 1841(b).
4. The QFP also must commit to examination by the Board and to the notice requirements of the Change in Bank Control Act if it acquires an additional bank.
5. 12 U.S.C. 1841(o)(10).

an assignment would undermine the ‘‘family relationship’’ requirement of the Act and would expand the exemption beyond its limited scope. Accordingly, Board staff believes that an assignment of the economic interests in the partnership interest of a QFP to a non-qualified person would be inconsistent with the ‘‘relationship’’ requirement of the statute. The partnership would not be in compliance with the statutory requirements of a QFP and would be required to register as a BHC.

The Change in Bank Control Act of 1978 (the CBC Act), title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, gives the federal bank supervisory agencies the authority to disapprove changes in control of insured depository institutions.[1] The Federal Reserve Board is the responsible federal banking agency for changes in control of bank holding companies and state member banks, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are responsible for insured state nonmember and national banks respectively.

The CBC Act requires any person (that is, an individual, a partnership, a corporation, a trust, an association, a joint venture, a pool, a sole proprietorship, or an unincorporated organization) seeking to acquire control of any insured depository institution or bank holding company to provide 60 days' prior written notice to the appropriate federal banking agency. The act specifically exempts transactions that are subject to section 3 of the Bank Holding Company Act of 1956 or section 18 of the Federal Deposit Insurance Act because those transactions are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and changes in control of insured depository institutions resulting from mergers, consolidations, or other similar transactions are not covered by the CBC Act.

The CBC Act describes the factors that the Federal Reserve and the other federal banking agencies are to consider in determining whether a transaction covered by the CBC Act should be disapproved. These factors include the financial condition, competence, experience, and integrity of the acquiring person (or persons acting in concert); the effect of the transaction on competition; whether the acquiring persons have provided all required information; and whether the proposed transaction would result in an adverse effect on the Bank Insurance Fund or the Savings Association Insurance Fund. The Federal Reserve Board's objectives in its administration of the CBC Act are to enhance and maintain public confidence in the banking system by preventing identifiable, serious adverse effects resulting from anticompetitive combinations of interests, inadequate financial support, and unsuitable management in the institutions. The Board will review each notice to acquire control of a state member bank or bank holding company and will disapprove transactions that are likely to have serious harmful effects. The Board's intention is to administer the CBC Act in a manner that will minimize delays and government regulation of private-sector transactions.

If the Board disapproves a change-in-control filing, the Board will notify the proposed acquiring party in writing within three days after its decision. The notice of disapproval will include a statement of the basis for disapproval. The CBC Act provides that the acquiring party may request a hearing by the Board in the event of a disapproval and provides a procedure for further review by the courts.

Forms for filing notices of proposed transactions covered by the CBC Act are available from the Federal Reserve Banks. Persons contemplating an acquisition that would result in a change in control of a BHC or state member bank should request the appropriate forms and instructions from the Reserve Bank in whose District the affected institution is located. Forms and instructions may also be accessed from the Federal Reserve Board's public web site (www.federalreserve.gov). The primary forms to be completed are the Interagency Biographical and Financial Report and the Interagency Notice of Change in Control. Filers are requested to consult with the appropriate Reserve Bank to confirm what specific information should be included in a particular notice. The Reserve Bank can provide specialized publication material that will assist the filers in placing a complete announcement of the proposed acquisition in the appropriate newspaper of general circulation. The Board of Governors also will publish the notices in the *Federal Register*. (See SR-03-19.)

When a substantially complete notice is received by the Federal Reserve Bank, a letter of acknowledgment will be sent to the acquiring person indicating the date of receipt. After reviewing the submitted information, the Federal Reserve may initiate name checks with certain other U.S. government agencies (including law enforcement) on some or all of the individuals related to the proposal. The information received from those name checks will be used to further the assessment of the relevant statutory factors, including the competence,

1. The term *insured depository institution* includes any depository institution holding company and any *other* company that controls an insured depository institution. The CBC Act is found in 12 U.S.C. 1817(j)(1)–(18).

experience, integrity, and financial ability of the individual filers.

2090.1.1 COMMITMENTS AND CONDITIONS FOR APPROVAL

Approvals granted by the Federal Reserve under the CBC Act may be subject to commitments or conditions that require the filer to consult with appropriate Federal Reserve staff before acquiring further shares of the subject banking organization. The Board or the Reserve Bank may also impose restrictions on the acquisition of additional shares by any person who already controls an institution. The imposition of such commitments, conditions, or limitations is intended to ensure that statutory factors remain consistent with approval.

2090.1.2 COMPLETION OF THE TRANSACTION

The transaction may be completed 61 days after the date of receipt stated in the acknowledgment letter, unless the acquiring person has been notified by the Board that the acquisition has been disapproved or that the 60-day period has been extended as provided for in subparagraph (j)(1) of the CBC Act. To avoid undue interference with normal business transactions, the Board may issue a notice of its intention not to disapprove a proposal, after consulting with the relevant state banking authorities as the CBC Act requires.

2090.1.3 INFORMATION TO BE INCLUDED IN NOTICES

The CBC Act requires a person proposing to acquire control of a bank holding company or state member bank to file a notice with the Federal Reserve Board that includes biographical and financial information on the filers; details of the proposed acquisition; information on any proposed structural, managerial, or financial changes that would affect the banking organization to be acquired; and other relevant information required by the Board.

A current statement of assets and liabilities, a brief income summary, and a statement of any material changes since the effective date of this financial-statement information is required. The Board reserves the right to require up to five years of financial data from any acquiring person. For complete details on the informational requirements of a change-in-control filing, see the Board's public web site at www.federalreserve.gov/generalinfo/applications/afi/. In particular, review the System's Form FR 2081a, Interagency Notice of Change in Control.

2090.1.4 TRANSACTIONS REQUIRING SUBMISSION OF PRIOR NOTICE

The CBC Act defines *control* as the power, directly or indirectly, to vote 25 percent or more of any class of voting securities or to direct the management or policies of a bank holding company or insured depository institution. Therefore, unless exempted by the CBC Act, any transaction that results in the acquiring party having voting control of 25 percent or more of any class of voting securities or that results in the power to direct the management or policies of such an institution would trigger the notice requirement. However, any person who on March 9, 1979, controlled a bank holding company or state member bank shall not be required to file a notice to maintain or increase control positions in the same institution. In addition, the Board's regulation on a rebuttable presumption of control allows persons who on March 9, 1979, fell within a presumption to acquire additional shares of an institution without filing notice so long as they will not have voting control of 25 percent or more of the institution (Regulation Y, 12 C.F.R. 225.41). In connection with transactions that would result in greater voting control, such persons may file the required notice or request that the Board make a determination that they already control the institution.

Section 225.41 of Regulation Y sets forth the specific types of transactions that require prior notice under the CBC Act. Prior notice is required by any person (acting directly or indirectly) that seeks to acquire control of a state member bank or bank holding company. A *person* may include an individual, a group of individuals acting in concert, or certain entities (for example, corporations, partnerships, or trusts) that own shares of banking organizations but that do not qualify as bank holding companies. A person acquires *control* of a banking organization whenever the person acquires ownership, control, or the power to vote 25 percent or more of any class of voting securities of the institution.

2090.1.4.1 Rebuttable Presumption of Control

Persons who have the power to vote less than 25 percent of an institution's shares may be required to file notice under the Board's rebuttable presumption of control, found in section 225.41 of Regulation Y. The Board presumes that an acquisition of voting securities of a state member bank or bank holding company constitutes the acquisition of control under the CBC Act, requiring prior notice to the Board, if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 10 percent or more of any class of voting securities of the institution, and if—

1. the institution has registered securities under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78*l*); or
2. no other person will own, control, or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction.[2]

Other transactions resulting in a person's control of less than 25 percent of a class of voting shares of a bank holding company or state member bank would not result in control for purposes of the CBC Act. In addition, customary one-time proxy solicitations and the receipt of pro rata stock dividends are not subject to the CBC Act's notice requirements.

In some cases, corporations, partnerships, certain trusts, associations, and similar organizations that are not already bank holding companies may be uncertain whether to proceed under the CBC Act or under the Bank Holding Company Act with respect to a particular acquisition. These organizations should comply with the notice requirements of the CBC Act if they are not required to secure prior Board approval under the Bank Holding Company Act. However, some transactions (described in sections 2(a)(5)(D) and 3(a)(5)(A) and (B) of the Bank Holding Company Act), particularly foreclosures by institutional lenders, fiduciary acquisitions by banks, and increases of majority holdings by bank holding companies, do not require the Board's prior approval. They are considered subject to section 3 of the Bank Holding Company Act and, therefore, do not require notices under the CBC Act.

2090.1.4.2 Rebuttable Presumption of Concerted Action

The following persons are presumed to be acting in concert[3] and must file a CBC Act notice if their share of ownership reaches the required levels:

1. a company and any controlling shareholder, partner, trustee, or management official of the company, if both the company and the person own voting shares of the state member bank or bank holding company
2. an individual and the individual's immediate family
3. companies under common control
4. persons that are parties to an agreement, contract, understanding, relationship, or other arrangement, whether written or otherwise, regarding the acquisition, voting, or transfer of control of voting securities of a state member bank or bank holding company, other than through a revocable proxy
5. persons who have made or propose to make a joint filing under sections 13 and 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78m), and the rules promulgated thereunder by the Securities and Exchange Commission
6. any person and any trust for which the person serves as trustee

If there is any doubt whether a proposed transaction requires a notice, the acquiring person should consult the Federal Reserve Bank for guidance. The CBC Act places the burden of providing notice on the prospective acquiring person.

2090.1.5 TRANSACTIONS NOT REQUIRING ANY NOTICE

Section 225.42 of Regulation Y sets forth the transactions that do not require any notice under the CBC Act or that require after-the-fact notice. The following transactions do not require any notice to the Federal Reserve:

2. If two or more persons, not acting in concert, each propose to acquire simultaneously equal percentages of 10 percent or more of a class of voting securities of the state member bank or bank holding company, each person must file prior notice to the Board.

3. *Acting in concert* includes knowing participation in a joint activity or parallel action towards a common goal of acquiring control of a state member bank or bank holding company whether or not pursuant to an express agreement.

1. *Existing control relationships.* The acquisition of additional shares if the acquirer is deemed to already have control of the banking organization.
2. *An increase in previously authorized acquisitions.* The acquisition of additional shares of a class of voting securities of a state member bank or bank holding company by any person (or persons acting in concert) who acquired and maintained control of the institution after complying with federal requirements.
3. *Any acquisition subject to approval under the Bank Holding Company Act or the Bank Merger Act.* Any acquisition of voting securities subject to approval under section 3 of the BHC Act or under the Bank Merger Act (section 18(c) of the Federal Deposit Insurance Act).
4. *Transactions exempt under the BHC Act.*
5. *A proxy solicitation.* Receipt of a revocable proxy in connection with a proxy solicitation for the purpose of conducting business at a regular or special meeting of the institution if the proxy terminates within a reasonable time.
6. *Stock dividends.* Receipt of voting securities as a result of a stock dividend (if the proportional interest of the recipient remains substantially the same).
7. *Acquisition of voting securities of a foreign banking organization.* The acquisition of voting securities of a qualifying foreign banking organization.

2090.1.6 TRANSACTIONS NOT REQUIRING PRIOR NOTICE

The transactions that require after-the-fact notice include the acquisition of voting securities (1) through inheritance, (2) as a bona fide gift, or (3) in satisfaction of a debt previously contracted in good faith. In these situations, the appropriate Reserve Bank must be notified within 90 days after the acquisition, and the acquirer must provide any relevant information requested by the Reserve Bank.

2090.1.7 UNAUTHORIZED OR UNDISCLOSED CHANGES IN BANK CONTROL

In some instances, a person acquires control of a banking organization without submitting the prior or after-the-fact notice required by Regulation Y. These unauthorized or undisclosed changes in bank control may not be known to the person, the state member bank, or the bank holding company but are discovered by Reserve Bank examiners during an inspection or examination of the affected institution. In most cases, such a violation of the CBC Act is addressed by having the person immediately file a notice with the Federal Reserve requesting authority to retain the acquired shares.[4] The filing should include an explanation of the circumstances that resulted in the violation and a description of the actions that have been (or will be) taken by the filers to ensure no further violations of the statute. Although the burden to file a timely change in bank control notice is on the persons who are acquiring control or causing a change in control of a banking organization, an acquired banking organization or a banking organization undergoing a change in control may have better information regarding current ownership positions, including shareholder lists, than the acquiring individuals or individuals who propose a change in control. Therefore, it is important that state member banks and bank holding companies be familiar with the regulations and policies governing changes in bank control and, when possible, share such information with shareholders who have significant ownership positions.

2090.1.8 CHANGES OR REPLACEMENT OF AN INSTITUTION'S CHIEF EXECUTIVE OFFICER OR ANY DIRECTOR

Institutions must report promptly any changes or replacement of its chief executive officer or of any director, in accordance with paragraph 12 of the CBC Act. Under section 225.42(a)(7) of Regulation Y, acquisitions of control of foreign bank holding companies are also exempt from the prior-notice requirements of the CBC Act,

4. A violation may be addressed through two other means. The affected party may either (1) submit, for the Federal Reserve's approval, a specific plan for the prompt termination of the control relationship or (2) contest the preliminary determination of a control relationship by filing a response that sets forth the facts and circumstances in support of the party's position that no control exists or, if appropriate, presenting such views orally to Federal Reserve staff.

but this exemption does not extend to the reports and information required under paragraphs 9, 10, and 12 of the act. (See section 2090.1.5.)

2090.1.9 DISAPPROVAL OF CHANGES IN CONTROL

The CBC Act sets forth various factors to be considered in the evaluation of a proposal. The Board is required to review the competitive impact of the transaction; the financial condition of the acquiring person; and the competence, experience, and integrity of that person and the proposed management of the institution. In assessing the financial condition of the acquiring person, the Board will weigh any debt-servicing requirements in light of the acquiring person's overall financial strength and the institution's earnings performance, asset condition, capital adequacy, and future prospects, as well as the likelihood of an acquiring party making unreasonable demands on the resources of the institution.

2090.1.10 ADDITIONAL REPORTING REQUIREMENTS

Paragraph 12 of the CBC Act requires that whenever a change in control of a bank holding company occurs, each insured depository institution is required to report promptly to the appropriate federal banking agency any changes or replacement of its chief executive officer or of any director occurring in the next 12-month period. A statement of the past and current business and professional affiliations of the new chief executive officer or directors should be included in each institution's report.

Paragraph 9 of the CBC Act indicates that whenever any insured depository institution makes a loan secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company), the president or other chief executive officer of the lending bank shall promptly report such fact to the appropriate federal banking agency of the bank (or bank holding company) whose stock secures the loan. However, no report need be made when the borrower has been the owner of record of the stock for a period of one year or more or when the stock is that of a newly organized bank before its opening. Reports required by this paragraph shall contain information similar to the informational requirements of the Notice of Change in Control.

2090.1.11 STOCK REDEMPTIONS

A stock redemption by a BHC may result in an existing shareholder (or shareholders) owning 25 percent or more of a class of voting securities, which would require the filing of both a change-in-control and treasury stock notification. Furthermore, a stock redemption by a BHC may result in an existing shareholder (or shareholders) owning between 10 percent and 25 percent of the outstanding shares and being the largest shareholder, thereby resulting in a rebuttable presumption of control. For additional information, see section 2090.3 "Treasury Stock Redemptions."

2090.1.12 CORRECTIVE ACTION

The Federal Reserve has enforcement jurisdiction over those persons who file or *should file* notices under the CBC Act. Accordingly, violations of the requirement to file a change in bank control notice may result in the Federal Reserve taking enforcement action against the relevant persons in appropriate circumstances, including those involving willful or negligent misconduct. Violations may result in the persons being subject to a variety of sanctions, including the assessment of a civil money penalty.

Violations of the CBC Act are addressed through the same type of investigative and enforcement authority and formal corrective actions that are used in other administrative remedies (12 U.S.C. 1818(b)–(n)). The CBC Act also authorizes the assessment of civil money penalties for any violation of the CBC Act (12 U.S.C. 1817(j)(16)) and allows the Board to seek divestiture of a BHC or bank from any person or company who violates the CBC Act (12 U.S.C. 1817(j)(15)).

2090.1.13 INSPECTION OBJECTIVES

1. To determine that the BHC has complied with the prior-notification requirements of the CBC Act and that changes in ownership between 10 percent and 25 percent have been reviewed for *rebuttable presumption* considerations.
2. To determine that the BHC has complied with the reporting requirements of paragraph 12 of the CBC Act regarding changes in its

board of directors or its chief executive officer that occur within 12 months of a change in control.

3. To determine that the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act regarding loans made directly by the BHC secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company).

2090.1.14 INSPECTION PROCEDURES

1. Review the BHC's stock certificate register or log to determine if any person (or group of persons acting in concert) has acquired 10 percent or more of any class of voting securities.
2. Review changes in control of between 10 percent and 25 percent of any class of voting securities to determine if the controlling party is the single largest shareholder.
3. When inspecting a BHC that was the subject of a change in control and when a prior notification was filed, review the notification to determine that information submitted on the management of the BHC is still valid. When changes in directors or the chief executive officer occurred within 12 months of the change in control, determine if the BHC has reported such changes in compliance with paragraph 12 of the CBC Act.
4. When inspecting a BHC that has redeemed any of its own shares subsequent to March 9, 1979, thereby lowering the number of shares outstanding, determine whether the holdings of any individual shareholder have increased proportionally to greater than 10 percent, which might trigger the rebuttable presumption of control and may require prior notification of a change in control.
5. Review any loans made directly by the BHC that are secured by 25 percent or more of the outstanding shares of a bank (or bank holding company) and determine if the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act.

2090.2.1 FORMATION OF A BANK HOLDING COMPANY AND CHANGES IN OWNERSHIP

The formation of a bank holding company (BHC) and certain changes in the ownership of banks owned by a BHC come under the provisions of section 3 of the BHC Act. Section 3(a)(1) prohibits the formation of a BHC without prior Board approval. A company may receive approval pursuant to section 3(a)(1) to become either a one-bank holding company or a multibank holding company.

Historically, there have been various tax benefits associated with forming a one-bank holding company, such as offsetting operating/capital losses of one corporation against the profits/capital gains of another.

Once a company becomes a BHC , either by the formation of a one-bank or multibank holding company, section 3(a)(3) of the act prohibits the direct or indirect acquisition of over 5 percent of any additional bank's or BHC's shares without prior Board approval. In addition to the above, section 3(a)(3) serves to prevent an existing BHC from increasing, without prior Board approval, its ownership in an existing subsidiary bank unless the BHC already owns 50 percent of the shares of the bank (section 3(a)(5)(B)). A BHC that owns more than 50 percent of a bank's shares may buy and sell those shares freely without Board approval, provided the ownership remains above 50 percent. If a BHC owns less than 50 percent of a bank's shares, prior Board approval is required before each additional acquisition of shares until the BHC's ownership of the bank reaches more than 50 percent.

2090.2.2 HISTORY OF THE POLICY STATEMENT ON SMALL BANK HOLDING COMPANIES

The Board issued the policy statement in 1980 to facilitate the transfer of ownership of small community-based banks in a manner consistent with bank safety and soundness. The Board has generally discouraged the use of debt by BHCs to finance the acquisition of banks or other companies because high levels of debt can impair the ability of the holding company to serve as a source of strength to its subsidiary banks. The Board has recognized, however, that small BHCs have less access to equity financing than larger BHCs and that the transfer of ownership of small banks often requires the use of acquisition debt. Accordingly, the Board adopted the policy statement to permit the formation and expansion of small BHCs with debt levels that are higher than typically permitted for larger BHCs. The policy statement, which is in an appendix of Regulation Y (12 C.F.R. 225, appendix C), contains several conditions and restrictions designed to ensure that small BHCs that operate with the higher levels of debt permitted by the policy statement do not present an undue risk to the safety and soundness of their subsidiary banks.

2090.2.3 SMALL BANK HOLDING COMPANY AND SAVINGS AND LOAN HOLDING COMPANY POLICY STATEMENT

In acting on applications filed under the BHC Act, the Board has adopted and continues to follow the principle that BHCs should serve as a source of strength for their subsidiary banks. When BHCs incur debt and rely on the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect on the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company level impairs the ability of a BHC to provide financial assistance to its subsidiary bank(s), and, in some cases, the servicing requirements on such debt may be a significant drain on the resources of the bank(s). For these reasons, the Board has not favored the use of acquisition debt in the formation of BHCs or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board therefore has permitted the formation and expansion of small BHCs with debt levels higher than would be permitted for larger BHCs. Approval of these applications has been given on the condition that the small BHCs demonstrate the ability to service the acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary banks within a relatively short period of time.

In the interest of continuing its policy of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has, as described below, adopted the following procedures and standards for the formation and expansion of small BHCs subject to this policy statement.

2090.2.3.1 Applicability of Policy Statement

The policy statement applies only to BHCs with *pro forma* consolidated assets of less than $3 billion that (1) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (2) do not conduct significant off-balance-sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (3) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. The Board may in its discretion exclude any BHC, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes. With the exception of section 4 (Additional Application Requirements for Expedited/Waived Processing), the policy statement applies to savings and loan holding companies (SLHCs) as if they were BHCs. While this policy statement primarily applies to the formation of small BHCs, it also applies to existing BHCs that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions.[1] The criteria are described below.

2090.2.3.2 Ongoing Requirements

The following guidelines must be followed on an ongoing basis for all organizations operating under this policy statement.

2090.2.3.2.1 Reduction in Parent Company Leverage

Small BHCs are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board expects that these BHCs reach a debt-to-equity ratio of .30 to 1 or less within 12 years after incurrence of the debt.[2] The BHC must also comply with debt-servicing and other requirements imposed by its creditors.

Subordinated debt associated with trust preferred securities generally would be treated as debt for purposes of paragraphs 2.C. (dividend restrictions), 3.A. (minimum down payment), 4.A.i (expedited treatment of certain filings), and 4.B.i (stock redemption filing requirements) of the policy statement. A BHC, however, may exclude from debt an amount of subordinated debt associated with trust preferred securities that is up to 25 percent of the BHC's equity (as defined below) less goodwill on the parent company's balance sheet, in determining compliance with the requirements of such paragraphs of the policy statement. In addition, a BHC subject to the policy statement that has not issued subordinated debt associated with a new issuance of trust preferred securities after December 31, 2005, may exclude from debt any subordinated debt associated with trust preferred securities until December 31, 2010. BHCs subject to this policy statement may also exclude from debt until December 31, 2010, any subordinated debt associated with refinanced issuances of trust preferred securities originally issued on or prior to December 31, 2005, provided that the refinancing does not increase the BHC's outstanding amount of subordinated debt. Subordinated debt associated with trust preferred securities will not be included as debt in determining compliance with any other requirements of this policy statement.

In addition, notwithstanding any other provision of the policy statement and for purposes of compliance with paragraphs 2.C., 3.A., 4.A.i., and 4.B.i. of the policy statement, both a BHC that is organized in mutual form and a BHC that has made a valid election to be taxed under Subchapter S of Chapter 1 of the U.S. Internal Revenue Code may exclude from debt subordinated debentures issued to the United States Department of the Treasury under (1) the

1. The appropriate Reserve Bank should be contacted to determine the manner in which a specific situation may qualify for treatment under this policy statement.

2. The term *debt* as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions) and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds.

Troubled Asset Relief Program established by the Emergency Economic Stabilization Act of 2008. (See 74 Fed. Reg. 26,077 (June 1, 2009), Division A of Public Law 110-343, 122 Stat. 3765 (2008)), and (2) the Small Business Lending Fund established by the Small Business Jobs Act of 2010, title IV of Public Law 111-240, 124 Stat. 2504 (2010).

The term *equity* as used in the ratio of debt to equity, means the total stockholders' equity of the BHC, as defined in accordance with generally accepted accounting principles. In determining the total amount of stockholders' equity, the BHC should account for its investments in the common stock of subsidiaries by the equity method of accounting.[3]

Ordinarily, the Board does not view redeemable preferred stock as a substitute for common stock in a small BHC. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) the preferred stock is redeemable only at the option of the issuer and (2) the debt-to-equity ratio of the holding company would be at or remain below .30:1 following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.

2090.2.3.2.2 Capital Adequacy

Each insured depository subsidiary of a small BHC is expected to be well capitalized. Any institution that is not well capitalized is expected to become well capitalized within a brief period of time.

2090.2.3.2.3 Dividend Restrictions

A small BHC whose debt to equity ratio is greater than 1.0:1 is not expected to pay corporate dividends until such time as it reduces its debt to equity ratio to 1.0:1 or less and other wise meets the criteria set forth in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.[4]

Small BHCs that become newly subject to the policy statement may switch to a plan that adheres to the intent of the policy statement provided they comply with the requirements set forth above.[5]

2090.2.3.3 Core Requirements for All Applicants

In assessing applications or notices by organizations subject to the policy statement, the Board will continue to take into account a full range of financial and other information about the applicant, and its current and proposed subsidiaries, including the recent trend and stability of earnings, past and prospective growth, asset quality, the ability to meet debt servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the following requirements:

2090.2.3.3.1 Minimum Down Payment

The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incurs debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the BHC, unless the owner(s) can demon-

3. For additional information on calculating equity, the denominator of the debt-to-equity ratio, see the instructions for calculating total equity capital in the Parent Company Only Financial Statements for Small Holding Companies (FR Y-9SP) report. Total equity capital includes perpetual preferred stock (including related surplus), common stock (including related surplus), retained earnings, accumulated other comprehensive income, and all other equity capital components including the total carrying value (at cost) of treasury stock and unearned Employee Stock Ownership Plan (ESOP) shares.

4. Dividends may be paid by small BHCs with debt to equity at or below 1.0:1 and otherwise meeting the requirements of sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) if the dividends are reasonable in amount, do not adversely affect the ability of the BHC to service its debt in an orderly manner, and do not adversely affect the ability of the subsidiary banks to be well-capitalized. It is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt to equity ratio be reduced to .30:1 within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

5. On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) was enacted. See Public Law 115-174 (May 24, 2018). Section 207 of EGRRCPA directed the Federal Reserve Board to revise the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement to raise the consolidated assets threshold from less than $1 billion to less than $3 billion within 180 days of the enactment of EGRRCPA. For the interim final rule, see 83 Fed. Reg. 44,195 (August 30, 2018).

strate that such debt can be serviced without reliance on the resources of the bank(s) or BHC.

2090.2.3.3.2 Ability to Reduce Parent Company Leverage

The BHC must clearly be able to reduce its debt-to-equity ratio and comply with its loan agreement(s) as stated within the ongoing requirements for reduction in parent company leverage, discussed under "Minimum Down Payment." Failure to meet the criteria would normally result in denial of an application.

2090.2.3.4 Additional Application Requirements for Expedited/Waived Processing

2090.2.3.4.1 Expedited Notices under Sections 225.14 and 225.23 of Regulation Y

A small BHC proposal will be eligible for the expedited processing procedures set forth in sections 225.14 and 225.23 of Regulation Y if (1) the BHC is in compliance with the ongoing requirements of this policy statement, (2) the BHC meets the previously discussed core requirements for all applicants noted above, and (3) the following requirements are met:

1. The parent BHC has a pro forma debt-to-equity ratio of 1.0:1 or less.
2. The BHC meets all the criteria for expedited action of sections 225.14 and 225.23 of Regulation Y.

2090.2.3.4.2 Waiver of Stock-Redemption Filing

A small BHC will be eligible for the stock-redemption filing exemption for well-capitalized BHCs that is found in section 225.4(b)(6) if the following requirements are met:

1. The parent BHC has a *pro forma* debt-to-equity ratio of 1.0:1 or less.
2. The BHC is in compliance with the ongoing requirements of this policy statement and meets the requirements of sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.

2090.2.4 INSPECTION OBJECTIVES

1. To determine compliance with all commitments made in the application/notification process.
2. To determine whether the BHC or SLHC is in compliance with the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (Regulation Y, appendix C), including whether the BHC's debt is being reduced within the required or expected time periods.

2090.2.5 INSPECTION PROCEDURES

1. Review all commitments made by the company and its shareholders to determine compliance therewith.
2. Determine whether the BHC or SLHC is in compliance with the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (Regulation Y, appendix C) by—
   a. verifying that the board of directors and senior management have established and regularly maintain a plan to
      - retire the BHC's or the SLHC's debt within 25 years of incurring the debt and
      - reach a debt-to-equity ratio of .30:1 or less within 12 years of incurring the debt.
3. Ascertain if the BHC uses a regular periodic monitoring process to ensure the full retirement of the holding company's debt within the above-stated required or expected periods.
4. Determine whether each insured depository subsidiary of a small BHC is well capitalized or, if not, whether it will be well capitalized within a brief period of time.
5. Determine whether the payment of corporate dividends has been restricted until the BHC's debt-to-equity ratio is 1.0:1 or less and until the BHC otherwise meets the criteria set forth in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.

2090.2.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Capital adequacy guidelines of BHCs, SLHCs, and state member banks (Regulation Q)		217	3–2100	
Small BHC and SLHC Policy Statement Regulation Y, appendix C		225	4–868	
Expedited action for certain acquisitions by well-run BHCs		225.14	4–024.1	
Expedited action for nonbanking proposals by well-run BHCs		225.23	4–037.1	
Savings and loan holding companies (Regulation LL) — Small BHC Policy Statement		238.8	4–750.8	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

"Bootstrapping" is the term generally used to describe a treasury stock transaction in which a company incurs debt to purchase or redeem its own outstanding shares. Bootstrapping is often used to facilitate a change in control whereby a shareholder or shareholder group need only buy few or no shares in order to gain control. The repurchase or redemption is often made in accordance with a written agreement made between a former controlling shareholder(s) and the new controlling shareholder(s).

Section 225.4(b) of Regulation Y requires a bank holding company to file prior written notice with the Board before a purchase or redemption of any of its own equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. (Net consideration is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period other than as a part of a new issue.)

Each notice shall furnish the following information:

- The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms of any debt incurred in connection with the transaction.
- A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions.
- A current and pro forma consolidated balance sheet if the bank holding company has total assets of over $150 million, or a current and pro forma parent-company-only balance sheet if the bank holding company has total assets of $150 million or less.

2090.3.1 CHANGE IN CONTROL ACT CONSIDERATIONS

As indicated earlier, treasury stock redemptions are often intended to facilitate a change in control of a bank holding company. By redeeming the shares held by an existing shareholder(s), the remaining shareholder(s) increases his proportionate ownership. If a "person's" share ownership should rise above 25 percent or more of the remaining outstanding shares (subsequent to March 9, 1979), that person would then "control" the BHC. Under these circumstances, a change in control notification would have to be filed. If the treasury stock redemption is for an amount sufficient to trigger the requirement for a prior notification of redemption, then dual notifications are called for (change in control and redemption of treasury shares).

Similarly, prior notification is also required if a treasury stock redemption should result in a shareholder's holdings rising to between 10 percent and 25 percent of the remaining outstanding shares, and if (a) that shareholder is the firm's largest single shareholder immediately after the acquisition; or (b) the institution is registered under section 12 of the Securities Exchange Act of 1934 (i.e., corporations having assets exceeding $1 million, more than 500 shareholders, and securities that are publicly traded). For additional information on change in control notification requirements, see section 2090.1.

Additional notices under the CIBC Act do not have to be filed if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a bank holding company, and subsequent treasury stock redemptions resulted in ownership of between 10 and 25 percent of the shares of the bank holding company. Refer to section 225.41(a)(2) of Regulation Y.[1]

2090.3.2 INSPECTION OBJECTIVES

1. To determine that a BHC that has redeemed shares of its own stock has complied with section 225.4(b) of Regulation Y.

2. To determine that any new controlling shareholder of a BHC that has redeemed shares of its own stock has complied with section 225.41(a) of Regulation Y.

3. To determine if a treasury stock transaction has taken place for the purpose of depleting the original 25 percent equity investment in the purchase price.

1. Revised by the Board, effective November 9, 1990.

2090.3.3 INSPECTION PROCEDURES

1. Review the BHC's reconcilement of stockholders' equity to determine if shares have been redeemed.
2. If shares have been redeemed, review for compliance with treasury stock redemption approval and reporting requirements.
3. Determine whether the BHC is using, repeatedly, the less than 10 percent ownership exemption to avoid notice requirements, thus undermining the capital position of the banking organization, resulting in an unsafe and unsound practice.
4. Determine if the less than 10 percent ownership exemption is being used by the bank holding company when it does not satisfy the requirements of the Board's capital guidelines for redemptions.

   The exemption should not be used by a bank holding company that does not meet the Board's capital guidelines for redemptions. Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Use of the exemption could significantly reduce its capital. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.

   The exemption should not be used by a small one-bank holding company if it would increase its debt-to-equity ratios significantly above those relied on by the Board in approving its application to become a bank holding company.
5. If shares have been redeemed, determine if any shareholder's holdings have risen to 25 percent or more of the outstanding shares.
6. If shares have been redeemed, determine if any shareholder's holdings have risen to between 10 percent and 25 percent of the outstanding shares. Furthermore, determine whether the shareholder is then the largest shareholder or the institution has registered securities under section 12 of the Securities Exchange Act of 1934.
7. If a stock redemption occurred recently in a bank holding company, determine if the shareholders have maintained a 25 percent equity investment.

Control and Ownership (Policy Statements on Equity Investments in Banks and Bank Holding Companies) Section 2090.4

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2009, this section has been revised to incorporate the Board's September 21, 2008, "Policy Statement on Equity Investments in Banks and Bank Holding Companies." (See the Board's September 22, 2008, Press Release and section 2090.4.4.) The policy statement provides additional guidance on the Board's position on minority equity investments in banks and bank holding companies that generally do not constitute "control" for purposes of the Bank Holding Company Act. This policy updates the guidance found in the Board's July 1982 "Policy Statement on Nonvoting Equity Investments by Bank Holding Companies."

2090.4.1 OVERVIEW AND GUIDING PRINCIPLES

For many years, bank holding companies, nonbank financial companies, private equity funds, and other firms made minority equity investments in banks and bank holding companies. These investments often raised questions about the extent to which the investment would cause the investor to become subject to supervision, regulation, and the other requirements applicable to bank holding companies under the Bank Holding Company Act (BHC Act or the Act) and the Board's Regulation Y. In general, the BHC Act applies to any company that controls a bank or bank holding company (banking organization). The BHC Act provides that a company has control over a banking organization if (1) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the banking organization; (2) the company controls, in any manner, the election of a majority of the directors or trustees of the banking organization; or (3) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.[1] Minority equity investments in banking organizations are designed not to trigger either of the first two prongs of the definition of control. These investments often raised questions, however, regarding whether the investor would be able to exercise a controlling influence over the management or policies of a banking organization.[2]

The text and legislative history of the control definition in the BHC Act make manifest that possession by an investor of a modicum of influence over a banking organization would not amount to a controlling influence. At the same time, the definition does not require that an investor have absolute control over the management and policies of a banking organization. Instead, the Act requires that an investor be able to exercise an amount of influence over a banking organization's management or policies that is significant but less than absolute control in fact of the banking organization. Notably, the primary definition of control in the Act is based on ownership of 25 percent or more of the voting shares of a banking organization—an amount that does not provide an investor in most cases with complete control over decisions but would allow the investor to play a significant role in the decision-making process.

In assessing whether an investor has the ability to exercise a controlling influence over a banking organization, the Board has been especially mindful of two key purposes of the BHC Act. First, the BHC Act was intended to ensure that companies that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner. The BHC Act is premised on the principle that a company that controls a banking organization may reap the benefits of its successful management of the banking organization but also must be prepared to provide additional financial and managerial resources to the banking organization to support the company's exercise of control. In this way, the Act ties the potential upside benefits of having a controlling influence over the management and policies of a banking organization to responsibility for the potential downside results of exercising that controlling influence. By tying control and responsibility together, the Act ensures that

1. 12 U.S.C. 1841(a)(2).

2. Contemporaneous minority investments in the same banking organization by multiple different investors also often raise questions about whether the multiple investors are a group acting in concert for purposes of the Change in Bank Control Act or are a single association for purposes of the BHC Act. These questions are beyond the scope of the 2008 Policy Statement.

companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decision-making process, thus protecting taxpayers from imprudent risk taking by companies that control banking organizations. Minority investors in banking organizations typically seek to limit their potential downside financial exposure in the event of the failure of the banking organization. Concomitantly, the BHC Act requires that minority investors seeking this protection limit their influence over the management and policies of the banking organization.

Second, the BHC Act was intended to limit the mixing of banking and commerce. In particular, the Act effectively prevents commercial firms and companies with commercial interests from also exercising a controlling influence over a banking organization. Many minority investors in banking organizations own commercial investments that conflict with this limitation.

2090.4.2 BOARD'S 1982 POLICY STATEMENT ON NONVOTING EQUITY INVESTMENTS BY BANK HOLDING COMPANIES

On July 8, 1982, the Board issued a Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the 1982 Policy Statement) to provide guidance on the Board's interpretation of the ''controlling influence'' prong of the control definition in the BHC Act.[3] That statement for the first time outlined the policies that the Board would consider in reviewing whether a minority investment in a banking organization would result in the exercise by the investor of a controlling influence over the management or policies of the banking organization. The 1982 Policy Statement focused on issues of particular concern in the 1980s in the context of investments by bank holding companies in out-of-state banking organizations. For example, the 1982 Policy Statement primarily addressed investments that included a long-term merger or stock purchase agreement between the investor and the banking organization that would be triggered on a change in the interstate banking laws, and so-called ''lock-up'' arrangements designed to prevent another company from acquiring the banking organization without the permission of the investor.

The 1982 Policy Statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognized that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case.

2090.4.2.1 Statutory and Regulatory Provisions

Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 percent of the voting shares of a bank without the Board's prior approval (12 U.S.C. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: that is, in the words of the statute, ''for any action to be taken that causes a bank to become a subsidiary of a bank holding company'' (12 U.S.C. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if

1. The company directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting shares of the bank;
2. The company controls in any manner the election of a majority of the board of directors of the bank; or
3. The Board determines, after notice and opportunity for hearing that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank (12 U.S.C. 1841(d)).

2090.4.2.2 Review of Agreements

Prior to the permissibility of interstate banking, bank holding companies sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 percent of the voting shares or control of the acquiree. These invest-

3. See 1982 FRB 413, 12 C.F.R. 225.143, or the *F.R.R.S* at 4-172.1.

ments involved a combination of the following arrangements:

1. Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);
2. Merger or asset acquisition agreements with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;
3. Provisions that limit or restrict major policies, operations, or decisions of the acquiree; and
4. Provisions that make acquisitions of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights were not exercisable by the investing bank holding company until interstate banking was permitted. They were transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

After a careful review of a number of these arrangements, the Board concluded that investments in nonvoting stock, absent other arrangements, could be consistent with the Act. Some of the agreements reviewed appeared consistent with the Act because they were limited to investments of relatively moderate size in nonvoting equity that may become voting equity. . .

However, other agreements reviewed by the Board raised substantial problems of consistency with the control provisions of the Act because the investors. . . sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements sought to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggested control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprived the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on voting shares were within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities (12 C.F.R. 225.31(d)(2).

Finally, investors wished to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board took the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[4] The Board concluded that the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, could result in such a substantial position of leverage over the management of the acquiree as to involve a structure that would inevitably result in control prohibited by the Act.

2090.4.2.3 Provisions that Avoid Control

In 1982, the context of any particular agreement, provisions of the type described above were acceptable if combined with other provisions that serve to preclude control. The Board believed that such agreements would not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

As a first step towards avoiding control, management had to be free to conduct banking and permissible nonbanking activities. Another step to avoid control included the right of the acquiree to ''call'' the equity investment and

4. See Board letter dated March 18, 1982, to C.A. Cavendes, Sociedad Financiera.

options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right made such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

A measure to avoid problems of control arising through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree might have included a provision granting the acquiree a right of first refusal before warrants, options, or other rights may be sold and requiring a public and dispersed distribution of those rights if the right of first refusal is not exercised.

The Board concluded that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreement involving a greater percentage. This guideline was drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

One effect of the guideline was to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline also made provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

Finally, acquirers were to avoid certain arrangements regardless of other provisions in the agreement that were designed to avoid control. These are

1. Agreements that enabled the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 percent of the voting shares of the acquiree;
2. Agreements whereby the investing company had the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and
3. The acquisition of more than 5 percent of the voting shares of the acquiree that "simultaneously" with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

2090.4.2.4 Review by the Board

The 1982 Policy Statement did not constitute the exclusive scope of the Board's concerns, nor were the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act.

2090.4.3 ACTIVITIES OF BANKING ORGANIZATIONS AND BOARD DETERMINATIONS SUBSEQUENT TO THE 1982 POLICY STATEMENT

Many aspects of the 1982 Policy Statement have broader applicability and have served as the foundation for the Board's review more generally of whether a minority investment in a banking organization would give the investor a controlling influence over the management or policies of the banking organization. In this regard, the 1982 Policy Statement identified a number of structural measures that the Board believed would limit the ability of an investor to exercise a controlling influence over a banking organization. These included restricting the use of covenants that constrain the discretion of banking organization management, limiting the amount of voting and nonvoting shares of the banking organization acquired by the investor, and limiting the ability of the investor to transfer large blocks of voting shares.

The Board made clear in the 1982 Policy Statement that the complexity of legitimate business arrangements precluded establishing rigid rules designed to cover all situations and that decisions regarding the presence or absence of control must take into account the specific facts and circumstances of each case. Accordingly, since the 1982 Policy Statement, the Board has determined whether an equity investor in a banking organization has a controlling influence over the management or policies of the banking organization by considering carefully all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization. Large minority investors in a banking organization typically have avoided acquiring a controlling influence over the banking organization by providing the Board with a set of passivity commitments and by avoiding certain control-enhancing mechanisms. Specifically, minority investors have avoided acquiring control over a banking organization by, among other things

- restricting the size of their voting and total equity investment in the banking organization;
- avoiding covenants that would enable the investor to restrict the ability of the banking organization's management to determine the major policies and operations of the banking organization;
- not attempting to influence the banking organization's process for making decisions about major policies and operations;
- limiting director and officer interlocks with the banking organization; and
- limiting business relationships between the investor and the banking organization.

2090.4.4 BOARD'S 2008 POLICY STATEMENT ON EQUITY INVESTMENTS IN BANKS AND BANK HOLDING COMPANIES

Since issuing the 1982 Policy Statement, the Board has reviewed a significant number of noncontrolling investments in banking organizations. The Board believed that it would be useful and appropriate to update its guidance in this area and therefore issued its Policy Statement on Equity Investments in Banks and Bank Holding Companies (the 2008 Policy Statement) on September 21, 2008. (See the Board's September 22, 2008, Press Release.)

2090.4.4.1 Specific Approaches to Avoid Control

The 2008 Policy Statement discusses the Board's views on specific approaches to avoid control.[5]

2090.4.4.1.1 Director Representation

The Board generally has not permitted a company that acquires between 10 and 24.9 percent of the voting stock of a banking organization (a minority investor) to have representation on the board of directors of the banking organization. The principal exception to this guideline has been in situations in which the investor owns less than 15 percent of the voting stock of the banking organization and another person (or group of persons acting together) owns a larger block of voting stock of the banking organization.

The Board has reexamined its precedent in this area and, based on its experience with minority investors and director representation, believes that a minority investor generally should be able to have a single representative on the board of directors of a banking organization without acquiring a controlling influence over the management or policies of the banking organization. Typically, boards of directors of banking organizations have 9 or 10 members. Although having a representative on the board of the banking organization enhances the influence of a minority investor, the Board's experience has shown that, in the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a *controlling* influence over the management or policies of the banking organization.[6]

Moreover, a minority investor that has up to two representatives on the board of directors of the banking organization is unlikely, absent other indicia of control, to be able to exercise a controlling influence over the banking organization when the investor's aggregate director representation is proportionate to its total interest in the banking organization[7] but does not exceed 25 percent of the voting members of the board,[8]

5. See the 2008 Policy Statement at 12 C.F.R. 225.144, beginning at paragraph (c).

6. In addition to formal representation on the board of directors of a banking organization, minority investors also frequently seek to have a representative attend meetings of the board of directors of the banking organization in the capacity of a nonvoting observer. Attendance by a representative of a minority investor as an observer at meetings of the board of directors of a banking organization allows the investor access to information and a mechanism for providing advice to the banking organization but has not in previous situations allowed the investor to exercise a controlling influence over the management or policies of the banking organization as long as the observer does not have any right to vote at meetings of the board.

7. An investor's total interest is equal to the greater of the investor's voting interest or total equity interest in the banking organization.

8. For example, an investor with a 10 percent voting interest and a 20 percent total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 20 percent of the board seats. On the other hand, an investor with a 15 percent voting interest and a 33 percent total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 25 percent

and another shareholder of the banking organization is a bank holding company that controls the banking organization under the BHC Act.[9] The presence of another larger, controlling shareholder of the banking organization that has been approved by the Board, is subject to supervision and regulation by the Board, and is obligated to serve as a source of strength for the banking organization should serve as a powerful countervailing force to whatever influence the minority investor may have as a result of its investment and proportional director representation.

The Board continues to believe that a representative of a minority investor that serves on the board of directors of the banking organization should not serve as the chairman of the board of the banking organization or as the chairman of a committee of the board of the banking organization. The Board generally believes, however, that representatives of a noncontrolling minority investor may serve as members of committees of the board of the banking organization when those representatives do not occupy more than 25 percent of the seats on any committee and do not have the authority or practical ability unilaterally to make (or block the making of) policy or other decisions that bind the board or management of the banking organization.

2090.4.4.1.2 Total Equity

The three-prong control test in the BHC Act makes no explicit reference to nonvoting equity investments. Nevertheless, the Board has long subscribed to the view that the overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. Accordingly, the Board traditionally has taken account of the presence and size of nonvoting equity investments in its controlling influence analysis. For example, in the 1982 Policy Statement, the Board set forth a guideline that nonvoting equity investments that exceed 25 percent of the total equity of a banking organization generally raise control issues under the BHC Act.[10] The Board has recognized in a few limited circumstances, however, that ownership by a minority investor of 25 percent or more of a banking organization's total equity may not confer a controlling influence, usually in situations when another controlling investor is present or other extenuating circumstances indicate that the exercise of a controlling influence by the minority investor is unlikely.

The Board continues to believe that an investor that makes a very large equity investment in a banking organization is likely to have a controlling influence over the banking organization's management or policies. Investors with large equity investments have a powerful incentive to wield influence over the banking organization in which they have invested. They have a substantial amount of money at stake in the enterprise, are among the first to absorb losses if the banking organization has financial difficulties, and participate in the profits of the banking organization going forward. Moreover, a banking organization is likely to pay heed to its large shareholders to help ensure it has the ability to raise equity capital in the future and to prevent the negative market signal that would be created by the sale of a large block of equity by an unhappy existing shareholder.

On the other hand, the Board recognizes that nonvoting equity does not provide the holder with voting rights that empower the holder to participate directly in the selection of banking organization management or otherwise in the banking organization's decision-making process. Moreover, as noted above, the BHC Act defines control in terms of ownership of 25 percent or more of a class of voting securities but does not impose an express limit on ownership of nonvoting shares. The Board continues to believe that, in most circumstances, an investor that owns 25 percent or more of the total equity of a banking organization owns enough of the capital resources of a banking organization to have a controlling influence over the management or policies of the banking organization. The Board continues to recognize, however, that the ability of an investor to exercise a controlling influence through nonvoting equity instruments depends significantly on the nature and extent of the investor's overall investment in the banking organization and on the capital structure of the banking organization.

(rather than 33 percent) of the board seats.

9. In determining what amount of director representation is proportional to an investor's voting interest in a banking organization, the investor should round to the nearest whole number. For example, the Board would consider a minority investor that owns 15 percent of the voting stock of a banking organization to have proportionate director representation if it had two representatives on a board of directors with 10 or more members (but not on a board of directors with 9 or fewer members).

10. 12 C.F.R. 225.143(d)(4) and (d)(5).

In particular, the Board would not expect that a minority investor would have a controlling influence over a banking organization if the investor owns a combination of voting shares and nonvoting shares that, when aggregated, represents less than one-third of the total equity of the organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor) and does not allow the investor to own, hold, or vote 15 percent or more of any class of voting securities of the organization. In these situations, the limitation on voting rights reduces the potential that the investor may exercise influence that is controlling.

In previous cases, investors that have acquired nonvoting shares often have sought the right to convert those shares to voting shares under various circumstances. The Board continues to believe that nonvoting shares that may be converted into voting shares at the election of the holder of the shares, or that mandatorily convert after the passage of time, should be considered voting shares at all times for purposes of the BHC Act. However, in previous cases, the Board has recognized that nonvoting shares that are convertible into voting shares carry less influence when the nonvoting shares may not be converted into voting shares in the hands of the investor and may only be transferred by the investor: (1) to an affiliate of the investor or to the banking organization; (2) in a widespread public distribution; (3) in transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of any class of voting securities of the banking organization; or (4) to a transferee that would control more than 50 percent of the voting securities of the banking organization without any transfer from the investor. Ownership of this form of nonvoting, convertible shares, within the limits discussed above, allows investors to provide capital to a banking organization in a way that is useful to the organization, minimizes the opportunity for the investor to exercise a controlling influence over the organization, and allows the investor to exit the investment without conveying control to another party outside the parameters of the BHC Act.

2090.4.4.1.3 Consultations with Management

In many previous cases, minority investors have agreed not to attempt to influence the operations, management, or strategies of the banking organization in which they have invested; not to threaten to sell their shares in the banking organization as a method for influencing decisions of banking organization management; and not to solicit proxies on any matter from the other shareholders of the banking organization. These commitments were designed to limit the exercise by a minority investor of a controlling influence over the management or policies of a banking organization.

The Board believes that it would be useful to provide additional guidance on the extent of communications between a minority investor and a banking organization's management that would be consistent with a noncontrol determination. The Board believes that a noncontrolling minority investor, like any other shareholder, generally may communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization's policies and operations. For example, an investor may, directly or through a representative on a banking organization's board of directors, advocate for changes in the banking organization's dividend policy; discuss strategies for raising additional debt or equity financing; argue that the banking organization should enter into or avoid a new business line or divest a material subsidiary; or attempt to convince banking organization management to merge the banking organization with another firm or sell the banking organization to a potential acquirer. These communications also generally may include advocacy by minority investors for changes in the banking organization's management and recommendations for new or alternative management.[11] Although these types of discussions represent attempts by an investor to influence the management or policies of the banking organization, discussions alone are not the type of controlling influence targeted by the BHC Act.

To avoid the exercise of a controlling influence, in all cases, the decision whether or not to adopt a particular position or take a particular action must remain with the banking organization's shareholders as a group, its board of directors, or its management, as appropriate. The role of the minority investor in these decisions must be limited to voting its shares in its discretion at a meeting of the shareholders of the banking

11. As discussed later in the 2008 Policy Statement, a minority investor may not have a contractual right to determine (or a veto right over) any of the major policies and operations of the bank or the composition of the bank's management team.

organization (directly or by proxy, including in connection with a proxy solicitation launched by another shareholder), and by exercising voting privileges as a member of the board of directors of the banking organization (to the extent permitted as discussed above). Importantly, communications by minority investors should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management.

2090.4.4.1.4 Other Indicia of Control

2090.4.4.1.4.1 Business Relationships

The Board traditionally has prohibited a noncontrolling minority investor in a banking organization from having any material business transactions or relationships with the banking organization. The Board historically has taken the view that a major supplier, customer, or lender to a banking organization can exercise considerable influence over the banking organization's management and policies—especially when coupled with a sizeable voting stock investment—by threatening to terminate or change the terms of the business relationship.

The Board has recognized over the years, however, that not all business relationships—even when accompanied by a material investment—provide the investor a controlling influence over the management or policies of the banking organization. Accordingly, the Board has frequently allowed business relationships that were quantitatively limited and qualitatively nonmaterial, particularly in situations where an investor's voting securities percentage in the banking organization was closer to 10 percent than 25 percent. The Board continues to believe that business relationships should remain limited and will continue to review business relationships on a case-by-case basis within the context of the other elements of the investment structure. In that review, the Board will pay particular attention to the size of the proposed business relationships and to whether the proposed business relationships would be on market terms, non-exclusive, and terminable without penalty by the banking organization.

2090.4.4.1.4.2 Covenants

Because the BHC Act explicitly defines control (and many of its other thresholds) in terms that include a percentage of voting securities, companies often have structured their investments in banking organizations in the form of nonvoting securities and have attempted to substitute contractual agreements for the rights that normally are obtained through voting securities. The Board has taken and continues to hold the view that covenants that substantially limit the discretion of a banking organization's management over major policies and decisions suggest the exercise of a controlling influence.[12] In particular, the Board has been concerned about covenants or contractual terms that place restrictions on, or otherwise inhibit, the banking organization's ability to make decisions about the following actions: (1) hiring, firing, and compensating executive officers; (2) engaging in new business lines or making substantial changes to its operations; (3) raising additional debt or equity capital; (4) merging or consolidating; (5) selling, leasing, transferring, or disposing of material subsidiaries or major assets; or (6) acquiring significant assets or control of another firm.[13]

On the other hand, the Board generally has not viewed as problematic for control purposes those covenants that give an investor rights permissible for a holder of nonvoting securities as described in section 2(q)(2) of Regulation Y.[14] These would include covenants that prohibit the banking organization from issuing senior securities or borrowing on a senior basis, modifying the terms of the investor's security, or liquidating the banking organization. Noncontrolling covenants also could include covenants that provide the investor with limited financial information rights and limited consultation rights.

12. See 12 C.F.R. 225.143(d)(2).

13. For an investment to be eligible for inclusion in a banking organization's regulatory capital, it must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices, see 12 C.F.R. 208, Appendix A, II and 12 C.F.R. 225, Appendix A, II.(i). As described in 12 C.F.R. 250.166(b)(3), such provisions include terms that could adversely affect the banking organization's liquidity or unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty, or that could limit the regulator's ability to resolve problem bank situations.

14. 12 C.F.R. 225.2(q)(2).

2090.4.4.2 Conclusion of the 2008 Policy Statement

As noted above, whether a minority investor in a banking organization has a controlling influence over the management or policies of the banking organization depends on all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization. This policy statement sets forth some of the most significant factors and principles the Board will consider in determining whether investments in a banking organization are noncontrolling for purposes of the BHC Act.

Importantly, controlling-influence determinations depend not just on the contractual rights and obligations of the investor and the banking organization; they also depend on the amount of influence the investor, in fact, exercises over the banking organization. Accordingly, the Board has and will continue to monitor carefully minority investments in banking organizations to ensure that investors do not, in fact, exercise a controlling influence over the management or policies of the banking organizations in which they invest. The Board also continues to evaluate its policies in this area and will modify them as appropriate going forward to ensure that minority investments in banking organizations remain consistent with the BHC Act.

2090.4.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Required Federal Reserve approval if a BHC acquires more than 5 percent (direct or indirect control) of voting shares of a bank	1842(a)(3)			
Federal Reserve approval of a BHC acquiring control of a bank	1842(a)(2)			
BHCs and direct or indirect controlling influence over a bank	1841(d)			
Acquiring a bank outside of the home state of the investing bank holding company	1842(d)(1)			
Long-term restrictions on the rights of a holder of voting securities		225.31(d)(2)		
Specific approaches that avoid control		225.144(c)		
Nonvoting equity investments as a percent of total equity and control issues		225.143(d)(4) and (d)(5)		
Covenants and controlling influence issues		225.143(d)(2)		
Covenants and rights permissible for a holder of nonvoting securities.		225.2(q)(2)		
Nonvoting Equity Investments by BHCs (1982 Policy Statement)		225.143	4-172.1	
Equity investments in banks and BHCs (2008 Policy Statement)		225.144		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Pursuant to Section 3 of the Bank Holding Company Act, a bank holding company, directly or through its subsidiary banks, may not acquire more than 5 percent of the shares of an additional bank without the Board's prior approval. However, it is recognized that banks acting as trustee may acquire such shares without prior notice. Therefore, the Act requires a bank or banks which are subsidiaries of bank holding companies and acquire in excess of the 5 percent threshold limit, to file an application with the Board within 90 days after the shares exceeding the limit are acquired. The limit generally applies *only* to other bank shares over which the acquiring fiduciary exercises sole discretionary voting authority. Nevertheless, the Board has waived this application requirement under most circumstances in Section 225.12 of Regulation Y, unless—

1. the acquiring bank or other company has sole discretionary authority to vote the securities and retains the authority for more than two years; or
2. the acquisition is for the benefit of the acquiring bank or other company, or its shareholders, employees, or subsidiaries.

In determining whether the threshold limits have been reached, shares acquired prior to January 1, 1971 can ordinarily be excluded. On the other hand, shares of another bank held under the following circumstances should, in certain instances, be included in the 5 percent threshold, even though sole discretionary voting authority is not held:

1. Shares held by a trust which is a "company", as defined in Section 2(b) of the Bank Holding Company Act; and,
2. Shares held as trustee for the benefit of the acquiring bank or bank holding company, or its shareholders, employees or subsidiaries.

A bank holding company should have procedures for monitoring holdings of the stock of other banks and bank holding companies for compliance with the foregoing application requirements of the Act, for compliance with reporting requirements on form Y–6, and for compliance with certain similar reporting requirements under the federal securities laws. A general 5 percent threshold applies in all three situations, although differing requirements and exemptions apply.

Examiners specifically trained in trust examinations may need to conduct this portion of an inspection and, in appropriate circumstances, the examiner may need to consult with Federal Reserve Bank legal counsel. Trust examiners routinely review such matters in connection with individual trust examinations. The inspection objectives will be to determine whether the holdings of shares of other banks or bank holding companies, in a fiduciary capacity, are appropriately monitored to comply with section 3(a) of the Bank Holding Company Act with other reporting requirements for such holdings.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2010, this section was revised to delete a discussion of, and references to, section 2(g)(3) of the BHC Act. Section 2(g)(3) was repealed by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Public Law No. 104-208).

2090.6.05 CONTROL DETERMINANTS

The spin-off or sale of property by a bank holding company may not sever the bank holding company's control relationship over such property for purposes of the Bank Holding Company Act. The factors which are normally considered in determining whether control has ceased include the presumptions of control listed in section 225.31(a) of Regulation Y and in sections 2(a)(2) and 2(g) of the Act, and certain ownership and voting rights.

Most of the irrebuttable and rebuttable presumptions of control were written to establish initially a control relationship between two companies. All of the presumptions of control must be considered before presuming that a divestiture is effective. Irrebuttable control relationships are established, or continue to be recognized, when any of the conditions listed in section 225.2(e) of Regulation Y or sections 2(a)(2)(A), 2(a)(2)(B), 2(g)(1), or 2(g)(2) of the Act exist. Thus, a company is assumed to have irrebuttable control over a bank or another company without a Board determination if:

1. The company directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of the voting securities of the bank or company;
2. The company controls in any manner the election of a majority of the directors, trustees, or general partners (individuals exercizing similar functions) of the bank or other company;
3. The Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

Rebuttable presumptions of control are listed in section 225.31(d) of Regulation Y and in sections 2(a)(2)(C) of the Act. These sections describe situations which are not as clearly defined as the irrebuttable presumptions. For example, a company which enters into a management contract that gives the company significant control over the operations or management of a bank or other company may be deemed to exercise a controlling influence over that bank or other company. Section 225.31(c) of Regulation Y and section 2(a)(2)(C) of the Act require a Board determination to establish that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or other company.

2090.6.1 INSPECTION OBJECTIVES

1. To determine whether or not a significant voting or ownership interest exists.
2. To determine whether any rebuttable presumptions of control raise any control issues (see section 225.31(d) of Regulation Y).
3. To determine whether section 2(g)(2) of the Act or any of the other irrebuttable presumptions of control listed in section 225.2(e) of Regulation Y raise any control issues.

2090.6.2 INSPECTION PROCEDURES

The examiner should review the stock records of the transferor, the transferee, and the transferred entity, if possible. Management contracts, trust agreements, and any pertinent agreements among these parties also should be reviewed for any evidence of a control relationship. When following these procedures for a bank holding company which has divested or will divest of property, the examiner should be aware that the criteria for establishing a continuing control relationship are more stringent than those for establishing an initial control relationship. Thus, the examiner should review all ownership and voting rights rather than just those above 5 or 25 percent.

The examiner should review the records of the bank holding company, its parents, and its subsidiaries as well as the records of any company being divested and the company (and its parent and subsidiaries) acquiring divested property for evidence of a continuing control relationship. If the transferee is an individual or if the records of the transferee are not available, the examiner should inquire whether any of the specific control relationships exist. Specifically, the examiner should determine whether the transferee, its parent, or its subsidiaries, are indebted to or have common personnel (officers, directors, trustees, beneficiaries, policy making employees, consultants, etc.) with the transferor, its parent, or its subsidiaries.

2090.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Presumptions of control	Sections 2(g)(1) and 2(g)(2) of the act	225.31(a) 225.139		
Statement of policy concerning divestitures		225.138		
Rebuttable presumptions of control		225.31(d)		
Requirements placed on transferee and transferor to ensure a complete separation				Alfred I. duPont Testamentary Trust; September 21, 1977
Control is not terminated if a rebuttable presumption of control is applicable				Alfred I. duPont Testamentary Trust; October 3, 1977
Explanation of "transferor," "transferee," "shares," and procedures		225.139(c)(1)		1978 FRB 211
"Transferee" includes individuals		225.139 (footnote 4)		Summit Home Insurance Company, Minneapolis, Minnesota; August 30, 1978 The Moody Foundation, Galveston, Texas; January 16, 1968
Presumption of control through common directors, officers, etc.		225.139		GATX Corporation, Chicago, Illinois; February 21, 1978

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Reduction of ownership to less than 5 percent of a subsidiary is an effective divestiture				Financial Securities Corporation, Lake City, Tennessee; August 29, 1972
Individual may be a transferee; an insignificant debt relationship may exist		225.139		Mercantile National Corporation, Dallas, Texas; June 2, 1975
Control terminated although shares were pledged as collateral on a note representing part of purchase price				Equimark Corporation, Pittsburgh, Pennsylvania; February 4, 1977
Application to retain control pursuant to rebuttable presumption; approved, but company not authorized to acquire additional shares				First Bancorp, Inc., Dallas, Texas; February 22, 1977
Application to divest control pursuant to rebuttable presumption; approved				Commanche Land and Cattle Company, Commanche, Texas; January 15, 1980
Indebtedness of transferee to transferor		225.139(c)(4)		1980 FRB 237
Board staff letter on a determination of control after a spin-off transaction				Imperial Bancorp; August 19, 1998

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to include a March 21, 2006, Board staff legal opinion that confirms that a direct conversion from a state-chartered bank to a national bank would not, by itself, cause a parent company to lose its grandfather rights maintained under section 4(f) of the BHC Act. The BHC Act prevents a grandfathered nonbank BHC from acquiring control of an additional bank or thrift as a limited-purpose trust company, which would not be a bank *for the purposes of the BHC Act.*

2090.7.1 CEBA AND FIRREA PROVISIONS FOR NONBANK BANKS

The Competitive Equality Banking Act (CEBA), effective August 10, 1987, amended section 2(c) of the BHC Act by expanding the definition of *bank* to include all FDIC-insured depository institutions. The definition also includes any other institution that (1) accepts demand deposits or other deposits that the depositor may make payable to third parties (demand deposits) and (2) is engaged in the business of making commercial loans. The new definition covers institutions that were not previously covered by the BHC Act (nonbank banks). Thrift institutions that remain primarily residential mortgage lenders continue to be excepted from the definition of bank.

CEBA amended section 4 of the BHC Act by adding a grandfather provision that permits a nonbanking company that on March 5, 1987, controlled an institution that became a bank under CEBA to retain the institution and not be treated as a bank holding company. A grandfathered company will lose its exemption, however, if it violates any of several prohibitions governing its activities. Among these prohibitions, a grandfathered company may not acquire control of an additional bank or a thrift institution or acquire more than 5 percent of the assets or shares of an additional bank or thrift.[1] In addition, no bank subsidiary of the grandfathered company may commence to accept demand deposits and engage in the business of making commercial loans. A bank subsidiary of the grandfathered company may also not permit an overdraft[2] (including an interday overdraft) or incur an overdraft on behalf of an affiliate[3] at a Federal Reserve Bank.[4]

If a grandfathered company no longer qualifies for an exemption, the company must divest control of all the banks it controls within 180 days after the date that the company receives notice from the Board that it no longer qualifies for the exemption. The exemption may be reinstated if, before the end of the 180-day notice period, the company (1) corrects the condition or ceases the activity that caused its exemption to end or submits a plan to the Board for approval to correct the condition or cease the activity within one year and (2) implements procedures reasonably adapted to avoid a recurrence of the condition or activity.

The Board may examine and require reports of grandfathered companies and of the nonbank banks they control but only to monitor or enforce compliance with the grandfather restrictions. The Board also may use civil enforcement powers, including cease-and-desist orders, to enforce compliance.

Grandfathered companies, their affiliates, and their nonbank banks are also subject to the

1. An exception to this prohibition is made for cases involving the acquisition of a failing thrift provided that (1) the thrift is acquired in an emergency acquisition and is either located in a state where the grandfathered company already controls a bank or has total assets of $500 million or more at the time of the acquisition or (2) the thrift is acquired from the RTC, FDIC, or director of the OTS in an acquisition in which federal or state authorities find the institution to be in danger of default.

2. Section 225.52 of Regulation Y further defines the restrictions on overdrafts.

3. Section 225.52(b)(2)(ii) of Regulation Y provides that a nonbank bank (or an industrial bank) incurs an overdraft on behalf of an affiliate when (1) the nonbank bank holds an account at a Federal Reserve bank for an affiliate from which third-party payments can be made and (2) the posting of an affiliate's transactions to the nonbank bank's or industrial bank's account creates an overdraft or increases the amount of an existing overdraft in the account.

4. The overdraft prohibition does not apply if the overdraft (1) results from an inadvertent computer or accounting error that is beyond the control of both the bank and the affiliate; (2) is permitted or incurred on behalf of an affiliate that is monitored by, reports to, and is recognized as a primary dealer by the Federal Reserve Bank of New York and is fully secured, as required by the Board, by direct U.S. obligations, obligations fully guaranteed as to principal and interest by the United States, or securities or obligations eligible for settlement by the Federal Reserve book-entry system; or (3) is permitted or incurred by or on behalf of an affiliate in connection with an activity that is financial in nature or incidental to a financial activity and does not cause the bank to violate any provision of sections 23A or 23B of the Federal Reserve Act directly or indirectly or by virtue of section 18(j) of the Federal Deposit Insurance Act.

anti-tying restrictions of the BHC Act and to the insider-lending restrictions of section 22(h) of the FRA and in Regulation O. Thus, for example, a nonbank bank may not condition a grant of credit on the purchase of a product or service from its grandfathered holding company, or vice versa, and it may not extend credit to insiders of the nonbank bank or its grandfathered holding company on preferential terms.

A bank holding company that controls a nonbank bank may retain it as long as the nonbank bank does not (1) engage in an activity[5] that would have caused it to be a bank before the effective date of CEBA or (2) increase the number of locations from which it does business after March 5, 1987. These limitations do not apply if (1) the nonbank bank is viewed as an additional bank subsidiary of the bank holding company and (2) the BHC's acquisition of the nonbank bank would be permissible under the interstate banking provisions of the BHC Act.

2090.7.2 RETAINING GRANDFATHER RIGHTS UNDER SECTION 4(F) OF THE BHC ACT

A state nonmember bank (Bank A) that became a "bank" for purposes of the BHC Act as a result of CEBA requested a determination that its conversion to a national bank and merger with a limited-purpose trust company would not cause its parent company to lose certain grandfather rights that it maintains under section 4(f) of the BHC Act. (See 12 U.S.C. 1843(f).)

The parent company could retain ownership of Bank A and not be treated as a bank holding company, but only if it and Bank A abided by the conditions set forth in section 4(f) of the BHC Act. One of these conditions generally prohibits the parent company from acquiring control of more than 5 percent of the shares or assets of an additional bank or savings association. (See 12 U.S.C. 1843(f)(2)(A)(i) and (ii).)

The parent company wished to convert Bank A into a national bank. The conversion would be effected directly, and the parent company would not establish, or acquire any shares of, a separate bank or savings association as part of the conversion process. Simultaneously with the conversion process, however, the parent company would establish a new, limited-purpose national bank trust company (trust company). It was represented that the trust company would comply with the limitations and restrictions in, and would qualify for, the trust company exception from the definition of *bank* under section 2(c)(2)(D) of the BHC Act. (See 12 U.S.C. 1841.) The parent company would then cause the trust company to merge into Bank A, with Bank A being the entity that survives the merger. Bank A would then change its name (new bank) and the location of its headquarters.

Under the proposed transaction, the parent company would remain the sole shareholder of new bank. It was represented that, prior to its merger with Bank A, the trust company would not be an operating company and would have no assets or liabilities. It was also represented that the proposal would not result in any change in ownership or control of Bank A.

The Board's legal staff concluded that the direct conversion of Bank A from a state-chartered bank to a national bank would not, by itself, cause the parent company to lose its grandfather rights under section 4(f) of the BHC Act.[6] Also, the BHC Act would not prevent the parent company from chartering the trust company. Although the BHC Act prevents a grandfathered nonbank bank from acquiring control of an additional bank or thrift (12 U.S.C. 1843(f)(2)(A)), the trust company as a limited-purpose trust company would not be a *bank* for the purposes of the BHC Act.

The Board's Legal Division staff stated that it would not recommend that the Board determine that the transactions described in the request would cause the parent company to lose its grandfather rights under section 4(f) of the BHC Act. New bank is required to comply with the conditions applicable to a nonbank bank and a grandfathered holding company, respectively, under the BHC Act. (See the Board staff legal opinion dated March 21, 2006.)

5. Previously, a nonbank bank could accept demand deposits *or* engage in the business of making commercial loans, but could not engage in both activities.

6. See letter from the general counsel of the Board, dated October 12, 2004.

2090.7.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Limitations on nonbank banks	1843(f)	225.52		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), effective August 9, 1990, provided [12 U.S.C. 1815 (e)] that any insured depository institution will be liable for any actual or reasonably anticipated loss incurred or to be incurred by the FDIC in connection with:

1. The default of a commonly controlled[1] depository institution; or
2. Any assistance provided by the FDIC to any commonly controlled insured depository institution.

2090.8.1 FIVE YEAR PROTECTION FROM LIABILITY (5-YEAR TRANSITION RULE)

Sister banks, for five years from the enactment of the law, are protected against losses due to the default of a thrift acquired before enactment. The law also grants a five- year protection to thrifts for loss due to the default of a bank acquired before the law's enactment.

2090.8.2 CROSS-GUARANTEE PROVISIONS

FIRREA contains cross-guarantee provisions. These provisions enable the FDIC to obtain reimbursement from insured depository institutions, in the event that the FDIC incurs a loss due to any assistance provided to, or a default of, a commonly controlled bank or thrift.

The FDIC will provide written notice when an insured depository institution is being held liable for losses sustained by the FDIC in connection with assistance to a commonly controlled bank or thrift. Upon receipt of the written notice from the FDIC, the insured depository institution is required to pay the amount specified. An insured depository institution is not liable for losses incurred by the FDIC, in connection with a commonly controlled institution, if the written notice is not received within two years from the date of the FDIC's loss.

The liability the insured depository institution has to the FDIC is senior to shareholders' claims and any obligation or liability owed to any affiliate of the depository institution.[2] Claims of the FDIC against the depository institution are subordinate to any deposit liabilities, secured obligations and obligations that are subordinated to depositors (i.e. subordinated debt).

The FDIC may grant an insured depository institution a waiver of the cross-guarantee provisions, if it determines that such an exemption is in the best interests of the either the Bank or Savings Association Insurance Funds. Limited partnerships and affiliates of limited partnerships (other than an insured depository institution, which is a majority owned subsidiary of such partnership) may also be exempted from the provisions, if the limited partnership or its affiliate has filed a registration statement with the Securities and Exchange Commission, on or before April 10, 1989. The registration statement must indicate that as of the date of the filing, the partnership intended to acquire one or more insured depository institutions. If an insured depository institution is granted an exemption from the cross-guarantee provisions, then the institution and all of its insured depository institution affiliates must comply with the restrictions of sections 23A and 23B of the Federal Reserve Act without regard to section 23A(d)(1) which provides for certain exemptions.

2090.8.3 EXCLUSION FOR INSTITUTIONS ACQUIRED IN DEBT COLLECTIONS

FIRREA provides an exclusion from the cross-guarantee provisions for an institution acquired in securing or collecting a debt previously contracted in good faith. However, during the entire exclusion period, the controlling bank and all of its insured depository institution affiliates must comply with sections 23A and 23B of the Federal Reserve Act (FRA),[3] for transactions with the insured depository institution involving acquisitions as a result of debts previously contracted in good faith.

1. Depository institutions are commonly controlled if:
 a. Such institutions are controlled by the same depository institution holding company (including any company, such as nonbank banks, that are required to file reports under [12 U.S.C. 1843(f)(6)]; or
 b. One depository institution is controlled by another depository institution.

2. Does not apply to any obligation to affiliates secured as of May 1, 1989.

3. Without regard to section 23A(d)(1) of the FRA.

The Federal Reserve has observed an increase in interest by some holding companies to establish arrangements that are designed to benefit certain shareholders, enhance short-term investor returns, and/or provide a distinct disincentive for investors to acquire or increase ownership in a holding company's common stock and other capital instruments. In some instances, supervisory staff has found that these shareholder protection arrangements would have negative implications on a holding company's capital or financial position, limit a holding company's financial flexibility and capital-raising capacity, or otherwise impair a holding company's ability to raise additional capital. These arrangements impede the ability of a holding company to serve as a source of strength to its insured depository subsidiaries[1] and were considered unsafe and unsound.

In December 2015, the Federal Reserve issued the following guidance to explain supervisory concerns related to arrangements structured by bank and savings and loan holding companies (collectively, "holding companies") to protect the financial investments made by shareholders (collectively, "shareholder protection arrangements"). In particular, such arrangements raise concerns because they could have negative implications on a holding company's capital or financial position, or limit the holding company's ability to raise capital in the future.[2] A holding company, regardless of its asset size, should be aware that the Federal Reserve may object to a shareholder protection arrangement based on the facts and circumstances and the features of the particular arrangement. Therefore, a holding company that is engaged in capital raising efforts or is considering the implementation or modification of a shareholder protection arrangement should review this guidance to help ensure that supervisory concerns are addressed. (Refer to SR-15-15)

1. Pursuant to section 616(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Board's Regulations Y and LL, a holding company is required to serve as a source of financial strength for its insured depository subsidiaries and should not conduct its operations in an unsafe or unsound manner. Specifically, a holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks and thrifts during periods of financial stress or adversity. See 12 U.S.C. 1831o-1; 12 C.F.R. 225.4(a); and 12 C.F.R. 238.8(a).

2. As discussed further below, these arrangements may come in many different forms, including all or portions of agreements between shareholders (or other relevant parties), company plans, organizing documents, and other contractual provisions that provide shareholder protections.

2093.0.1 SHAREHOLDER PROTECTION ARRANGEMENTS—SUPERVISORY ISSUES

Examples of shareholder protection arrangements that have raised supervisory issues include, but are not limited to, provisions whereby:

- The holding company agrees to provide an investor with cash payments reflecting the difference between the price paid by the investor and a lower price per share paid by investors in subsequent transactions;[3]
- The holding company agrees to provide an investor with additional shares of stock for minimal or no additional cost in the event that the holding company issues shares at a price below the price paid by the investor;
- Existing shareholders of the holding company are able to acquire additional shares at significant discounts to market value in a new offering if any shareholder crosses a specific ownership threshold;[4]
- Investors with less-than-majority control are granted the contractual right to restrict or prevent the holding company from issuing additional shares; or

3. Provisions of this type and the next example are often referred to as "down-round" provisions. Down-round provisions can take many forms, but all are designed to protect existing shareholders in the event a holding company's stock price declines in a subsequent effort to raise capital or sell the holding company.

4. Provisions of this type are often referred to as "poison pills" and were originally developed as defenses against contested acquisitions. There are multiple common forms, but these provisions generally operate by increasing the ownership interest of shareholders other than a buyer of a significant block of shares, thereby diluting the buyer and preventing the takeover bid.

Poison pill structures have also been applied in the context of tax benefit preservation plans (TBPPs), which, in general terms, are designed to preserve net operating losses within the requirements of section 382 of the Internal Revenue Code. Under section 382, the use of deferred tax assets can be restricted by an "ownership change." Thus, TBPPs and poison pills use similar mechanisms to restrict changes in ownership, despite different underlying purposes. TBPPs may also take forms different from traditional poison pills.

As an example, a TBPP or poison pill may provide all shareholders, other than the shareholder crossing the relevant threshold, the right to acquire shares of the holding company at a substantial discount, reducing the incentive of shareholders to acquire more shares at or above the threshold. These rights may or may not terminate within a set amount of time.

- The holding company's board of directors has the authority to nullify share purchases under certain circumstances, require the holding company to repurchase the shares of the company from a new owner of the shares, or take other actions that would significantly inhibit secondary market transactions in the shares of the holding company.[5]

Arrangements of these types (in whatever form) have the potential to impose additional financial obligations on a holding company or restrict in some way the primary or secondary market for the holding company's shares. Often, these arrangements serve to protect the value of the initial investment made by a particular subset of shareholders rather than the viability of the issuing holding company, or, in other ways, provide current shareholders with an advantage over future, similarly situated, investors.[6]

2093.0.2 SUPERVISORY OVERSIGHT

If supervisory or applications staff determine that a particular shareholder protection arrangement impairs the ability of a holding company to raise or maintain capital, particularly during a period of stress on the firm, or that provisions of the arrangement are in violation of applicable supervisory enforcement actions, Federal Reserve staff should consult with appropriate Federal Reserve Board supervisory staff to determine the appropriate action. This can occur when:

- *Federal Reserve staff become aware of a proposed shareholder protection arrangement (for example, as part of an effort to raise capital or a proposal to expand):* Federal Reserve staff should incorporate a review of such arrangements during consideration of the specific proposal, whether or not there is a formal application or other approval requirement.
- *Federal Reserve staff become aware of an existing shareholder protection arrangement during the course of a supervisory activity (for example, in discussions with the holding company's management):* Federal Reserve staff should incorporate a review of such arrangements in the examination scope or supervisory plan for the holding company and, on limited occasions, in connection with an application filing.[7]

The Federal Reserve may direct a holding company's board of directors to modify or remove a shareholder protection arrangement that gives rise to safety-and-soundness concerns. The corrective actions, if any, will vary depending on the facts and circumstances of the holding company, as well as applicable state and federal laws and regulations, corporate charter and by-laws, and other considerations.[8] The Reserve Bank's communications with the holding company should comply with applicable supervisory guidance, including SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings." If a holding company has questions regarding the removal or modification of a shareholder protection arrangement, the holding company should consult with the appropriate Federal Reserve Bank.

5. These arrangements could include complete prohibitions on share transfers, as well as certain forms of buy-sell agreements, rights of first refusal, or similar arrangements that sufficiently restrict the transfer of shares as to effectively prohibit most, if not all, transfers.

6. In general, the right to participate in subsequent offerings to prevent dilution of ownership, when fully paid for, has not raised concerns.

7. This guidance is focused on supervisory actions going forward and is not intended to require active confirmation by a holding company or Federal Reserve staff on a routine basis that a shareholder protection issue does not exist. To facilitate the identification of shareholder protection arrangements that raise supervisory concern, the management and other representatives of holding companies are encouraged to bring all such existing or proposed arrangements to the attention of relevant supervisory and applications staff when appropriate.

8. Holding companies subject to the Board's Regulation Q (12 C.F.R. 217) are subject to additional regulatory requirements that should be considered in connection with shareholder protection arrangements. In particular, common equity tier 1 capital instruments and additional tier 1 capital instruments are required to satisfy eligibility criteria that effectively disqualify instruments with certain features used in some shareholder protection arrangements, such as features that limit or discourage future capital issuances, compensate existing investors if new instruments are issued at a lower price, create incentives to redeem, or interfere with the full discretion of the issuer to cancel dividend payments except under limited circumstances. See 12 C.F.R. 217.20. Further, the Board may require a holding company to exclude capital instruments from regulatory capital if such instruments have characteristics or terms that diminish the instrument's ability to absorb losses, or otherwise present safety-and-soundness concerns. See 12 C.F.R. 217.1(d)(2).

2100.0.1 FOREIGN OPERATIONS OF U.S. BANKING ORGANIZATIONS

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

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

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

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

2100.0.2 EDGE ACT AND AGREEMENT CORPORATIONS

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

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

2100.0.3 SUPERVISION OF FOREIGN BANKING ORGANIZATIONS OPERATING IN THE UNITED STATES

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

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

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

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

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

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

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

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

2120.0.1 INTRODUCTION

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

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

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

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

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

2120.0.3 BANKS AND THE FECA

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

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

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

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

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

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

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

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

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

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

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

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

2120.0.6 INSPECTION OBJECTIVES

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

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

2120.0.7 INSPECTION PROCEDURES

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

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

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

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

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

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

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

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

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

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

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

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

7. Verification of audit programs and internal controls.

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

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

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

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

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

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

2120.0.9 ADVISORY OPINIONS

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

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

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

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

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

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

2122.0.1 APPLICATION TO LARGE HOLDING COMPANIES

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

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

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

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

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

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

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

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

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

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

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

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

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

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

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

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

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

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

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

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

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

5. See section 2010.10 regarding internal loan review.

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

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

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

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

2122.0.4.1 Limits and Approval Requirements

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

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

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

2122.0.4.3 Allowance

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

2122.0.4.4 Pricing and Profitability

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

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

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

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2015, footnote 2 was revised to include a reference to SR-14-4, "Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Banking Organizations with $10–$50 Billion in Total Consolidated Assets." This guidance within SR-14-4 supersedes the guidance within SR-94-13, "Loan Review Requirements for On-Site Examinations" for the specified banking organizations.

2124.0.1 FULL-SCOPE INSPECTIONS AND TRANSACTION TESTING

Full-scope inspections under a risk-focused approach must be performed to fulfill the objectives of a full-scope inspection. Inspections can be adjusted, depending on the circumstances of the banking organization being evaluated. At a minimum, full-scope inspections should include sufficient procedures to reach an informed judgment on the assigned ratings for the factors addressed by the bank holding company RFI/C(D) rating system. The business of banking is fundamentally predicated on taking risks, and the components of the supervisory rating system are strongly influenced by risk exposure. Consequently, the procedures for full-scope inspections focus to a large degree on assessing the types and extent of risks to which a bank holding company and its subsidiaries are exposed, evaluating the organization's methods of managing and controlling its risk exposures, and ascertaining whether management and directors fully understand and are actively monitoring the organization's exposure to those risks. Given the Federal Reserve's responsibility for ensuring compliance with banking laws and regulations, inspections also include an appropriate level of compliance testing. (See SR-96-14.)

Historically, Federal Reserve examinations and inspections have placed significant reliance on transaction-testing procedures. For example, to evaluate the adequacy of the credit-administration process, assess the quality of loans, and ensure the adequacy of the allowance for loan and lease losses (ALLL), a high percentage of large loan amounts have traditionally been reviewed individually. Similarly, the assessment of the accuracy of regulatory reporting often has involved extensive review of reconciliations of a bank holding company's general ledger to the FR Y-9C report and other FR Y-series reports. Other similar procedures typically have been completed to ascertain compliance with applicable laws and regulations, to determine whether the banking and nonbank subsidiaries are following their internal policies and procedures and those of the bank holding company, and to evaluate the adequacy of internal control systems.

Transaction testing remains a reliable and essential inspection technique for assessing a banking organization's condition and verifying its adherence to internal policies, procedures, and controls. In a highly dynamic banking market, however, such testing is not sufficient for ensuring continued safe and sound operations. As evolving financial instruments and markets have enabled banking organizations to rapidly reposition their portfolio risk exposures, periodic assessments of a banking organization's condition, based on transaction testing alone, cannot keep pace with the moment-to-moment changes occurring in financial risk profiles.

To ensure that banking organizations have in place the processes necessary to identify, measure, monitor, and control their risk exposures, inspections must focus more on evaluating the appropriateness of a very high degree of transaction testing. Under a risk-focused approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or risks are considered minimal. However, when an organization's risk-management processes or internal controls are considered inappropriate (such as when there is an inadequate segregation of duties or when on-site testing determines that such processes or controls are lacking), additional transaction testing sufficient to fully assess the degree of risk exposure in that function or activity must be performed. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be undertaken and appropriate follow-up actions should be initiated, including the requirement of additional audit work and appropriate enforcement actions.

In most cases, full-scope inspections are conducted on or around a single date. This approach is appropriate for the vast majority of banking organizations supervised by the Federal Reserve. However, as the largest banking organizations have undergone considerable geographic expansion and the range of their products has become more diversified, coordinating the efforts of the large number of examiners necessary to conduct inspections at a single point in time has become more difficult. To avoid causing undue burden on these banking organizations, full-scope inspections for many large companies are conducted over the course of a year, rather than over a span of weeks, in a series of targeted reviews focusing on one or two significant aspects of the bank holding company's operations. This approach to conducting full-scope inspections provides more-continuous supervisory contact with the largest bank holding companies and facilitates improved coordination of inspection efforts with other federal banking agencies. It also provides more flexibility in the allocation of examiner resources, which has been especially important as the complexity of banking markets and products has increased and led to the development of cadres of examiners with specialized skills.

2124.0.2 RISK-FOCUSED INSPECTIONS

Developments in the business of banking have increased the range of banking activities, heightening demands on examiner resources and making the need for examiners to effectively focus their activities on areas of the greatest risk even more crucial. Improved in-office planning can result in more efficient and effective on-site inspections that are focused on risks particular to specific organizations of the bank holding company. Such improved planning minimizes supervisory burden and provides for the close coordination of the supervisory efforts of the Federal Reserve with those of the other state and federal banking agencies. Improved planning also allows information requests to be better tailored to the specific organizations.

2124.0.2.1 Risk Assessment

To focus procedures on the areas of greatest risk, a risk assessment should be performed before on-site supervisory activities. The risk-assessment process highlights both the strengths and vulnerabilities of a bank holding company and provides a foundation from which to determine the procedures to be conducted during an inspection. Risk assessments identify the financial activities in which a banking organization has chosen to engage, determine the types and quantities of risks to which these activities expose the organization, and consider the quality of management and control of these risks. At the conclusion of the risk-assessment process, a preliminary supervisory strategy can be formulated for the bank holding company and its subsidiaries and for each of their major activities. Naturally, those activities that are most significant to the organization's risk profile or that have inadequate risk-management processes or rudimentary internal controls represent the highest risks and should undergo the most rigorous scrutiny and testing.

Identifying the significant activities of a bank holding company, including those activities conducted off-balance-sheet, should be the first step in the risk-assessment process. These activities may be identified through the review of prior bank examination and bank holding company inspection reports and workpapers, surveillance and monitoring reports generated by Board and Reserve Bank staffs, Uniform Bank Performance Reports and Bank Holding Company Performance Reports, regulatory reports (for example, bank Call Reports and the FR Y-9C and FFIEC 002 reports), and other relevant supervisory materials. When appropriate, the following information should be reviewed: strategic plans and budgets, internal management reports, board of directors information packages, correspondence and minutes of meetings between the bank holding company and the Reserve Bank, annual reports and quarterly SEC filings, press releases and published news stories, and stock analysts' reports. In addition, examiners should hold periodic discussions with management to gain insight into their latest strategies or plans for changes in activities or management processes.

Once significant activities have been identified, the types and quantities of risks to which these activities expose the bank holding company should be determined. This allows examiners to identify high-risk areas that should be emphasized in conducting inspections. The types of risk that may be encountered in banking activities individually or in various combinations include, but are not limited to, credit, market, liquidity, operational, legal, and reputational risks.[1] For example, lending activities are a primary source of credit and liquidity risks.

1. Appendix A defines these primary risk types.

They may also present considerable market risk (if the bank holding company or its subsidiaries are originating mortgage loans for later resale), interest-rate risk (if fixed-rate loans are being granted), or legal risk (if loans are poorly documented). Similarly, the asset-liability management function has traditionally been associated with exposures to interest-rate and liquidity risks. Operational risks are also associated with many of the transactions undertaken by this function, and market risks are associated with the investments and hedging instruments commonly used by the asset-liability management function. The quantity of risks associated with a given activity may be indicated by the volume of assets and off-balance-sheet items that the activity represents or by the portion of revenue for which the activity accounts. Activities that are new to an organization or for which exposure is not readily quantified may also represent high risks that should be evaluated during inspections.

A number of analytical techniques may be used to estimate the quantity of risk exposure, depending on the activity or risk type being evaluated. For example, to assess the quantity of credit risk in loans and commitments, the level of past-due loans, internally classified or watch list loans, nonperforming loans, and concentrations of credit exposure to particular industries or geographic regions should be considered (see section 2010.2). In addition, as part of the assessment of credit risk, the adequacy of the overall ALLL can be evaluated by considering trends in past-due, special-mention, and classified loans; historic charge-off levels; and the coverage of nonperforming loans by the ALLL. Analytical techniques for gauging the exposure of a bank holding company and its subsidiaries to interest-rate risk, as part of the evaluation of asset-liability management practices, can include a review of the historical performance of net interest margins, as well as the results of internal projections of future earnings performance or net economic value under a variety of plausible interest-rate scenarios. The measurement of the quantity of market risk arising from trading in cash and derivative instruments may take into account the historic volatility of trading revenues, the results of internal models calculating the level of capital and earnings at risk under various market scenarios, and the market value of contracts relative to their notional amounts.

Once the types and quantities of risk in each activity have been identified, a preliminary assessment of the banking organization's process to identify, measure, monitor, and control these risks should be completed. This evaluation should be based on findings from previous examination and inspection activities conducted by the Reserve Bank or other banking agencies, supplemented by the review of internal policies and procedures, management reports, and other documents that provide information on the extent and reliability of internal risk-management systems. Sound risk-management processes vary from one banking organization to another, but generally include four basic elements for each individual financial activity or function and for the organization in aggregate. These elements are (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, risk-monitoring, and management information systems; and (4) comprehensive internal audits and controls. (See sections 4070.1 (SR-95-51) and 4071.0 (SR-16-11).)

The preliminary evaluation of the risk-management process for each activity or function also helps determine the extent of transaction testing that should be planned for each area. If the organization's risk-management process appears appropriate and reliable, then a limited amount of transaction testing may well suffice. If, on the other hand, the risk-management process appears inappropriate or inadequate to the types and quantities of risk in an activity or function, examiners should plan a much higher level of transaction testing. They should also plan to conduct the most testing in those areas that comprise the most significant portions of a bank holding company's activities and, thus, typically represent high potential sources of risk.

2124.0.2.2 Preparation of a Scope Memorandum

Once the inspection planning and risk-assessment processes are completed, a scope memorandum should be prepared. A scope memorandum provides a detailed summary of the supervisory strategy for a bank holding company and assigns specific responsibilities to inspection team members. A scope memorandum should be tailored to the size and complexity of the bank holding company that is subject to review, define the objectives of each inspection, and generally include—

1. a summary of the results of the prior inspection;
2. a summary of the strategy and significant activities of the banking organization, including its new products and activities;
3. a description of the bank holding company's organization and management structure;
4. a summary of performance since the prior inspection;
5. a statement of the objectives of the current inspection;
6. an overview of the activities and risks to be addressed by the inspection; and
7. a description of the procedures that are to be performed at the inspection.

For large complex organizations operating in a number of states or internationally, the planning and risk-assessment processes are necessarily more complicated. The traditional scope memorandum may have to be broadened into a more extensive set of planning documents to reflect the unique requirements of complex bank holding companies. Examples of these planning documents include annual consolidated analyses, periodic risk assessments, and supervisory plans.

2124.0.2.3 On-Site Procedures

The amount of review and transaction testing necessary to evaluate particular functions or activities of a bank holding company generally depends on the quality of the process the company uses to identify, measure, monitor, and control the risks of an activity. When the risk-management process is considered sound, further procedures are limited to a relatively small number of tests of the integrity of the management system. Once the integrity of the management system is verified through limited testing, conclusions on the extent of risks within the function or activity are drawn based on internal management assessments of those risks rather than on the results of more-extensive transaction testing by examiners. On the other hand, if initial inquiries into the risk-management system—or efforts to verify the integrity of the system—raise material doubts as to the system's effectiveness, no significant reliance should be placed on the system. A more extensive series of tests should be undertaken to ensure that the banking organization's exposure to risk from a given function or activity can be accurately gauged and evaluated. More-extensive transaction testing is also generally completed for activities that are much more significant to a bank holding company than is completed for other areas, although the actual level of testing for these significant activities may be reduced commensurate with the quality of internal risk-management processes.

Consider, as an example, the risk exposure associated with commercial lending activities. Traditionally, examiners have reviewed a relatively high number and dollar volume of real estate–associated loans.[2] If, however, credit-administration practices are considered satisfactory, fewer loans may need be reviewed to verify that this is the case (that is, fewer loans than would be reviewed if deficiencies in credit-administration practices were suspected). This review may be achieved through a valid statistical sampling technique, when appropriate. It should be noted that if credit-administration practices are initially considered sound, but if loans reviewed to verify this raise doubts about the accuracy of internal assessments or the compliance with internal policies and procedures, the number and volume of loans subject to review should generally be expanded. Examiners should thus review a sufficient number of loans in order to ensure that the level of risk is clearly understood, an accurate determination of the adequacy of the ALLL can be made, and the deficiencies in the credit risk-management process can be comprehensively detailed.

2124.0.2.4 Evaluation of Audit Function as Part of Assessment of Internal Control Structure

A bank holding company's internal control structure is critical to its safe and sound functioning in general and to its risk-management system in particular. When properly structured, internal controls promote effective operations and reliable financial and regulatory reporting; safeguard assets; and help to ensure compliance with laws, regulations, and internal policies and procedures. In many banking organizations, internal controls are tested by an independent

2. Guidance on the selection of loans for review is provided in SR-94-13, "Loan Review Requirements for On-Site Examinations." The guidance within SR-94-13 is superseded by SR-14-4, "Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Banking Organizations with $10–$50 Billion in Total Consolidated Assets," but only for these banking organizations. SR-14-4 clarifies expectations for the assessment of material retail credit portfolios for these institutions (see appendix 1 at section 2010.2.11).

internal auditor who reports directly to the board of directors or its audit committee. However, in some smaller banking organizations whose size and complexity of operations do not warrant an internal audit department, reviews of internal controls may be conducted by other personnel independent of the area subject to review.

Because the audit function is an integral part of a bank holding company's assessment of its internal control system, examiners must include a review of the organization's control-assessment activities in every inspection. Such reviews help identify significant risks and facilitate a comprehensive evaluation of the organization's internal control structure and also provide information to determine the inspection procedures that should be completed in assessing internal controls for particular functions and activities and for the bank holding company overall. When conducting this review, examiners should evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks. In addition, examiners should meet with the internal auditors or other personnel responsible for evaluating internal controls. Examiners should review internal control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or board of directors.

Depending on the size and complexity of the activities conducted by a bank holding company, the examiner should also consider conducting a similar review of the work performed by the company's external auditors. Such a review often provides added insight into key risk areas by detailing the nature and extent of the external auditors' testing of those areas.

2124.0.2.5 Evaluation of Overall Risk-Management Process

To highlight the importance of a banking organization's risk-management process, bank holding companies are assigned a risk-management rating on a five-point scale as a significant part of the evaluation of the management components of the bank holding company RFI/C(D) rating system. (See section 4070.0.) In addition, U.S. branches and agencies of foreign banking organizations are assigned a similar rating under the ROCA rating system.[3] These risk-management ratings encompass evaluations of the quality of risk-management processes for all significant activities and all types of risks. As such, they should largely summarize conclusions on the adequacy of risk-management processes for each individual function or activity evaluated.

In assigning risk-management ratings, it is important that examiners consider the quality of the risk-management process for the bank holding company overall, as well as for each individual function. At smaller bank holding companies engaged in traditional banking and nonbanking activities, relatively basic risk-management processes established for each significant activity, such as lending or asset-liability management, may be adequate to allow senior management to effectively manage the organization's overall risk profile. On the other hand, at larger bank holding companies that are typically engaged in more-complex and widely diversified activities, effective risk-management systems must evaluate various functional management processes in combination so that aggregate risk exposures can be identified and monitored by senior management. Management information reports should typically be generated for the overall organization, as well as for individual functional areas. Some aggregate or specific company-wide limits may also be needed for the principal types of risks that are relevant to the company's activities.

A critical aspect of ensuring that a bank holding company's risk-management and control procedures remain adequate is the ongoing testing of the strength and integrity of these procedures and the extent to which the procedures are understood and followed throughout the organization. When assigning a risk-management rating, examiners should assess the adequacy of the company's efforts to ensure that its procedures are being followed. The company's validation efforts must be conducted by individuals who have proper levels of organizational independence and expertise, such as internal or external auditors, internal risk-management units, or managers or other professionals of the bank holding company who have no direct connection to the activities for which procedures are being assessed.

3. U.S. branches and agencies of foreign banking organizations are assigned separate ROCA ratings for risk management, operational controls, compliance, and asset quality, under guidance included in SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations."

2124.0.2.6 Evaluation of Compliance with Laws and Regulations

Compliance with relevant laws and regulations should be assessed at every inspection. The steps taken to complete these assessments, however, will vary depending on the circumstances of the bank holding company being reviewed. When an organization has a history of satisfactory compliance with relevant laws and regulations or an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. For example, when evaluating compliance with the appraisal requirements of Regulation Y at a bank holding company with a formal compliance function, compliance may be ascertained by reviewing the scope and findings of internal and external audit activities, evaluating the internal appraisal-ordering and -review processes, and sampling a selection of appraisals for compliance, as part of the supervisory loan-review process. On the other hand, at bank holding companies that have a less satisfactory compliance record or that lack a compliance function, more appraisals would naturally need to be tested to assess the overall compliance with the appraisal requirements of Regulation Y.

2124.0.2.7 Documentation of Supervisory Findings

The examiners' workpaper documentation of supervisory findings is necessary for Reserve Bank management to objectively verify the inspection work performed. Such documentation also provides a source of information on the condition and prospects of a bank holding company that is invaluable for planning future reviews. Most important, examiners' workpaper documentation provides support for the conclusions and recommendations detailed in the inspection report.

2124.0.2.8 Communication of Supervisory Findings

Effective and open communication between bank supervisory agencies and the board of directors and management of bank holding companies is essential to ensuring that the results of inspections are fully understood; the directorship and management are aware of any identified deficiencies; and, when necessary, they take appropriate corrective actions.

2124.0.3 INSPECTION OBJECTIVES

1. To ensure that the bank holding company has in place the processes necessary to identify, measure, monitor, and control its risk exposures for each of its activities or functions.
2. To improve inspection efficiencies by stressing increased in-office planning of inspections, using a risk-focused emphasis.
3. To identify and assess significant on- and off-balance-sheet activities and the greatest types and quantities of risk exposures and vulnerabilities to the bank holding company, tailoring the extent of transaction testing to the results of this review and other inspections' findings.
4. To review and assess the effectiveness and adequacy of documentation of the bank holding company's control and assessment activities and arrangements, including its internal control structure, and the qualifications of internal and external auditors and other independent personnel involved in the program.
5. To emphasize the preparation of a risk-focused scope memorandum that is tailored to the size and complexity of the bank holding company under inspection.
6. To evaluate compliance with laws and regulations.
7. To adequately document and communicate inspection supervisory findings, recommendations, and conclusions.

2124.0.4 INSPECTION PROCEDURES

1. Identify the significant on- and off-balance-sheet activities of the bank holding company.
   a. Review prior inspection reports and workpapers, surveillance and monitoring reports generated by the Board and Reserve Bank staff, Uniform Bank Performance Reports and Bank Holding Company Performance Reports, regulatory reports (for example, bank Call Reports and FR Y-series and other FFIEC reports), and other relevant supervisory materials.
   b. Review strategic plans and budgets; internal management reports; board of directors information packages; correspondence and minutes, including minutes of meetings held between the bank holding company and the Reserve Bank; annual reports and quarterly SEC filings; press releases and published news stories; and stock analysts' reports.

2. Hold periodic discussions with management to gain insight into recently adopted strategies or plans to change activities or management processes.
3. Once the significant activities have been identified, determine and analyze the types (for example, credit, market, liquidity, operational, legal, and reputational) and quantities of risks to which those activities expose the bank holding company, placing greater inspection emphasis on the high-risk areas.
4. Develop an assessment of the processes that are used to identify, measure, monitor, and control the risks. Focus on the extent of board and senior management oversight; the adequacy of policies, procedures, limits, risk-measurement, risk-monitoring, and management information systems; and the existence of adequately documented internal audits and controls.
5. Prepare a scope memorandum tailored to the size and complexity of the bank holding company under inspection.
6. Conduct limited tests of the integrity of the risk-management system. Conduct more-extensive transaction testing for those areas of a bank holding company that are very significant compared with other areas, adjusting the level of transaction testing to the quality of internal risk-management processes. If initial inquiries or efforts to verify the system raise material doubts as to its effectiveness, place no reliance on the integrity of the bank holding company's risk-management system and conduct more-extensive transaction testing.
7. Review the bank holding company's risk-assessment control activities, including an assessment of internal controls for particular functions and activities and for the bank holding company overall.
   a. Evaluate the independence and competence of the personnel conducting control assessments and the effectiveness of the assessment program in covering the bank holding company's significant activities and risks.
   b. Meet the independent external and internal auditors and other personnel responsible for evaluating internal controls and review the internal control risk assessments, work plans, reports, workpapers, and related communications with the audit committee or the board of directors.
8. Assess the adequacy of efforts to ensure that the current risk-management and control procedures are being followed.
9. Assess compliance with laws and regulations, adjusting the extent of transaction testing with the organization's history of satisfactory compliance.
10. Document all work performed and the supervisory findings. Include information on the condition and prospects of the bank holding company and its significant subsidiaries, as well as the inspection's conclusions and recommendations.

2124.0.5 APPENDIX A—DEFINITIONS OF RISK TYPES EVALUATED AT INSPECTIONS

1. *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
2. *Market risk* is the risk to a bank holding company's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
3. *Liquidity risk* is the potential that a bank holding company will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").
4. *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
5. *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a bank holding company.
6. *Reputational risk* is the potential that negative publicity on a bank holding company's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

What's New In This Revised Section

Effective July 2014, this section was revised to include Appendix B — Managing Foreign Exchange Settlement Risks for Physically Settled Transactions. See SR-13-24. This guidance sets forth seven principles or "guidelines" for managing foreign exchange transaction settlement risks. The Federal Reserve supports these principles as part of its continuing effort to promote the global financial system's ability to withstand severe market disruptions. Institutions covered by SR-13-24 should apply the seven guidelines to their foreign exchange activities with the stated clarifications regarding application of the guidance in the United States.

The Federal Reserve adopted a new framework for the consolidated supervision of large financial institutions on December 17, 2012.[1] The framework strengthens traditional microprudential supervision and regulation to enhance the safety and soundness of individual firms. It also incorporates macroprudential considerations to reduce potential threats to the stability of the financial system and to provide insights into financial market trends. The consolidated supervision framework has two primary objectives:

- *Enhancing resiliency of a firm to lower the probability of its failure or inability to serve as a financial intermediary.*
  Each firm is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations) and its core business lines[2] can survive under a broad range of internal or external stresses. This requires financial resilience by maintaining sufficient capital and liquidity, and operational resilience by maintaining effective corporate governance, risk management, and recovery planning.
- *Reducing the impact on the financial system and the broader economy in the event of a firm's failure or material weakness.*
  Each firm is expected to ensure the sustainability of its critical operations[3] and banking offices[4] under a broad range of internal or external stresses. This requires, among other things, effective resolution planning that addresses the complexity and the interconnectivity of the firm's operations.

These objectives are consistent with key provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These provisions include enhanced prudential standards, which provide the Federal Reserve with the flexibility to tailor the application of these standards to individual firms or groups of firms.[5] (See SR-12-17/CA-12-14 and the supplemental guidance in SR-13-23.)

2124.05.1 FRAMEWORK APPLICABILITY

The new framework is designed to support a tailored supervisory approach that accounts for the unique risk characteristics of each firm, including the nature and degree of potential systemic risks inherent in a firm's activities and operations, as well as broader trends across firms. This framework applies to the following institutions:

- *Large Institution Supervision Coordinating Committee (LISCC) firms:* the largest, most complex U.S. and foreign financial organizations subject to consolidated supervision by the Federal Reserve. Nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve are included in the LISCC portfolio. LISCC firms are considered to pose the greatest systemic risk to the U.S. economy.
  The LISCC is a multidisciplinary body that

1. The previous framework, SR-99-15, "Risk-Focused Supervision of Large Complex Banking Organizations," is superseded. In addition, for the firms described in subsection 2124.05.1, "Framework Applicability," the framework for consolidated supervision set forth in SR-08-9/CA-08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations," is no longer applicable.
2. "Core business lines" are those business lines (including associated operations, services, functions, and support) that, in the firm's view, upon failure would result in a material loss of revenue, profit, or franchise value.
3. "Critical operations" are those operations (including associated services, functions, and support) that if they were to fail or be discontinued could pose a threat to the financial stability of the United States.
4. "Banking offices" are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.
5. 12 U.S.C. 5365 and 12 U.S.C. 5365(a)(2).

oversees supervision and evaluates conditions of supervised firms. The committee also develops cross-firm perspectives and monitors interconnectedness and common practices that could lead to greater systemic risk.

- *Large Banking Organizations (LBOs):* domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more that are not included in the LISCC portfolio.
- *Large Foreign Banking Organizations (Large FBOs):* foreign banking organizations with combined assets of U.S. operations of $50 billion or more that are not included in the LISCC portfolio.

In certain instances, the framework applies to the intermediate holding company that is the primary focus of regulations and supervisory activities for the consolidated entity.

2124.05.2 FRAMEWORK OVERVIEW

The supervisory framework comprises the framework's sections' A, B, and C. Sections A and B specifies the Federal Reserve's expectations across the following core areas of supervisory focus:

A. Enhancing Resiliency of a Firm
   (1) Capital and Liquidity Planning and Positions
   (2) Corporate Governance
   (3) Recovery Planning
   (4) Management of Core Business Lines
B. Reducing the Impact of a Firm's Failure
   (1) Management of Critical Operations
   (2) Support for Banking Offices
   (3) Resolution Planning
   (4) Additional Macroprudential Supervisory Approaches to Address Risks to Financial Stability
C. Conduct of Supervisory Activities

The Federal Reserve may periodically identify additional supervisory priorities beyond these core areas of focus as necessary to enhance firm-specific supervision and develop cross-firm perspectives.

Subsection 2124.05.5, "Conduct of Supervisory Activities," (framework section C) outlines the conduct of supervisory activities used to maintain a comprehensive understanding and assessment of each firm. Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other bank supervisors and functional regulators. The Federal Reserve generally relies to the fullest extent possible on the information and assessments provided by other supervisors and regulators to support effective supervision. Supervisory agencies engaged in the supervision of large financial institutions continue to enhance formal and informal discussions to jointly identify and address key vulnerabilities, and to coordinate supervisory strategies for these firms.

As a general matter, this framework is applicable in circumstances when the consolidated organization and its banking offices are in at least satisfactory condition and there are no material weaknesses or risks across these core areas of supervisory focus. The Federal Reserve applies additional supervisory expectations, and undertakes related activities, to address identified concerns including areas subject to formal or informal enforcement action.

2124.05.3 ENHANCING RESILIENCY OF A FIRM

2124.05.3.1 Capital and Liquidity Planning and Positions

The financial crisis demonstrated the need for stronger regulatory and supervisory assessments of firms' financial resiliency.[6] The Federal Reserve noted significant weaknesses in the adequacy of firms' point-in-time regulatory capital to cover accumulated and prospective risks, as well as in firms' liquidity buffers and risk-management practices.[7] These weaknesses contributed to the failure or near failure of many financial firms and exacerbated the crisis. To support effective capital and liquidity planning, and the adequacy of capital and liquidity positions, each firm should:

a) Maintain strong capital and liquidity positions that not only comply with regulatory requirements, but also support the firm's ongoing ability to meet its obligations to creditors and other counterparties, as well as

6. See the Board's final rule on capital plan requirements for large bank holding companies (76 Fed. Reg. 74631, December 1, 2011); SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management" (75 *Fed. Reg.* 13656, March 22, 2010); and section 4066.0 of this manual.

7. The capital components of this framework, including those related to stress testing, will apply to savings and loan holding companies after they become subject to minimum regulatory capital requirements.

continue to serve as a financial intermediary through periods of stress.

b) Have in place robust internal processes that enable the firm to maintain capital and liquidity commensurate with its unique risks under normal and stressful conditions, and to provide timely restoration of financial buffers in the event of drawdown.

c) Maintain processes that enable the identification and measurement of potential risks to asset quality, earnings, cash flows, and other primary determinants of capital and liquidity positions.

d) Utilize comprehensive projections of the level and composition of capital and liquidity resources, supported by rigorous and regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios.

e) Maintain sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, policies, and controls.[8]

f) Establish goals for capital and liquidity positions that are approved by the firm's board of directors and reflect the potential impact of legal or regulatory restrictions on the transfer of capital or liquidity between legal entities.

g) Maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of capital and liquidity risk measurement and management processes.

2124.05.3.2 Corporate Governance

In order for a firm to be sustainable under a broad range of economic, operational, legal or other stresses, its board of directors (or equivalent for the U.S. operations of FBOs) should provide effective corporate governance with the support of senior management. The board is expected to establish and maintain the firm's culture, incentives, structure, and processes that promote its compliance with laws, regulations, and supervisory guidance. Each firm's board of directors and committees, with support from senior management, should:

a) Maintain a clearly articulated corporate strategy and institutional risk appetite. The board should set direction and oversight for revenue and profit generation, risk management and control functions, and other areas essential to sustaining the consolidated organization.

b) Ensure that the firm's senior management has the expertise and level of involvement required to manage the firm's core business lines, critical operations, banking offices, and other material entities.[9] These areas should receive sufficient operational support to remain in a safe and sound condition under a broad range of stressed conditions.

c) Maintain a corporate culture that emphasizes the importance of compliance with laws and regulations and consumer protection, as well as the avoidance of conflicts of interest and the management of reputational and legal risks.

d) Ensure the organization's internal audit, corporate compliance, and risk management and internal control functions are effective and independent, with demonstrated influence over business-line decision making that is not marginalized by a focus on short-term revenue generation over longer-term sustainability.[10]

e) Assign senior managers with the responsibility for ensuring that investments across business lines and operations align with corporate strategies, and that compensation arrangements and other incentives are consistent with the corporate culture and institutional risk appetite.[11]

f) Ensure that management information systems (MIS) support the responsibilities of the board of directors to oversee the firm's core business lines, critical operations, and other core areas of supervisory focus.

2124.05.3.3 Recovery Planning

Robust recovery planning is central to ensuring the ongoing resiliency of a firm's consolidated operations as well as its core business lines, critical operations, banking offices, and other material entities. Each firm should plan for potential financial or operational weaknesses

8. See SR-11-7, and section 2126.0 of this manual.

9. "Material entities" are subsidiaries or foreign offices of the firm that are significant to the activities of a core business line or critical operation.

10. See SR-08-8/CA-08-11, and section 2124.07 of this manual.

11. Refer to "Guidance on Sound Incentive Compensation Policies" (75 Fed. Reg. 36395, June 25, 2010) and section 2068.0 of this manual.

and identify actions to correct those weaknesses. Therefore, each firm should:

a) Maintain clearly documented quantitative and qualitative criteria that would trigger timely implementation of specific elements of the firm's recovery plan and provide for more rigorous remediation activities if initial actions prove insufficient.
b) Ensure that trigger events reflect a sufficiently broad range of market- and firm-specific stresses across financial, operational, reputational, legal, and compliance risks.
c) Ensure that recovery planning reflects a holistic view of sustainability and resiliency. Recovery planning should be closely integrated with resolution planning, capital and liquidity planning, and other aspects of financial contingency, crisis management, and business continuity planning.[12]
d) Undertake recovery testing and training exercises that consider a broad range of internal and external risk scenarios and account for interconnectivities across operations and legal entities.
e) Ensure that the recovery plan is updated as needed, and reflects lessons learned from reviews of trigger events, testing, and training exercises.
f) Ensure that recovery planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related MIS reporting to the board and its committees.

2124.05.3.4 Management of Core Business Lines

Effective management of core business lines is essential to ensuring the resilience of the consolidated organization, as these activities are the primary drivers of the firm's revenue generation, profitability, and franchise value. For this reason, a firm's corporate governance should extend (as discussed in subsection 2124.05.3.2, "Corporate Governance" (*framework section A.2*)) to the management of each core business line. Each core business line should have:

- Business-line senior management with qualifications and experience commensurate with the size and complexity of related activities and operations;
- A strategic planning process that ensures areas of growth and innovation are effectively managed;
- Appropriate compensation and other incentives that are consistent with the institutional risk appetite and in compliance with laws and regulations;
- An independent and strong risk-management framework that supports identification, measurement, assessment, and control of the full spectrum of risks; and
- Timely identification and resolution of audit, compliance, and regulatory issues

2124.05.4 REDUCING THE IMPACT OF A FIRM'S FAILURE

2124.05.4.1 Management of Critical Operations

The failure or discontinuance of any of a firm's critical operations could weaken the U.S. economy or pose a threat to the financial stability of the United States. Each of the supervisory expectations outlined around management of core business lines (see subsection 2124.05.3.4, "Management of Core Business Lines" (*framework section A.4*)) applies equally to management of critical operations to ensure their financial and operational resilience. Additionally, each firm should ensure that critical operations are sufficiently resilient to be maintained, continued, and funded even in the event of failure or material financial or operational distress. These expectations should be fully reflected in recovery and resolution planning.

2124.05.4.2 Support for Banking Offices

The Federal Reserve's consolidated supervision program has historically focused on protecting the safety and soundness of U.S. depository institution subsidiaries of bank holding companies and the U.S. branches and agencies of foreign banking organizations (collectively defined as banking offices). This is due to the risks posed by banking offices' access to the federal safety net. Specifically, these offices pose risks to the payment system, the Federal Reserve's discount window, and—in the case of most U.S. depository institutions—federal deposit insurance funds.

12. Business continuity expectations include adherence with expectations set forth in SR-03-9, including the geographic diversity and resiliency of data centers and operations, and testing of recovery and resumption arrangements.

A consolidated organization should serve as a source of financial and managerial strength to its banking offices. The activities of the parent company and affiliated nondepository subsidiaries should not present material risks to affiliated banking offices, the consolidated organization itself, or to the consolidated organization's ability to support its banking offices.[13] Each firm should:

a) Provide for the strength and resiliency of its banking offices, ensuring prompt financial and operational support so that each office remains in a safe and sound condition under a broad range of stressed conditions.
b) Ensure that the activities of the parent company and nondepository institution subsidiaries do not present undue direct or indirect risks to the safety and soundness of banking offices. This includes the transmission of financial, operational, legal, compliance, or reputational risks that may undermine public confidence in the financial strength of its banking offices.
c) Maintain sufficient liquidity, cash flow, and capital strength at the parent company and nondepository institution subsidiaries to service debt obligations and cover fixed charges. The parent company needs to consider whether there are any legal or regulatory restrictions on financial transfers between legal entities within the organization.
d) Implement and maintain effective policies, procedures, and systems to ensure compliance with applicable laws and regulations. This includes compliance with respect to covered transactions subject to the Board's Regulation W, which implements sections 23A and 23B of the Federal Reserve Act and limits a bank's transactions with its affiliates.[14]

13. Due to structural differences, there are important distinctions in the forms of support provided to U.S. depository institution subsidiaries versus those provided to the U.S. branches and agencies of foreign banks. For example, branches/agencies do not hold capital and have differing business and liquidity profiles, governance mechanisms, and regulatory requirements than depository institutions. Therefore, the Federal Reserve will consider these differences in its implementation of this supervisory framework for the U.S. branches and agencies of FBOs, and expects parent FBOs and their U.S. branches and agencies to do the same. The extent of supervisory activity undertaken to assess the adequacy of parent company support for U.S branches and agencies of FBOs is scaled to the condition, size, and interconnectedness of these offices.

14. See SR-03-2, and section 2020.1 of this manual.

2124.05.4.3 Resolution Planning

To promote financial stability, the Dodd-Frank Act requires each bank holding company with consolidated assets of $50 billion or more, as well as nonbank financial companies designated by the FSOC, to develop and maintain plans for rapid and orderly resolution in the event of material financial distress or failure. These plans should be utilized as an element of the firm's strategic planning and address the complexity and interconnectivity of the firm's operations.[15]

The Federal Reserve and the FDIC jointly review a firm's resolution plan relative to supervisory requirements, including:

a) The firm's strategic analysis describing its plans for rapid and orderly resolution under the U.S. Bankruptcy Code (or other relevant insolvency regimes). This strategy must not pose systemic risk and must exclude reliance on extraordinary support from the United States or any other government to prevent failure of the firm.
b) The firm's strategy for maintaining and funding material entities, critical operations, and core business lines in the event of material financial distress.
c) Analysis of potential impediments to resolution, and actions to make the firm more resolvable or otherwise reduce its complexity and interconnectivity.
d) Analysis of whether the failure of a major counterparty would likely result in the material financial distress or failure of the firm.
e) The manner and extent to which an insured depository subsidiary is adequately protected from risks arising from the activities of nondepository subsidiaries.
f) For a U.S. firm with foreign operations, its strategy for addressing the risks arising from these foreign operations to its U.S. operations, and its ability to maintain core business lines and critical operations in foreign jurisdictions.
g) Analysis of whether resolution planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related MIS reporting to the board of directors and its committees.

15. Refer to 12 C.F.R. 243 (Federal Reserve) and 12 C.F.R. 381 (FDIC) for the "Resolution Plans Required" regulations. See also, 76 *Fed. Reg.* 67323, November 1, 2011.

2125.05.4.4 Additional Macroprudential Supervisory Approaches to Address Risks to Financial Stability

The financial crisis demonstrated that too narrow a focus on the safety and soundness of individual firms can result in a failure to detect and address emerging threats to financial stability that arise across many firms. The Dodd-Frank Act requires the Federal Reserve to consider the broader risks to financial stability posed by individual companies and through the interconnectedness among these companies. See section 1040.0.3 of this manual.

The Federal Reserve aims to reduce systemic risks by increasing the capacity of firms and markets to absorb shocks when problems occur, and by reducing potential costs in the event of financial distress or failure of a systemically important institution. Supervision carried out under this framework will support a variety of macroprudential supervisory approaches beyond those already discussed, including:

a) Using insights developed through microprudential supervision and related data collection and analysis to identify, understand, and assess potential systemic risks. Areas of review could include, for example, emerging trends in critical operations, interconnectedness, rapidly expanding markets, cyclical industries, and financial products lacking substitutes or effecting large market segments.
b) Identifying potential risks to financial stability indicated by the information in supervisory stress tests and through trends in scenarios employed by firms in their internal stress tests.
c) Using comparative and aggregate analysis to monitor industry practices, common investment or funding strategies, changes in degree or form of financial interconnectedness, or other developments with implications for financial stability.
d) Coordinating with the Federal Reserve's supervision of systemically important financial market utilities to identify and address risks related to payment, clearing, and settlement activities, as well as to identify potential structural vulnerabilities.
e) Working closely with the FSOC and other regulators and supervisors to support the designation and supervision of systemically important nonbank firms, and to enhance the monitoring of systemic risk.
f) Enhancing international coordination with foreign counterparts, including national supervisors and international bodies such as the Basel Committee on Bank Supervision, the Financial Stability Board, and the Senior Supervisors Group. These activities focus on enhancing oversight of internationally active financial firms and markets and on minimizing the opportunities for firms to take advantage of weaker or inconsistent regulations.

2124.05.5 CONDUCT OF SUPERVISORY ACTIVITIES

The Federal Reserve uses a range of supervisory activities to maintain a comprehensive understanding and assessment of each firm, including:

a) Coordinated horizontal reviews involve examination of several institutions simultaneously, encompassing firm-specific supervision and the development of cross-firm perspectives. The Federal Reserve recognizes the priority of these reviews through the dedication of multidisciplinary skills and experienced staff. Examples include analysis of capital adequacy and planning via the Comprehensive Capital Analysis and Review (CCAR), as well as horizontal evaluations of resolution plans and incentive compensation practices.
b) Firm-specific examination and continuous monitoring activities[16] are undertaken to maintain an understanding and assessment across the core areas of supervisory focus for each firm. These activities include review and assessment of changes in strategy, inherent risks, control processes, and key personnel, and follow-up on previously identified concerns (for example, areas subject to enforcement actions or other supervisory issues, or emerging vulnerabilities).
c) In developing and executing a detailed supervisory plan for each firm, the Federal Reserve generally relies to the fullest extent possible on the information and assessments provided by other relevant supervisors and functional regulators. The Federal Reserve

16. "Continuous monitoring activities" include meetings with a banking organization's management; analysis of internal MIS reports, market indicators, and other internal and external information; review of internal and external audit findings; and coordination with other relevant supervisors and functional regulators and utilization of their work as appropriate.

actively participates in interagency information sharing and coordination, consistent with applicable laws, to promote comprehensive and effective supervision and limit unnecessary duplication of information requests. Supervisory agencies continue to enhance formal and informal discussions to jointly identify and address key vulnerabilities, and to coordinate supervisory strategies for large financial institutions.

d) In certain instances, supervisors may be able to rely on a firm's internal audit or internal control functions in developing a comprehensive understanding and assessment.

2124.05.6 APPENDIX A

2124.05.6.1 Risk Transfer Considerations When Assessing Capital Adequacy

The following discussion, SR-13-23, provides supplemental guidance to SR-12-17/CA letter 12-14 pertaining to its supervisory focus on an institution's capital adequacy and liquidity sufficiency. The supplemental guidance centers on how certain risk transfer transactions affect assessments of capital adequacy at large financial institutions (hereafter referred to as firms).[17] It provides clarification on supervisory expectations when assessing a firm's capital adequacy in certain circumstances when the risk-based capital framework may not fully capture the residual risks of a transaction.[18]

Risk mitigation techniques can reduce a firm's level of risk. In general, the Federal Reserve views a firm's engagement in risk-reducing transactions as a sound risk-management practice. There are, however, certain risk-reducing transactions for which the risk-based capital framework may not fully capture the residual risks that a firm faces on a post-transaction basis. As a result of inquiries and discussions with market participants, the Federal Reserve has identified specific characteristics of risk transfer transactions that give rise to this concern and on which further guidance is needed, including cases in which

- A firm transfers the risk of a portfolio to a counterparty (which may be a thinly capitalized special purpose vehicle (SPV)) that is unable to absorb losses equal to the risk-based capital requirement for the risk transferred; or
- A firm transfers the risk of a portfolio to an unconsolidated, "sponsored" affiliate entity of the firm (which also may be an SPV).

In cases involving unaffiliated counterparties, while the transactions may result in a significant reduction in a firm's risk-weighted assets and associated capital requirements under the regulatory capital framework, the firm may nonetheless face residual risks. These residual risks arise because the effectiveness of a firm's hedge involving a thinly capitalized SPV counterparty would be limited to the loss absorption capacity of the SPV itself. In cases involving unconsolidated "sponsored" affiliates of the firm, the residual risk arises from the implicit obligation the sponsoring firm may have to provide support to the affiliate in times of stress. SR-13-23 addresses how the Federal Reserve supervisory staff will view such risk-reducing transactions[19] in evaluating a firm under the Board's capital plan rule and the associated annual Comprehensive Capital Analysis and Review (CCAR).[20]

In the case of a risk transfer transaction with a non-affiliated, limited-recourse SPV or other counterparty with limited loss-absorption capacity, Federal Reserve supervisory staff will evaluate the difference between the amount of capital required for the hedged exposures before the risk transfer transaction and the counterparty's loss-absorbing resources. When evaluating capital adequacy, including in the context of CCAR, supervisory staff will evaluate whether a firm holds sufficient capital in addition to its minimum regulatory capital requirements to cover this difference.[21] In addition, when a firm engages in such a risk transfer transaction, the

17. This guidance applies to large financial institutions that are domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more and foreign banking organizations with combined assets of U.S. operations of $50 billion or more.

18. See 12 CFR 217. The risk-based capital framework establishes risk-based and leverage capital requirements for banking organizations, including top-tier savings and loan holding companies, except those that are substantially engaged in insurance underwriting or commercial activities. This guidance would apply to such entities at such time as risk-based and leverage capital requirements become applicable to them.

19. While the cases described are examples, the principles set forth should apply to other transactions that call into question the degree to which risk transfer has occurred.

20. See 12 CFR 225.8(d)(2)(i). For additional guidance on CCAR, refer to the Federal Reserve's website at www.federalreserve.gov/bankinforeg/ccar.htm. The capital plan rule and CCAR apply only to bank holding companies with total consolidated assets of $50 billion or more.

21. Supervisory staff may also analyze whether the counterparty has liabilities in addition to the specific risk transfer transaction.

firm should be able to demonstrate that it reflects the residual risk in its internal assessment of capital adequacy and maintains sufficient capital to address such risk. In this regard, a commitment by a third party to provide additional capital in a period of financial stress would not be counted toward the loss-absorbing capacity of the counterparty.

Example: A firm has a $100 portfolio that has a capital requirement of $8. If the firm undertakes a transaction to transfer the risk of this portfolio to an unaffiliated SPV with paid-in capital of $3, then the firm would need to be able to demonstrate that, in addition to meeting its minimum regulatory capital requirements, the firm has sufficient capital to cover the $5 difference between the SPV's capital and the capital requirement associated with the portfolio.

In the case of risk transfer to an unconsolidated, ‘‘sponsored’’ affiliated entity, the nature of the firm's relationship with the entity calls into question the degree of risk transfer in the transaction. Firms are discouraged from entering into such transactions, which generally do not involve effective risk transfer because of the sponsored entity's ongoing relationship with the firm and, as noted above, the implicit obligation that the firm may have to provide capital to the sponsored entity in a period of financial stress affecting the sponsored entity. Firms engaging in such transactions should presume for the purpose of their internal capital adequacy assessment as well as for capital planning purposes that no risk transfer has occurred.

Supervisors will strongly scrutinize risk transfer transactions that result in substantial reductions in risk-weighted assets, including in supervisors' assessment of a firm's overall capital adequacy, capital planning, and risk management through CCAR. Based on an assessment of the risks retained by the firm, the Board may in particular cases determine not to recognize a transaction as a risk mitigant for risk-based capital purposes.[22] Firms should bring these types of risk transfer transactions to the attention of their senior management and supervisors. Supervisors will evaluate whether a firm can adequately demonstrate that the firm has taken into account any residual risks in connection with the transaction.

2124.05.7 APPENDIX B—MANAGING FOREIGN EXCHANGE SETTLEMENT RISKS FOR PHYSICALLY SETTLED TRANSACTIONS

The Federal Reserve notes that the Basel Committee on Banking Supervision (Committee), with input from the Federal Reserve,[23] published ‘‘Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions’’ (guidance) in February 2013. This guidance sets forth seven principles or ‘‘guidelines’’ for managing foreign exchange transaction-settlement risks. The Federal Reserve considers this guidance on foreign exchange settlement risks to be a component of its current, broad-based focus on banking institutions' foreign exchange activities.

The Federal Reserve supports these principles as part of its continuing effort to promote the global financial system's ability to withstand severe market disruptions, and has determined that the institutions subject to SR-13-24 (covered institutions)[24] should apply the seven guidelines, which are summarized below (see sections 3.1 through 3.7 of the guidance), to their foreign exchange activities, with the following clarifications regarding application of the guidance in the United States.[25]

22. See generally 12 CFR 217.1(d)(1), (d)(3), and (d)(5). In addition, under the Board's current capital adequacy guidelines for bank holding companies and state member banks (banking organizations), the Board may determine that the regulatory capital treatment for a banking organization's exposure or other relationship to an entity not consolidated on the banking organization's balance sheet is not commensurate with the actual risk relationship of the banking organization to the entity. In making this determination, the Board may require the banking organization to treat the entity as if it were consolidated onto the balance sheet of the banking organization for risk-based capital purposes and calculate the appropriate risk-based capital ratios accordingly, all as specified by the Board. See 12 CFR parts 208 and 225, Appendix A, section I.

23. This guidance applies to large financial institutions supervised by the Federal Reserve, as defined in SR-12-17/CA-12-14. This guidance does not apply to community and regional banking organizations, defined as those with less than $50 billion in total consolidated assets, unless the banking organization engages in significant foreign exchange activities.

24. While the Committee's guidance uses the term ‘‘bank,’’ for purposes of SR-13-24, ‘‘covered institutions’’ are those defined in SR-12-17/CA-12-14 as Large Institution Supervision Coordinating Committee (LISCC) firms, large banking organizations (LBOs), and U.S operations of large foreign banking Organizations (large FBOs), as well as any other banking organization that engages in significant foreign exchange activities.

25. The guidance applies to foreign exchange transactions that consist of two settlement payment flows. This includes spot transactions, forwards, swaps, deliverable options, and

- *Guideline 1—Governance.* A bank should have strong governance arrangements over its foreign exchange settlement-related risks, including a comprehensive risk-management process and active engagement by the board of directors.

  Paragraph 3.1.8 of the guidance states that the board of directors of a covered institution should oversee the management of the compliance function associated with settling foreign exchange transactions. For purposes of the application of the guidelines by covered institutions, senior management should routinely communicate significant compliance matters to the board of directors. The board of directors may choose to delegate regular oversight to a single board member or a committee of the board.
- *Guideline 2—Principal risk.* A bank should use financial market infrastructures that provide payment-versus-payment settlement to eliminate principal risk when settling foreign exchange transactions. Where payment-versus-payment settlement is not practicable, a bank should properly identify, measure, control, and reduce the size and duration of its remaining principal risk.
- *Guideline 3—Replacement-cost risk.* A bank should employ prudent risk-mitigation regimes to properly identify, measure, monitor, and control replacement-cost risk for foreign exchange transactions until settlement has been confirmed and reconciled.

  Paragraph 3.3.7 of the guidance refers to transactions with affiliates. Covered institutions are encouraged to exchange variation margin for inter-affiliate transactions as a matter of sound business practice.
- *Guideline 4—Liquidity risk.* A bank should properly identify, measure, monitor, and control its liquidity needs and risks in each currency when settling foreign exchange transactions.
- *Guideline 5—Operational risk.* A bank should properly identify, assess, monitor, and control its operational risks. A bank should ensure that its systems support appropriate risk-management controls, and have sufficient capacity, scalability, and resiliency to handle foreign exchange volumes under normal and stressed conditions.
- *Guideline 6—Legal risk.* A bank should ensure that agreements and contracts are legally enforceable for each aspect of its activities in all relevant jurisdictions.

  Paragraph 3.6.2 of the guidance states that institutions conducting business in multiple jurisdictions should identify, measure, monitor, and control for the risks arising from conflicts of laws across jurisdictions and suggests accomplishing these objectives by obtaining legal opinions from qualified internal or external counsel. The Federal Reserve does not expect a covered institution to obtain a legal opinion for every transaction; rather, management should seek legal advice that addresses standardized terms, master netting and other significant agreements, and individual transactions as appropriate.
- *Guideline 7—Capital for foreign exchange transactions.* When analyzing capital needs, a bank should consider all foreign exchange settlement-related risks, including principal risk and replacement-cost risk. A bank should ensure that sufficient capital is held against these potential exposures, as appropriate.

While the Federal Reserve acknowledges the principles set forth in section 3.7 of the guidance, and in particular that all risks related to the settlement of foreign exchange transactions should be considered in determining capital needs under the applicable capital framework, the guidance does not and is not intended to modify the calculation of regulatory capital requirements for covered institutions.

currency swaps involving exchange of principal. It excludes instruments that involve one-way settlement payments, such as non-deliverable forwards, non-deliverable options, and contracts for difference. The Federal Reserve expects that the guidance will be applied broadly by the covered institutions and notes that there may be limited instances in which an institution need not apply this guidance to an insignificant currency exposure.

Banking organizations have greatly expanded the scope, complexity, and global nature of their business activities. At the same time, compliance requirements associated with these activities have become more complex. As a result, organizations have confronted significant risk management and corporate governance challenges, particularly with respect to compliance risks that transcend business lines, legal entities, and jurisdictions of operation.[1] To address these challenges, many banking organizations have implemented or enhanced firmwide compliance risk-management programs and program oversight.

While the guiding principles of sound risk management are the same for compliance as for other types of risk, the management and oversight of compliance risk presents certain challenges. For example, quantitative limits reflecting the firm's risk appetite can be established for market and credit risks, allocated to the various business lines within the organization, and monitored by units independent of the business line. Compliance risk does not lend itself to similar processes for establishing and allocating overall risk tolerance, in part because organizations must comply with applicable rules and standards. Additionally, existing compliance risk metrics are often less meaningful in terms of aggregation and trend analysis as compared with more traditional market- and credit-risk metrics. These distinguishing characteristics of compliance risk underscore the need for a firmwide approach to compliance risk management and oversight for large, complex organizations. A firmwide compliance function that plays a key role in managing and overseeing compliance risk while promoting a strong culture of compliance across the organization is particularly important for large, complex organizations that have a number of separate business lines and legal entities that must comply with a wide range of applicable rules and standards.

The Federal Reserve strongly encourages large banking organizations with complex compliance profiles to ensure that the necessary resources are dedicated to fully implementing effective firmwide compliance risk-management programs and oversight in a timely manner.[2]

The Federal Reserve's expectations for all supervised banking organizations are consistent with the principles outlined in a paper issued in April 2005 by the Basel Committee on Banking Supervision, entitled *Compliance and the compliance function in banks* (Basel compliance paper). The principles in the Basel compliance paper have become widely recognized as global sound practices for compliance risk management and oversight, and the Federal Reserve endorses these principles. This section provides clarification as to the Federal Reserve's views regarding certain compliance risk management and oversight matters with regard to banking organizations with complex compliance profiles in the specific areas addressed within this section (see SR-08-8/CA-08-11):

1. organizations that should implement a firmwide approach to compliance risk management and oversight;
2. independence of compliance staff;
3. compliance monitoring and testing; and
4. responsibilities of boards of directors and senior management regarding compliance risk management and oversight.

2124.07.1 FIRMWIDE COMPLIANCE RISK MANAGEMENT AND OVERSIGHT

2124.07.1.1 Overview

Organizations supervised by the Federal Reserve, regardless of size and complexity, should have effective compliance risk-management programs that are appropriately tailored to the organizations' risk profiles.[3] The

1. Compliance risk is the risk of legal or regulatory sanctions, financial loss, or damage to reputation resulting from failure to comply with laws, regulations, rules, other regulatory requirements, or codes of conduct and other standards of self-regulatory organizations applicable to the banking organization (applicable rules and standards). (See, generally, *Compliance and the compliance function in banks*, Basel Committee on Banking Supervision, April 2005, www.bis.org.)

2. Effective compliance risk-management programs incorporate controls designed to maintain compliance with applicable rules and standards, including safety and soundness and consumer protection guidance issued by supervisory authorities.

3. See SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies." This letter provides general guidance on risk-management processes and internal controls for consolidated organizations and discusses the elements of a sound risk-management system. SR-95-51 states that bank

manner in which the program is implemented and the type of oversight needed for that program can vary considerably, depending upon the scope and complexity of the organization's activities, the geographic reach of the organization, and other inherent risk factors. Larger, more complex banking organizations tend to conduct a wide range of business activities that are subject to complex compliance requirements that frequently transcend business lines and legal entities and, accordingly, present risk-management and corporate governance challenges. Consequently, these organizations typically require a firmwide approach to compliance risk management and oversight that includes a corporate compliance function. In contrast, smaller, less-complex banking organizations are not generally confronted with the types of compliance risks and challenges that require a comprehensive firmwide approach to effectively manage and oversee compliance risk. The following discussion, therefore, is *not* directed at smaller, less-complex banking organizations.

Firmwide compliance risk management refers to the processes established to manage compliance risk across an entire organization, both within and across business lines, support units, legal entities, and jurisdictions of operation. This approach ensures that compliance risk management is conducted in a context broader than would take place solely within individual business lines or legal entities. The need for a firmwide approach to compliance risk management at larger, more complex banking organizations is well demonstrated in areas such as anti-money-laundering, privacy, affiliate transactions, conflicts of interest, and fair lending, where legal and regulatory requirements may apply to multiple business lines or legal entities within the banking organization. Certain other compliance risks may also warrant a firmwide risk-management approach to address similar rules and standards that apply to the organization's operations across different jurisdictions. In all such instances, compliance risk management benefits from an aggregate view of the organization's compliance risk exposure and an integrated approach to managing those risks.

holding companies should be able to assess the major risks of the consolidated organization. See also 12 CFR 208, appendix D-1, "Interagency Guidelines Establishing Standards for Safety and Soundness."

The processes established for managing compliance risk on a firmwide basis should be formalized in a compliance *program* that establishes the framework for identifying, assessing, controlling, measuring, monitoring, and reporting compliance risks across the organization, and for providing compliance training throughout the organization. A banking organization's compliance risk-management program should be documented in the form of compliance policies and procedures and compliance risk-management standards.[4]

Firmwide compliance oversight refers to the processes established to oversee compliance risk management across the entire organization, both within and across business lines, legal entities, and jurisdictions of operation. In larger, more complex banking organizations, a key component of firmwide compliance oversight is a corporate compliance function that has day-to-day responsibility for overseeing and supporting the implementation of the organization's firmwide compliance risk-management program, and that plays a key role in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation. Board oversight of such functions are often carried out by the board's risk committee or a committee or subcommittee primarily dedicated to oversight of compliance.

4. Compliance policies refer to both (1) firmwide compliance policies that apply to all employees throughout the organization as they conduct their business and support activities and (2) the more detailed, business-specific policies that are further tailored to, and more specifically address, compliance risks inherent in specific business lines and jurisdictions of operation, and apply to employees conducting business and support activities for the specific business line and/or jurisdiction of operation. Compliance procedures refer to the control procedures that are designed to implement compliance policies. Compliance risk-management standards refer to policies and procedures applicable to compliance staff as they fulfill their day-to-day compliance responsibilities. Compliance standards should clearly articulate expectations regarding the processes to be followed in implementing the organization's firmwide compliance risk-management program, including the processes and criteria to be utilized in identifying, assessing, controlling, measuring, monitoring, and reporting compliance risk, and in providing compliance training. Compliance standards should also clearly articulate the roles and responsibilities of the various committees, functions, and staff with compliance support and oversight responsibilities.

2124.07.1.2 Federal Reserve Supervisory Policies on Compliance Risk Management and Oversight

2124.07.1.2.1 Large Banking Organizations with Complex Compliance Profiles

Although balance sheet size is not the defining indication of a banking organization's compliance risk-management needs, experience has demonstrated that banking organizations with $50 billion or more in consolidated total assets typically have multiple legal entities that pose the type of compliance risks and challenges that call for a comprehensive firmwide approach to appropriately control compliance risk and provide effective oversight. Accordingly, such organizations should generally implement firmwide compliance risk-management programs and have a corporate compliance function.

Compliance programs at such organizations should include more robust processes for identifying, assessing, controlling, measuring, monitoring, and reporting compliance risk, and for providing compliance training throughout the organization in order to appropriately control the heightened level and complexity of compliance risk. The corporate compliance function should play a key role in overseeing and supporting the implementation of the compliance risk-management program and in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation.[5]

2124.07.1.2.2 Large Banking Organizations with Less-Complex Compliance Profiles

In some instances, banking organizations that meet the $50 billion asset threshold may have few legal entities, may be less complex in nature, and may engage in only a very limited range of business activities. Such organizations may be able to effectively manage and oversee compliance risk without implementing a comprehensive firmwide approach. Alternatively, these organizations may choose to implement a firmwide approach whose scope is highly risk-focused on particular compliance risks that exist throughout the organization. In lieu of relying on a corporate compliance function to play a key role in providing day-to-day oversight of the compliance program, these organizations may rely on executive and management committees that are actively involved in providing ongoing corporate oversight of the compliance risk-management program. An organization that adopts this approach, however, should ensure that its compliance program incorporates controls that effectively address compliance risks that transcend business lines, legal entities, and jurisdictions of operation; that appropriate firmwide standards are established for the business lines to follow in managing compliance risk and reporting on key compliance matters; and that the organization is appropriately overseeing the implementation of its compliance risk-management program.

2124.07.1.2.3 Foreign Banking Organizations

Each foreign banking organization supervised by the Federal Reserve should implement a compliance program that is appropriately tailored to the scope, complexity, and risk profile of the organization's U.S. operations. The program should be reasonably designed to ensure that the organization's U.S. operations comply with applicable U.S. rules and standards and should establish effective controls over compliance risks that transcend business lines or legal entities. Foreign banking organizations with large, complex U.S. operations should implement compliance programs for these operations that have more robust processes for identifying, assessing, controlling, measuring, monitoring, and reporting compliance risk, and for providing compliance training, than would be appropriate for foreign banking organizations with smaller, less-complex U.S. operations.[6]

5. While the corporate compliance function is generally responsible for overseeing and supporting the compliance risk-management program, it is recognized that the primary responsibility for aspects of the compliance program may be assigned to other units within the organization (e.g., finance, information technology, and human resources). The corporate compliance function, therefore, may or may not have responsibility for monitoring and testing the controls over certain compliance activities embedded within these units, such as those over regulatory reporting and regulatory capital. Nevertheless, it is important that an organization's compliance program incorporates appropriate controls over these risks and that proper oversight of the management of these risks is conducted.

6. Foreign banking organizations with $50 billion or more in U.S. third-party assets will generally be considered as large banking organizations with complex compliance profiles for purposes of SR-08-8/CA-08-1, unless their U.S. activities are less complex in nature as described in subsection 2124.07.1. The Federal Reserve's views on compliance risk-management

With respect to oversight, foreign banking organizations should provide effective oversight of compliance risks within their U.S. operations, including risks that transcend business lines or legal entities. A foreign banking organization, however, has flexibility in organizing its oversight structure. Compliance oversight of U.S. activities may be conducted in a manner that is consistent with the foreign banking organization's broader compliance risk-management framework. Alternatively, a separate function may be established specifically to provide compliance oversight of the organization's U.S. operations. Regardless of the oversight structure utilized by a foreign banking organization, its established oversight mechanisms, governing policies and procedures, and supporting infrastructure for its U.S. operations should be sufficiently transparent for the Federal Reserve to assess their adequacy.

2124.07.2 INDEPENDENCE OF COMPLIANCE STAFF

Federal Reserve supervisory findings at large, complex banking organizations consistently reinforce the need for compliance staff to be appropriately independent of the business lines for which they have compliance responsibilities. Compliance independence facilitates objectivity and avoids inherent conflicts of interest that may hinder the effective implementation of a compliance program. A particular challenge for many organizations is attaining an appropriate level of independence with respect to compliance staff operating within the business lines.

The Federal Reserve does not prescribe a particular organizational structure for the compliance function. Large banking organizations with complex compliance profiles are encouraged, however, to avoid inherent conflicts of interest by ensuring that accountability exists between the corporate compliance function and compliance staff within the business lines. Such accountability would provide the corporate compliance function with ultimate authority regarding the handling of compliance matters, personnel decisions, and actions relating to compliance staff, including retaining control over the budget for, and remuneration of, all compliance staff.[7] Compliance independence should not, however, preclude compliance staff from working closely with the management and staff of the various business lines. To the contrary, compliance functions are generally more effective when strong working relationships between compliance and business line staff exist.

The Federal Reserve recognizes, however, that many large, complex banking organizations have chosen to implement an organizational structure in which compliance staff within a business line have a reporting line into the management of the business. In these circumstances, compliance staff should also have a reporting line through to the corporate compliance function with respect to compliance responsibilities. In addition, a banking organization that chooses to implement such a dual reporting structure should ensure that the following minimum standards are observed in order to minimize potential conflicts of interest associated with this approach:

1. In organizations with dual reporting-line structures, the corporate compliance function should play a key role in determining how compliance matters are handled and in personnel decisions and actions (including remuneration) affecting business-line compliance and local compliance staff, particularly senior compliance staff. Furthermore, the organization should have in place a process designed to ensure that disputes between the corporate compliance function and business-line management regarding compliance matters are resolved objectively. Under such a process, the final decision-making authority should rest either with the corporate compliance function or with a member or committee of senior management that has no business-line responsibilities.
2. Compensation and incentive programs should be carefully structured to avoid undermining the independence of compliance staff. Compliance staff should not be compensated on the basis of the financial performance of the business line. Such an arrangement creates an improper conflict of interest.
3. Banking organizations with dual reporting-line structures should implement appropriate controls and enhanced corporate oversight to identify and address issues that may arise from conflicts of interest affecting compli-

programs apply equally to the large, complex U.S. operations of foreign banking organizations.

7. The reference to all compliance staff includes corporate, business-line, and local compliance staff.

ance staff within the business lines. For example, in these circumstances, the process for providing corporate oversight of monitoring and testing activities performed by compliance staff within the business lines should be especially robust.

2124.07.3 COMPLIANCE MONITORING AND TESTING

Robust compliance monitoring and testing play a key role in identifying weaknesses in existing compliance risk-management controls and are, therefore, critical components of an effective firmwide compliance risk-management program.

2124.07.3.1 Risk Assessments and Monitoring and Testing Programs

Risk assessments are the foundation of an effective compliance monitoring and testing program. The scope and frequency of compliance monitoring and testing activities should be a function of a comprehensive assessment of the overall compliance risk associated with a particular business activity.[8] Large complex banking organizations should ensure that comprehensive risk-assessment methodologies are developed and fully implemented, and that compliance monitoring and testing activities are based upon the resulting risk assessments.

2124.07.3.2 Testing

Compliance testing is necessary to validate (1) that key assumptions, data sources, and procedures utilized in measuring and monitoring compliance risk can be relied upon on an ongoing basis and (2) in the case of transaction testing, that controls are working as intended. The testing of controls and remediation of deficiencies identified as a result of testing activities are essential to maintaining an effective internal control framework.

The scope and frequency of compliance testing activities should be based upon the assessment of the specific compliance risks associated with a particular business activity. Periodic testing of compliance controls by compliance staff is strongly encouraged as this practice tends to result in an enhanced level of compliance testing. If, however, compliance testing is performed exclusively by the internal audit function, particular care should be taken to ensure that high-risk compliance elements are not otherwise obscured by a lower overall risk rating of a broadly defined audit entity. Otherwise, the scope and frequency of audit coverage of higher-risk compliance elements tend to be insufficient.

2124.07.4 RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND SENIOR MANAGEMENT

The primary responsibility for complying with applicable rules and standards rests with the individuals within the organization as they conduct their day-to-day business and support activities. Under the board's oversight, senior management, and the corporate compliance function are responsible for establishing and implementing a comprehensive and effective compliance risk-management program and oversight framework that is reasonably designed to prevent and detect compliance breaches and issues.

To achieve its objectives, a sound and effective firmwide compliance risk-management program should have the support of both the board and senior management. Both board and management should encourage ethical conduct and compliance with applicable rules and standards through the firm's culture. A strong compliance culture reinforces the principle that an organization must conduct its activities in accordance with applicable rules and standards, and encourages employees to conduct all activities in accordance with both the letter and the spirit of applicable rules and standards.

As set forth in applicable law and supervisory guidance, the board and senior management of a banking organization have different, but complementary, roles with respect to compliance risk.[9] The following discussion is intended to clarify existing Federal Reserve supervisory

8. Risk assessments should be based upon firmwide standards that establish the method for, and criteria to be utilized in, assessing risk throughout the organization. Risk assessments should take into consideration both the risk inherent in the activity and the strength and effectiveness of controls designed to mitigate the risk.

9. See, for example, the Basel compliance paper; SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 Billion"; and SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; and the United States Sentencing

views with regard to responsibilities of the board related to compliance risk management and oversight, and to differentiate these responsibilities from those of senior management.

2124.07.4.1 Boards of Directors

The board should oversee the development of, review, approve, and periodically monitor the firm's compliance strategy and its alignment with the overall strategy of the firm.[10] The board should direct senior management on the board's information needs regarding the types of compliance risks to which the organization is exposed, any significant compliance matters, and the effectiveness of the compliance risk-management program. The board should oversee and hold senior management accountable for the effective implementation of the compliance risk-management program and for the appropriate and timely resolution of compliance issues. The board should hold senior management accountable for the implementation of performance management and compensation programs that promote sound risk management, compliance with laws, regulations, and internal standards, including for conduct.

The board should promote the stature and independence of the corporate compliance function within the organization and provide the appropriate level of resources to conduct their activities effectively.

2124.07.4.2 Senior Management

Senior management is responsible for communicating, implementing, and reinforcing the organization's compliance culture. Senior management also should implement and enforce the compliance policies and compliance risk-management standards. Senior management of the corporate compliance function should establish, support, and oversee the organization's compliance risk-management program. The corporate compliance function should report to the board, or a committee thereof, on significant compliance matters and the effectiveness of the compliance risk-management program.

Senior management should be fully capable, qualified, and properly motivated to manage the compliance risks arising from the organization's business activities. Senior management should communicate the importance of compliance across, and at all levels of, the organization through ongoing training and other means. Under board oversight, senior management should establish appropriate incentives to integrate compliance objectives into the management goals and compensation structure across the organization, and implement appropriate disciplinary actions and other measures for serious compliance and compliance risk-management failures. Senior management within the corporate compliance function and senior compliance personnel within individual business lines should have the appropriate authority, independence, and access to personnel and information within the organization, and appropriate resources to conduct their activities effectively.

Senior management of a foreign banking organization's U.S. operations should provide sufficient information to governance or control functions in its home country and should ensure 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. management should assess the effectiveness of established governance and control mechanisms on an ongoing basis, including processes for reporting and escalating areas of concern and implementation of corrective action as necessary.

Commission's *Federal Sentencing Guidelines Manual*, chapter eight, "Sentencing of Organizations."

10. Foreign banking organizations should ensure that, with respect to their U.S. operations, the responsibilities of the board described in this section are fulfilled in an appropriate manner through their oversight structure and risk-management framework.

The Federal Reserve utilizes risk-focused supervision frameworks for the various supervisory portfolios, based on the asset size of an institution. These frameworks incorporate a methodology to assess an organization's risks and business activities and to tailor supervisory activities to its risk profile. These frameworks aim to sharpen the focus of supervisory activities on areas that pose the greatest risk to the safety and soundness of banking organizations and on management processes to identify, measure, monitor, and control risks.[1]

The Federal Reserve recognizes that the use of information technology can greatly affect a banking organization's financial condition and operating performance.[2] With the dependency of banking organizations on the use of information technology, the Federal Reserve expects an organization's board of directors to oversee and senior management to effectively manage the risks associated with information technology. Accordingly, examiners must consider the risks associated with information technology in their evaluations of an organization's significant business activities and assess the effectiveness of the risk-management process that the organization applies to information technology. See SR-98-9, "Assessment of Information Technology in the Risk-Focused Frameworks for the Supervision of Community Banks and Large Complex Banking Organizations."

This manual section provides additional guidance for examiners on supervisory objectives—

1. highlighting the critical dependence of the financial services industry on information technology and its potential effect on safety and soundness,
2. reinforcing the concept that the risk-focused supervisory process and related products (risk assessments, supervisory plans, and scope memoranda) for an organization should address the risks associated with its use of information technology,[3] and
3. providing a basic framework and a common vocabulary to evaluate the effectiveness of processes used to manage the risks associated with information technology.

2124.1.1 CHANGING ROLE OF INFORMATION TECHNOLOGY

Financial institutions' use of information technology has evolved over time from the automation of routine transactions and preparation of financial reports to the use of artificial intelligence and online banking services. Some decision-making processes such as credit scoring and securities trading have been fully automated. Complex financial products also rely on technology because of the great use of valuation models. Moreover, technological advances in communications and connectivity have minimized geographic constraints within the industry.

While information technology enables banking organizations to carry out their activities more efficiently and effectively, information technology also can be a source of risk to the industry. The operational concerns associated with information processing, traditionally the domain of the "back office," have assumed critical importance during banking mergers and consolidations.

Banking organizations, recognizing the dependency of their operations and decision-making processes on efficient and effective use of information technology, devote significant resources to the management of their information technology resources. In large banking organizations, the positions of the chief information officer and chief technology officer have become more visible executives. In addition, managers of activities that rely on end-user computing and distributed processing systems have been assigned more direct responsibility for the information technology used in their activities. As a result, the management of the risks associated with information technology

1. The types of risk may be categorized according to those presented in the guidelines for rating risk management (that is, credit, market, liquidity, operational, legal, and reputational) or by categories defined by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, those categories may be used if all relevant types of risks are captured. See SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

2. Information technology refers to a business resource that is the combination of computers (hardware and software), telecommunications, and information.

3. Refer to the FFIEC IT Examination Handbook Infobase at: https://ithandbook.ffiec.gov.

should be evaluated for each significant business activity as well as for the overall organization.

Notwithstanding the move towards decentralized management of information technology, large centralized computer systems are still an integral part of the information technology on which many large banking organizations rely. This includes systems critical to the access to payments systems platforms and to the transfer and custody of securities. Similarly, with the continued growth of outsourcing, many third-party information technology service centers also perform a vital role in the banking industry. Therefore, the supervisory review of the effectiveness and reliability of the critical management information systems and third-party processors will continue to be included in the Federal Reserve's supervisory review of a firm's operational resiliency.

2124.1.2 IMPLICATIONS FOR RISK-FOCUSED SUPERVISION

The risk-focused supervisory process evolves and adapts in response to the changing role of information technology in firms' operations, with a greater emphasis being placed on an evaluation of the adequacy of a firm's information technology resources and an assessment of a firm's operational resiliency and risks to its safety and soundness. Accordingly, examiners consider information technology when developing their risk assessments and supervisory plans. Examiners are expected to exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities, the general safety-and-soundness examiners and information technology specialists coordinate their risk assessment, supervisory plan, and scope of the examination or inspection. In general, examiners will

1. Develop a broad understanding of the organization's approach, strategy, and structure with regard to information technology. This requires a determination of the role and importance of information technology to the organization and any unique characteristics or issues.
2. Incorporate an analysis of information technology systems into risk assessments, supervisory plans, and scope memoranda. The analysis should include identification of critical information technology systems, related management responsibility, and the major technology components. An organization's information technology systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems.
3. Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on information technology systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business safely and soundly.
4. Determine whether senior management is adequately identifying, measuring, monitoring, and controlling the significant risks associated with information technology for the overall organization and its major business activities.

2124.1.3 FRAMEWORK FOR EVALUATING INFORMATION TECHNOLOGY

In order to provide a common terminology and consistent approach for evaluating the adequacy of an organization's information technology, five information technology elements are introduced and defined below. These elements may be used to evaluate the information technology processes at the functional business level or for the organization as a whole. They may also be applied to a variety of information technology management structures: centralized, decentralized, or outsourced.[4]

Although deficiencies in information technology appear to be most directly related to operational risk, information technology also can affect the other business risks (credit, market, liquidity, legal, and reputational), depending on the specific circumstances. Examiners should view the information technology elements in an integrated manner with the overall business risks of the organization or business activity; a deficiency in any one of these five elements could have a substantive adverse effect on the organization's or an activity's business risks.

4. When banking organizations outsource operations, they delegate a certain level of responsibility and authority to an outside party (depending on the contractual arrangements). However, ultimate accountability remains with the banking organization.

Moreover, the elements below do not replace or independently add to the business risks described in SR-95-51. Rather, these elements should be assessed in relation to all of the organization's business risks.

These elements are to be used as a flexible tool to facilitate discussion between the organization and examiners about the risks associated with information technology. Where an organization uses different terminology to describe information technology elements, examiners may use the organization's terminology provided the organization adequately addresses the five elements discussed below. Regardless of the terminology employed, examiners should focus on those systems and issues that are considered critical to the organization.

The five information technology elements are

1. *Management processes*. Management processes[5] encompass planning, investment, development, execution, and staffing of information technology from a corporate-wide and business-specific perspective. Management processes over information technology are effective when they are adequately and appropriately aligned with, and supportive of, the organization's mission and business objectives. Management processes include strategic planning, management and reporting hierarchy, management succession, and a regular independent review function. Examiners should determine if the information technology strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the information technology function has effective management processes to execute that strategy.
2. *Architecture*. Architecture[6] refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. In assessing the adequacy of information technology architecture, examiners should consider the hardware's capability to run the software, the compatibility and integration with other systems and sources of data, the ability to upgrade to higher levels of performance and capacity, and the adequacy of controls.
3. *Integrity*. Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. An information technology system has an effective level of integrity when the resulting information flows are accurate and complete. Insufficient integrity in an organization's systems could adversely affect day-to-day reliability, processing performance, input and output accuracy, and the ease of use of critical information. Examiners should review and consider whether the organization relies upon information system audits or independent application reviews to ensure the integrity of its systems. To assess the integrity of an organization's systems, examiners should review the reliability, accuracy, and completeness of information delivered.
4. *Security*. Security refers to the safety afforded to information assets and their data processing environments, using both physical and logical controls to achieve a level of protection commensurate with the value of the assets. Information technology has effective security when controls prevent unauthorized access; modification; destruction; or disclosure of information assets during their creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
5. *Availability*. Availability refers to the delivery of information to end-users. Information technology has effective availability when information is consistently delivered on a timely basis in support of business and decision-making processes. In assessing the adequacy of availability, examiners should consider the capability of information tech-

5. Also referred to as "organization" or "strategic."
6. Sometimes referred to as "infrastructure."

nology to provide information from either primary or secondary sources to the end-users, as well as the ability of back-up systems, presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources, reconstruct its information assets, and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including the loss of utilities and communication lines and operational failure of hardware, software, and network communications).

Appendix A provides a table with examples of situations where deficiencies in information technology elements potentially have a negative effect on the business risks of an organization. The table also provides possible actions that an organization could take in these situations to mitigate its risks. The examples in this table are representative and should not be viewed as an exhaustive list of the risks associated with information technology.

2124.1.4 ALIGNING EXAMINER STAFFING WITH THE TECHNOLOGY ENVIRONMENT

Complex computer systems are an integral part of the information technology for large organizations. Information technology processes have become embedded in the various business activities of a banking organization—particularly with the increased use of local area networks and personal computers. Many community and regional banks continue to rely on third-party information technology service providers. Therefore, the level of technical expertise needed for a particular examination or inspection will vary and should be identified during examination planning. For example, a specialist in information technology or the particular business activity may be the most appropriate person to review an institution's information technology integrity, while general safety-and-soundness examiners may be better suited to review management processes related to information technology.

Development of the overall supervisory approach for an organization requires collaboration between general safety-and-soundness examiners and information technology specialists. Accordingly, a discussion of information technology should be integrated into the supervisory process and products. That is, examiners should consider and comment on the risks associated with information technology when developing an understanding of an organization, assessing an organization's risks, and preparing a scope memorandum.

Appendix A—Examples of Information Technology Elements that Should Be Considered in Assessing Business Risks of Particular Situations

Situation	*IT elements to be considered*	*Potential effect on business risks*	*Risk mitigants*
A bank holding company expands very rapidly via acquisition into new product lines and geographic areas.	*Management processes.* Lack of clear, cohesive strategies could result in dependence on different systems that are incompatible and fragmented. *Integrity.* Unreliable information could be produced due to incompatible systems. *Availability.* Critical information may not be available to management when needed.	*Credit risk.* Exposure to less creditworthy borrowers may increase. *Liquidity risk.* Depositors may withdraw funds or close accounts due to unreliable account information. *Operational risk.* Controls may be inadequate to address the increase in manual interventions to correct incompatibility problems between affiliates' systems, leading to a greater potential for fraudulent transactions.	Develop a well-thought-out plan for integrating acquired systems, mapping data flows and sources, and ensuring reliability of systems.
A bank's consumer loan division inputs erroneous entries into the general-ledger system.	*Integrity.* Billing errors and unwarranted late-payment fees could occur due to the inaccurate loan information maintained by the system.	*Reputational risk.* Knowledge of errors could become widespread resulting in adverse public opinion. *Operational risk.* Increased expenditures may be required to resolve accounting operations problems. *Legal risk.* Litigation could arise because of errors in customer accounts due to processing deficiencies.	Improve policies and procedures related to input of accounting entries. Ensure internal audit considers system aspects of accounting operations.
Substantial turnover occurs in bank's wire-transfer department.	*Security.* Security procedures could be compromised due to inadequate training and lack of qualified personnel. *Integrity.* System may not be able to provide "real-time" funds availability.	*Operational risk.* Financial losses could occur due to fraud or incorrectly sent wire transfers. *Legal risk.* Litigation could arise as a result of errors in customer accounts and fraudulent wire transfers. *Reputational risk.* Knowledge of fraudulent or erroneous wire operations could result in adverse public opinion.	Increase and strengthen procedural and access controls for wire operations. Implement security measures such as passwords and firewalls. Develop and monitor appropriate audit trails. Provide for adequate training program and staffing levels.

Banking organizations routinely rely on third parties for a range of products, services, and other activities. The use of third parties can offer banking organizations significant benefits, such as quicker and more efficient access to technologies, human capital, delivery channels, products, services, and markets. The federal banking agencies have observed an increase in the number and type of banking organizations' third-party relationships. The use of third parties, especially those using new technologies, may present elevated risks to banking organizations and their customers, including operational, compliance, and strategic risks. Importantly, the use of third parties does not diminish or remove banking organizations' responsibilities to ensure that activities are performed in a safe and sound manner and in compliance with applicable laws and regulations.

Not all relationships present the same level of risk, and therefore not all relationships require the same level or type of oversight or risk management. As part of sound risk management, a banking organization analyzes the risks associated with each third-party relationship and tailors risk-management practices, commensurate with the banking organization's size, complexity, and risk profile and with the nature of the third-party relationship.

In 2023, the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (collectively, "the agencies") issued guidance titled, "Interagency Guidance on Third-Party Relationships: Risk Management" ("interagency guidance").[1] The interagency guidance aims to promote consistency in the agencies' third-party risk-management guidance and to clearly articulate risk-based principles for the agencies' third-party risk management. The interagency guidance also is intended to assist banking organizations in identifying and managing risks associated with third-party relationships and in complying with applicable laws and regulations.[2]

The following resources provide more information and supervisory guidance on third-party relationships and the risk management of these relationships.

- SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management" (June 2023)
  — *Third-Party Risk Management: A Guide for Community Banks* (May 2024)
- *Community Bank Access to Innovation through Partnerships* (October 2023)
- *Conducting Due Diligence on Financial Technology Companies: A Guide for Community Banks* (October 2023)
- *Commercial Bank Examination Manual*, section 4062.1, "Risk Management of Third-Party Relationships"
- Federal Financial Institutions Examination Council (FFIEC) *Information Technology Examination Handbook*, specifically the booklet on "Outsourcing Technology Services"

1. 88 Fed. Reg. 37,920 (June 9, 2023).
2. The interagency guidance is relevant to all banking organizations supervised by the agencies. For the Federal Reserve Board, this includes state member banks, bank holding companies, savings and loan holding companies, U.S. branches and agencies of foreign banking organizations, and Edge Act and agreement corporations.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2012, this section was revised to remove references to SR-97-32, "Sound Practices Guidance for Information Security Networks" and SR-00-4, "Outsourcing of Information and Transaction Processing," which were deemed inactive by SR-12-6. A reference to inactive SR-03-12, "Revisions to the Suspicious Activity Report Form," was also removed.

2124.4.1 INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

The federal banking agencies jointly issued interagency guidelines establishing information security standards (the information security standards), which became effective July 1, 2001.[1] (See appendix A, section 2124.4.5.) The Board of Governors of the Federal Reserve System approved amendments to the standards on December 16, 2004 (effective July 1, 2005). The amended information security standards implement sections of 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805) and section 216 of the Fair and Accurate Credit Transactions Act of 2003 (15 U.S.C. 1681w). The Gramm-Leach-Bliley Act requires the agencies to establish information standards consisting of administrative, technical, and physical safeguards for customer records and information. (See SR-01-15.) Bank holding companies and financial holding companies must comply with the information security standards (see appendix F for Regulation Y).[2] The information security standards apply to customer information maintained by or on behalf of state member banks, bank holding companies, and the nonbank subsidiaries or affiliates of each.[3] The information security standards include standards for the proper disposal of consumer and customer information and guidance on response programs for unauthorized access to customer information. (See SR-05-23/CA-05-10.) See sections 2124.4.1.1 and 2124.4.2.

Under the information security standards, each bank holding company falling within the scope of the standards must implement a comprehensive, written information security program.[4] A bank holding company's board of directors, or an appropriate committee of the board, must oversee the company's development, implementation, and maintenance of the information security program—this board oversight includes assigning specific responsibility for the program's implementation and reviewing reports received from management. The information security program should include administrative, technical, and physical safeguards appropriate to the size and complexity of the bank holding company and the nature and scope of its activities.

While all parts of a bank holding company are not required to implement a uniform information security program and set of policies, all elements of the information security program must be coordinated. A bank holding company must ensure that each of its subsidiaries is subject to a comprehensive information security program. It may fulfill this requirement either 1) by including a subsidiary within the scope of the bank's holding company's comprehensive information security program or (2) by having the subsidiary implement a separate comprehensive information security program in accordance with the information security standards and procedures of appendix F, Regulation Y.

A bank holding company's information security program must be designed to (1) ensure the security and confidentiality of customer information,[5] (2) protect against anticipated threats

1. The 2001 information security standards were titled Interagency Guidelines Establishing Standards for Safeguarding Customer Information. See 66 *Fed. Reg.* 8,616–8,641 (February 1, 2001); 69 *Fed. Reg.* 7,610–7,621 (December 28, 2004); and Regulation H, 12 CFR 208, appendix D-2; Regulation K, 12 CFR 211.9 and 211.24; and Regulation Y, 12 CFR 225, appendix F.

2. The discussion in this section applies equally to financial holding companies and bank holding companies.

3. The information security standards do not apply to brokers, dealers, investment companies, and investment advisers, or to persons providing insurance under the applicable state insurance authority of the state in which the person is domiciled. The appropriate federal agency or state insurance authority regulates these insurance entities under sections 501 and 505 of the Gramm-Leach-Bliley Act.

4. The information security standards apply to customer information; as a result, a bank holding company that does not maintain any customer information is not subject to the information security standards. In addition, when customer information is maintained only in the banking subsidiaries or functionally regulated nonbank subsidiaries of the holding company, examiners generally may rely on the primary supervisor's assessment of the subsidiaries' information security programs, if applicable, to determine the holding company's compliance with the information security standards.

5. *Customer information* is defined to include any record, whether in paper, electronic, or other form, containing *non-*

or hazards to the security or integrity of such information, (3) protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer, and (4) ensure the proper disposal of customer information and consumer information.[6] Each bank holding company must identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems. An assessment must be made of the (1) likelihood and potential damage of these threats, taking into consideration the sensitivity of the customer information, and (2) sufficiency of policies, procedures, customer information systems, and other arrangements that are in place to control risks.

Appropriate policies, procedures, training, and testing must be implemented to manage and control identified risks. Management must also report at least annually to the board of directors or an appropriate committee of the board. Management's reports should describe the overall status of the information security program and the bank holding company's compliance with the information security standards. The reports should discuss material matters related to the BHC's information security program, addressing issues such as risk assessment, risk-management and -control decisions, service-provider arrangements, results of testing, security breaches or violations and management's responses to them, and recommendations for changes in the information security program.

The information security standards outline specific information security measures that bank holding companies must consider in implementing an information security program. A bank holding company should adopt appropriate measures to manage and control identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of its activities. The measures that a bank holding company must consider and may adopt include access controls, access restrictions, encryption of electronic customer information, dual control procedures, segregation of duties, and employee background checks for employees who have responsibilities for or access to customer information. In addition, a bank holding company must have monitoring systems and response programs and measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures. Training and testing, are critical components to implement an effective information security program. Each bank holding company must regularly test the key controls, systems, and procedures. Tests should be conducted or reviewed by independent third parties or by staff who are independent of the individuals who develop or maintain the security program.

The Federal Reserve recognizes that banking organizations are highly sensitive to the importance of safeguarding customer information and the need to maintain effective information security programs. Existing examination and inspection procedures and supervisory processes already address information security. As a result, most banking organizations may not need to implement any new controls and procedures.

Examiners should assess compliance with the information security standards during each safety-and-soundness inspection, which may include targeted reviews of information technol-

public personal information, as defined in Regulation P, about a financial institution's customer that is maintained by or on behalf of the bank holding company.

6. A *customer* is defined in the same manner in Regulation P—a consumer who has established a continuing relationship with a bank holding company, under which the bank holding company provides one or more financial products or services to the consumer to be used primarily for personal, family, or household purposes. The definition of customer does not include a business, nor does it include a consumer who has not established an ongoing relationship with the bank holding company.

ogy. Ongoing compliance with the information security standards should be monitored as needed during the risk-focused inspection process. Material instances of noncompliance should be noted in the inspection report.

Bank holding companies are required to oversee their service-provider arrangements in order to (1) protect the security of customer information maintained or processed by their service providers; (2) ensure that their service providers properly dispose of customer and consumer information; and (3) whenever warranted, monitor their service providers to confirm that a provider has satisfied its contractual obligations.

A bank holding company must use appropriate due diligence in selecting its service providers. Bank holding companies should review a potential service provider's information security program or the measures the service provider will use to protect the bank holding company's customer information.[7] All contracts must require that the service provider implement appropriate measures designed to meet the objectives of the information security standards.

When indicated by the bank holding company's risk assessment, the performance of its service providers must be monitored to confirm that they have satisfied their obligations under the information security program. A bank holding company's methods for overseeing its service providers may differ depending on the type of services, the service provider, or the level of risk to the customer information. For example, if a service provider is subject to regulations or a code of conduct that imposes a duty to protect customer information consistent with the objectives of the information security standards, a bank holding company may consider that duty in exercising its due diligence and oversight of the service provider. If a service provider hires a subservicer (that is, subcontracts), the subservicer would not be considered a "service provider" under the guidelines.

2124.4.1.1 Disposal of Customer and Consumer Information

The information security standards address standards for the proper disposal of consumer information, pursuant to sections 621 and 628 of the Fair Credit Reporting Act (15 U.S.C. 1681s and 1681w). Under section 225.4 of Regulation Y, a BHC is required to properly dispose of consumer information in accordance with 16 C.F.R. 682. To address the risks associated with identity theft, a BHC and its nonbank subsidiaries and affiliates (a financial institution) is generally required to develop, implement, and maintain, as part of its existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports.

Consumer information is defined as any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the banking organization for a business purpose. Consumer information also means a compilation of such records.

The following are examples of consumer information:

1. a consumer report that a bank obtains
2. information from a consumer report that the bank obtains from its affiliate after the consumer has been given a notice and has elected not to opt out of that sharing
3. information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
4. information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
5. information from a consumer report that the bank obtains about an employee or prospective employee

Consumer information does not include any record that does not personally identify an individual, nor does it include the following:

1. aggregate information, such as the mean credit score, derived from a group of consumer reports
2. blind data, such as payment history on accounts that are not personally identifiable, that may be used for developing credit scoring models or for other purposes

7. A *service provider* is deemed to be a person or entity that maintains, processes, or is otherwise permitted access to customer information through its direct provision of services directly to the bank holding company.

2124.4.2 RESPONSE PROGRAMS FOR UNAUTHORIZED ACCESS TO CUSTOMER INFORMATION AND CUSTOMER NOTICE

The information security standards list measures to be included in a bank holding company's information security program. These measures include "response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies."[8] A response program is the principal means for a financial institution to protect against the unauthorized "use" of customer information that could lead to "substantial harm or inconvenience" for its customer. For example, customer notification is an important tool that enables a customer to take steps to prevent identity theft, such as by arranging to have a fraud alert placed in his or her credit file.

Prompt action by both the institution and the customer following any unauthorized access to customer information is crucial to preventing or limiting damages from identity theft. As a result, every financial institution should develop and implement a response program appropriate to its size and complexity and to the nature and scope of its activities. The program should be designed to address incidents of unauthorized access to customer information.

The Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice[9] (the guidance) interprets section 501(b) of the Gramm-Leach-Bliley Act (the GLB Act) and the information security standards.[10] The guidance describes the response programs, including customer notification procedures, that a financial institution should develop and implement to address unauthorized access to or use of customer information that could result in substantial harm or inconvenience to a customer.

8. See the information security standards, 12 CFR 225, appendix F, supplement A.

9. The guidance was jointly issued on March 23, 2005 (effective March 29, 2005), by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

10. See 12 C.F.R. 225, appendix F. The Interagency Guidelines Establishing Information Security Standards were formerly known as the Interagency Guidelines Establishing Standards for Safeguarding Customer Information.

When evaluating the adequacy of an institution's required information security program, examiners are to consider whether the institution has developed and implemented a response program equivalent to the guidance. At a minimum, an institution's response program should contain procedures for (1) assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused; (2) notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined later in the guidance; (3) immediately notifying law enforcement in situations involving federal criminal violations requiring immediate attention; (4) taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, such as by monitoring, freezing, or closing affected accounts, while preserving records and other evidence; and (5) notifying customers when warranted.

The guidance does not apply to a financial institution's foreign offices, branches, or affiliates. However, a financial institution subject to the information security standards is responsible for the security of its customer information, whether the information is maintained within or outside of the United States, such as by a service provider located outside of the United States.

The guidance also applies to customer information, meaning any record containing nonpublic personal information about a financial institution's customer, whether in paper, electronic, or other form, *that is maintained by or on behalf of the institution*.[11] (See the Board's privacy rule, Regulation P, at section 216.3(n)(2) (12 C.F.R. 216.3(n)(2).) Consequently, the guidance applies only to information that is within the control of the institution and its service providers. The guidance would not apply to information directly disclosed by a customer to a third party, for example, through a fraudulent web site.

The guidance also does not apply to information involving business or commercial accounts. Instead, the guidance applies to nonpublic personal information about a "customer" as that term is used in the information security standards, namely, a consumer who obtains a financial product or service from a financial institution to be used primarily for personal, family, or

11. See the information security standards, 12 C.F.R. 225, appendix F, section I.C.2.c.

household purposes, and who has a continuing relationship with the institution.[12]

2124.4.2.1 Response Programs

Financial institutions should take preventive measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks on employees who are authorized to access customer information.[13] However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems[14] that occur nonetheless. A response program should be a key part of an institution's information security program. The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

In addition, each institution should be able to address incidents of unauthorized access to customer information in customer information systems maintained by its domestic and foreign service providers. Therefore, consistent with the obligations in the information security standards that relate to these arrangements and with existing guidance on this topic issued by the agencies, an institution's contract with its service provider should require the service provider to take appropriate actions to address incidents of unauthorized access to the financial institution's customer information. These actions include notifying the institution as soon as possible of any such incident, which enables the institution to expeditiously implement its response program.

12. See the information security standards, 12 C.F.R. 225, appendix F, at section I.C.2.b. and the Board's Privacy Rule (Regulation P), section 216.3(h) (12 C.F.R. 216.3(h)).

13. Institutions should also conduct background checks on employees to ensure that they do not violate 12 U.S.C. 1829, which prohibits an institution from hiring an individual convicted of certain criminal offenses or who is subject to a prohibition order under 12 U.S.C. 1818(e)(6).

14. Under the information security standards, an institution's *customer information systems* consist of all the methods used to access, collect, store, use, transmit, protect, or dispose of customer information, including the systems maintained by its service providers. See the information security standards, 12 C.F.R. 225, appendix F, section I.C.2.d.

2124.4.2.1.1 Components of a Response Program

At a minimum, an institution's response program should contain procedures for the following:

1. assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused
2. notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined below
3. consistent with the Suspicious Activity Report (SAR) regulations,[15] notifying appropriate law enforcement authorities, in addition to filing a timely SAR in situations involving federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing
4. taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, for example, by monitoring, freezing, or closing affected accounts, while preserving records and other evidence
5. notifying customers when warranted

As noted above for the second component, a financial institution and a bank holding company are to notify its primary federal regulator of a security breach involving sensitive customer information, whether or not it notifies its customers. The banking organization experiencing such a breach should promptly notify its supervisory central point of contact at its Reserve Bank and provide information on the nature of the incident and on whether law enforcement authorities were notified or a SAR was or will be filed. When reporting security breaches involving sensitive customer information, the institution should provide the central point of contact with information on the steps taken to contain and control the incident, the

15. An institution's obligation to file a SAR is set out in the SAR regulations and supervisory guidance. See 12 C.F.R. 208.62 (state member banks); 12 C.F.R. 211.5(k) (Edge and agreement corporations); 12 C.F.R. 211.24(f) (uninsured state branches and agencies of foreign banks); and 12 C.F.R. 225.4(f) (bank holding companies and their nonbank subsidiaries). See also SR-01-11, "Identity Theft and Pretext Calling."

number of customers potentially affected, whether customer notification is warranted, and whether a service provider was involved. A banking organization should not delay providing prompt initial notification to its central point of contact. (See SR-05-23/CA-05-10.)

If an incident of unauthorized access to customer information involves customer information systems maintained by an institution's service providers, the financial institution is responsible for notifying its customers and regulator. However, an institution may authorize or contract with its service provider to notify the institution's customers or regulator on its behalf.

2124.4.2.2 Customer Notice

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer information, in accordance with the standard set forth below, is a key part of that duty.

Timely notification of customers is important to managing an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution believes that it may be potentially embarrassed or inconvenienced by doing so.

2124.4.2.2.1 Standard for Providing Notice

When a financial institution becomes aware of an incident of unauthorized access to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused. If the institution determines that misuse of its information about a customer has occurred or is reasonably possible, it should notify the affected customer as soon as possible.

Customer notice may be delayed if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and provides the institution with a written request for the delay. However, the institution should notify its customers as soon as notification will no longer interfere with the investigation.

2124.4.2.2.2 Sensitive Customer Information

Under the information security standards, an institution must protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer. Substantial harm or inconvenience is most likely to result from improper access to *sensitive customer information* because this type of information is most likely to be misused, as in the commission of identity theft.

For purposes of the guidance, *sensitive customer information* means a customer's name, address, or telephone number, in conjunction with the customer's Social Security number, driver's license number, account number, credit or debit card number, or with a personal identification number or password that would permit access to the customer's account. *Sensitive customer information* also includes any combination of components of customer information that would allow someone to log on to or access the customer's account, such as a user name and password or a password and an account number.

2124.4.2.2.3 Affected Customers

If a financial institution, on the basis of its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers for whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations in which an institution determines that a group of files has been accessed improperly but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

2124.4.2.2.4 Content of Customer Notice

Customer notice should be given in a clear and conspicuous manner. The notice should describe the incident in general terms and the type of customer information that was the subject of unauthorized access or use. The notice should also generally describe what the institution has done to protect the customers' information from further unauthorized access, and include a telephone number that customers can call for further information and assistance.[16] The notice should remind customers of the need to remain vigilant over the next 12 to 24 months, and to promptly report incidents of suspected identity theft to the institution. The notice should include the following additional items, when appropriate:

1. a recommendation that the customer review account statements and immediately report any suspicious activity to the institution
2. a description of fraud alerts and an explanation of how the customer may place a fraud alert in his or her consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud
3. a recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted
4. an explanation of how the customer may obtain a credit report free of charge
5. information about the availability of the Federal Trade Commission (FTC) online guidance regarding steps consumers can take to protect themselves against identity theft (The notice should encourage the customer to report any incidents of identity theft to the FTC and should provide the FTC's web site address and toll-free telephone number that customers may use to obtain the identity theft guidance and to report suspected incidents of identity theft.)[17]

Financial institutions are encouraged to notify the nationwide consumer reporting agencies before sending notices to a large number of customers when those notices include contact information for the reporting agencies.

2124.4.2.2.5 Delivery of Customer Notice

Customer notice should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it. For example, the institution may choose to contact all affected customers by telephone, by mail, or by electronic mail in the case of customers for whom it has a valid e-mail address and who have agreed to receive communications electronically.

2124.4.3 Inspection Objective

1. To review and assess the bank holding company's compliance with the Interagency Guidelines Establishing Information Security Standards, which include standards for safeguarding customer information (the examiners should thus review the BHC's information security program, including its response program for unauthorized access to customer information and customer notice and its guidelines on the proper disposal of customer information and consumer information) and all other applicable laws, rules, and regulations.

2124.4.4 Inspection Procedures

1. Referencing the "Establishment of Information Security Standards" section of the internal control questionnaire in section 4060.4 of the System's *Commercial Bank Examination Manual,* assess the BHC's compliance with the Interagency Guidelines Establishing Information Security Standards including its standards for safeguarding customer information.
2. Conduct a review that is a sufficient basis for evaluating the BHC's overall information security program and its compliance with the information security standards.

16. The institution should, therefore, ensure that it has reasonable policies and procedures in place, including trained personnel, to respond appropriately to customer inquiries and requests for assistance.

17. The FTC web site for the ID theft brochure and the FTC hotline phone number are www.ftc.gov/bcp/consumer.shtm and 1-877-IDTHEFT. The institution may also refer customers to any materials developed pursuant to section 151(b) of the FACT Act (educational materials developed by the FTC to teach the public how to prevent identity theft).

2124.4.5 APPENDIX A—INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

Sections II and III of the information security standards are provided below. For more information, see the Interagency Guidelines Establishing Information Security Standards in Regulation Y, section 225, appendix F (12 C.F.R. 225, appendix F). The guidelines were previously titled Interagency Guidelines Establishing Standards for Safeguarding Customer Information. The information security standards were amended, effective July 1, 2005, to implement section 216 of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act). To address the risks associated with identity theft, the amendments generally require financial institutions to develop, implement, and maintain, as part of their existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports. The term *consumer information* is defined in the revised rule.

II. Standards for Safeguarding Customer Information

A. Information Security Program

Each bank holding company is to implement a comprehensive, written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the bank holding company and the nature and scope of its activities. While all parts of the bank holding company are not required to implement a uniform set of policies, all elements of the information security program are to be coordinated. A bank holding company is also to ensure that each of its subsidiaries is subject to a comprehensive information security program. The bank holding company may fulfill this requirement either by including a subsidiary within the scope of the bank holding company's comprehensive information security program or by causing the subsidiary to implement a separate comprehensive information security program in accordance with the standards and procedures in sections II and III that apply to bank holding companies.

B. Objectives

A bank holding company's information security program shall be designed to—

1. ensure the security and confidentiality of customer information;
2. protect against any anticipated threats or hazards to the security or integrity of such information;
3. protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and
4. ensure the proper disposal of customer information and consumer information.

III. Development and Implementation Of Information Security Program

A. Involve the Board of Directors

The board of directors or an appropriate committee of the board of each bank holding company is to—

1. approve the bank holding company's written information security program; and
2. oversee the development, implementation, and maintenance of the bank holding company's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

B. Assess Risk

Each bank holding company is to—

1. identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;
2. assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information;
3. assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks; and
4. ensure the proper disposal of customer information and consumer information.

C. Manage and Control Risk

Each bank holding company is to—

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank holding company's activities. Each bank holding company must consider whether the following security measures are appropriate for the bank holding company and, if so, adopt those measures the bank holding company concludes are appropriate:
   a. access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means
   b. access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals;
   c. encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access
   d. procedures designed to ensure that customer information system modifications are consistent with the bank holding company's information security program
   e. dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer Information
   f. monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems
   g. response programs that specify actions to be taken when the bank holding company suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies
   h. measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures
2. Train staff to implement the bank holding company's information security program.
3. Regularly test the key controls, systems, and procedures of the information security program. The frequency and nature of such tests should be determined by the bank holding company's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.
4. Develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of customer information and consumer information in accordance with each of the requirements in this section III.

D. Oversee Service-Provider Arrangements

Each bank holding company is to—

1. exercise appropriate due diligence in selecting its service providers;
2. require its service providers by contract to implement appropriate measures designed to meet the objectives of the information security standards; and
3. where indicated by the bank holding company's risk assessment, monitor its service providers to confirm that they have satisfied their obligations with regard to the requirements for overseeing provider arrangements. As part of this monitoring, a bank holding company should review audits, summaries of test results, or other equivalent evaluations of its service providers.

E. Adjust the Program

Each bank holding company is to monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the bank holding company's own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

F. Report to the Board

Each bank holding company is to report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the bank holding company's compliance with the information security standards. The reports should discuss material matters related to its program, addressing issues such as risk assessment; risk management and control decisions; service-provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

G. Implement the Standards

For effective dates, see 12 C.F.R. 225, appendix F, section III.G.

2124.5.1 IDENTITY THEFT RED FLAGS PREVENTION PROGRAM

The federal financial institution regulatory agencies[1] and the Federal Trade Commission (FTC) have issued joint regulations and guidelines on the *detection*, *prevention*, and *mitigation* of identity theft in connection with opening of certain accounts or maintaining certain existing accounts in response to the Fair and Accurate Credit Transactions Act of 2003 (The FACT Act).[2] Under the FACT Act, bank holding companies (BHCs) and their nonbank subsidiaries are subject to the FTC's regulations.[3] These regulations require financial institutions[4] or creditors[5] that offer or maintain one or more "covered accounts" to develop and implement a written Identity Theft Prevention Program (Program). A Program is to be designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The Program must be tailored to the entity's size, complexity, and the nature and scope of its operations and activities. The regulations also require (debit and credit) card issuers to validate notifications of changes of address under certain circumstances.

The joint final rules and guidelines were effective on January 1, 2008. The mandatory compliance date for the rules was November 1, 2008.[6] (See section 681 of the FTC's Red Flags Rule (16 CFR 681) and 72 *Fed. Reg.* 63718-63775, November 9, 2007.)

This section describes the provisions of the Red Flags Rule and its guidelines (appendix A) to be used when examining a BHC and its nonbank subsidiaries over which the Federal Reserve has supervisory authority (collectively referred to as "BHC"). (See SR-08-7/CA-08-10 and its interagency attachments.)

2124.5.1.1 Risk Assessment

Prior to the development of the Program, a financial institution or creditor must initially and then periodically conduct a risk assessment to determine whether it offers or maintains covered accounts. It must take into consideration (1) the methods it provides to open its accounts, (2) the methods it provides to access accounts, and (3) its previous experiences with identity theft. If the financial institution or creditor has covered accounts, it must evaluate its potential vulnerability to identity theft. The institution should also consider whether a reasonably foreseeable risk of identity theft may exist in connection with the accounts it offers or maintains and those that may be opened or accessed remotely, through methods that do not require face-to-face contact, such as through the Internet or telephone. Financial institutions or creditors that offer or maintain business accounts that have been the target of identity theft should factor those experiences with identity theft into their determination.

If the financial institution or creditor determines that it has covered accounts, the risk assessment will enable it to identify which of its accounts the Program must address. If a financial institution or creditor initially determines that it does *not* have covered accounts, it must periodically reassess whether it must develop and implement a Program in light of changes in the accounts that it offers or maintains.

1. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

2. Section 111 of the FACT Act defines "identity theft" as "a fraud committed or attempted using the identifying information of another person."

3. The FACT Act gives the Board the authority to write rules for state member banks but not BHCs. Nonetheless, the Board retains its supervisory and enforcement authority over BHCs, pursuant to section 1818 of the Federal Deposit Insurance Act. The Board and FTC Red Flags Rules are substantially the same.

4. For purposes of the rule, the term "financial institution" means a "State or National bank, a State or Federal savings and loan association, a mutual savings bank . . . or any other person that, directly or indirectly, holds a transaction account . . . belonging to a consumer."

5. Under section 111 of the FACT Act, the term "creditor" means any person (a natural person, a corporation, government or governmental subdivision, trust, estate, partnership, cooperative, or association) who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee or original creditor who participates in the decision to extend, renew, or continue credit.

6. The FTC subsequently granted a six-month delay of enforcement of its Red Flags Rule until May 1, 2009. (See www2.ftc.gov/opa/2008/10/redflags.shtm.) This delay in enforcement is limited to the Identity Theft Red Flags Rule (16 CFR 681.1), and does not extend to the rule regarding changes of address applicable to card issuers (16 C.F.R. 681.2).

2124.5.1.2 Elements of the Program

The elements of the actual Program will vary depending on the size and complexity of the financial institution or creditor. A financial institution or creditor that determines that it is required to establish and maintain an Identity Theft Prevention Program must (1) identify relevant Red Flags for its covered accounts, (2) detect the Red Flags that have been incorporated into its Program, and (3) respond appropriately to the detected Red Flags. The Red Flags are patterns, practices, or specific activities that indicate the possible existence of identity theft or the potential to lead to identity theft. A financial institution or creditor must ensure (1) that its Program is updated periodically to address the changing risks associated with its customers and their accounts and (2) the safety and soundness of the financial institution or creditor from identity theft.

2124.5.1.3 Guidelines

Each financial institution or creditor that is required to implement a written Program must consider the Guidelines for Identity Theft Detection, Prevention, and Mitigation (16 C.F.R. 681, appendix A of the rule) (the Guidelines) and include those guidelines that are appropriate in its Program. Section I of the Guidelines, "The Program," discusses a Program's design that may include, as appropriate, existing policies, procedures, and arrangements that control foreseeable risks to the institution's customers or to the safety and soundness of the financial institution or creditor from identity theft.

2124.5.1.3.1 Identification of Red Flags

A financial institution or creditor should incorporate relevant Red Flags into the Program from sources such as (1) incidents of identity theft that it has experienced, (2) methods of identity theft that have been identified as reflecting changes in identity theft risks, and (3) applicable supervisory guidance.

2124.5.1.3.2 Categories of Red Flags

Section II of the Guidelines, "Categories of Red Flags," provides some guidance in identifying relevant Red Flags.[7] A financial institution or creditor should include, as appropriate,

1. alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services;
2. the presentation of suspicious documents;
3. the presentation of suspicious personal identifying information, such as a suspicious address change;
4. the unusual use of, or other suspicious activity related to, a covered account; and
5. notices received from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution or creditor.

The above categories do not represent a comprehensive list of all types of Red Flags that may indicate the possibility of identity theft. Institutions must also consider specific business lines and any previous exposures to identity theft. No specific Red Flag is mandatory for all financial institutions or creditors. Rather, the Program should follow the risk-based, nonprescriptive approach regarding the identification of Red Flags.

2124.5.1.3.3 Detect the Program's Red Flags

In accordance with Section III of the Guidelines, each financial institution or creditor's Program should address the detection of Red Flags in connection with the opening of covered accounts and existing covered accounts. A financial institution or creditor is required to detect, prevent, and mitigate identity theft in connection with such accounts. The policies and procedures regarding opening a covered account subject to the Program should explain how an institution could identify information about, and verify the identity of, a person opening an account.[8] In the case of existing covered accounts, institutions could authenticate customers, monitor transactions, and verify the validity of change of address requests.

7. Examples of Red Flags from each of these categories are appended as supplement A to appendix A.
8. See 31 U.S.C. 5318(l) and 31 C.F.R. 103.121.

2124.5.1.3.4 Respond Appropriately to any Detected Red Flags

A financial institution or creditor should consider precursors to identity theft to stop identity theft before it occurs. Section IV of the Guidelines, "Prevention and Mitigation," states that an institution's procedures should provide for appropriate responses to Red Flags that it has detected that are commensurate with the degree of risk posed. When determining an appropriate response, the institution should consider aggravating factors that may heighten its risk of identity theft. Such factors may include (1) a data security incident that results in unauthorized disclosures of nonpublic personal information, (2) records the institution holds or that are held by another creditor or third party, or (3) notice that the institution's customer has provided information related to its covered account to someone fraudulently claiming to represent the institution or to a fraudulent website. Appropriate responses may include the following: (1) monitoring a covered account for evidence of identity theft; (2) contacting the customer; (3) changing any passwords, security codes, or other security devices that permit access to a secured account; (4) reopening a covered account with a new account number; (5) not opening a new covered account; (6) closing an existing covered account; (7) not attempting to collect on a covered account or not selling a covered account to a debt collector; (8) notifying law enforcement; or (9) determining that no response is warranted under the particular circumstances.

2124.5.1.3.5 Periodically Updating the Program's Relevant Red Flags

Section V of the Guidelines, "Updating the Program," states that a financial institution or creditor should periodically update its Program (including its relevant Red Flags) to reflect any changes in risks to its customers or to the safety and soundness of the institution from identity theft, based on (but not limited to) factors such as

1. the experiences of the institution with identity theft,
2. changes in methods of identity theft,
3. changes in methods to detect, prevent, and mitigate identity theft,
4. changes in the types of accounts that the institution offers or maintains, and
5. changes in the institution's structure, including its mergers, acquisitions, joint ventures, and any business arrangements, such as alliances and service provider arrangements.

2124.5.1.4 Administration of Program

A financial institution or creditor that is required to implement a Program must provide for the continued oversight and administration of its Program. The following are the steps that are needed in the administration of a Red Flags Program:

1. *Obtain approval from either the institution's board of directors or any appropriate committee of the board of directors of the initial written Program;*
2. *Involve either the board of directors, a designated committee of the board of directors, or a designated senior-management-level employee in the oversight, development, implementation, and administration of the Program.*[9] This includes
   - assigning specific responsibility for the Program's implementation,
   - reviewing reports prepared by staff regarding the institution's compliance (the reports should be prepared at least annually), and
   - reviewing material changes to the Program as necessary to address changing identity theft risks.
3. *Train staff.* The financial institution or creditor must train relevant staff to effectively implement and monitor the Program. Training should be provided as changes are made to the financial institution or creditor's Program based on its periodic risk assessment.
4. *Exercise appropriate and effective oversight of service provider arrangements.* Section VI of the Guidelines, "Methods for Administering the Program," indicates a financial institution or creditor is ultimately responsible for complying with the rules and guidelines for outsourcing an activity to a third-party

9. BHC subsidiaries can use the security program developed at the holding company level. However, if subsidiary institutions choose to use a security program developed at the holding company level, the board of directors or an appropriate committee at each subsidiary institution must conduct an independent review to ensure that the program is suitable and complies with the requirements prescribed by its primary regulator.

service provider. Whenever a financial institution or creditor engages a service provider to perform an activity in connection with one or more covered accounts, the institution should ensure that the activity of the service provider is conducted in accordance with reasonable policies and procedures designed to detect, prevent, and mitigate the risk of identity theft. With regard to the institution's oversight of its Program, periodic reports from service providers are to be issued on the Program's development, implementation, and administration.

2124.5.2 INSPECTION OBJECTIVES

1. To determine if the BHC has developed, implemented, and maintained a written Program for new and existing accounts that are covered by the FACT Act and the Federal Trade Commission's rules on Fair Credit Reporting, section 681, Subpart A—Identity Theft Red Flags (16 C.F.R. 681, subpart A), which implements provisions of the FACT Act.
2. To make a determination of whether the Program is
   a. designed to detect, prevent, and mitigate identity theft in connection with the opening of a new, or an existing, covered account and if the Program includes the detection of relevant "Red Flags" and
   b. appropriate to the size and complexity of the "financial institution" or "creditor" and the nature and scope of its activities.
3. To ascertain whether the BHC assesses the validity of change of address notifications that it receives for the credit and debit cards that it has issued to customers.

2124.5.3 INSPECTION PROCEDURES

1. Verify that the BHC has determined initially, and periodically thereafter, whether it offers or maintains accounts covered by the FACT Act and section 681, Subpart A—Identity Theft Red Flags (16 C.F.R. 681, subpart A).
2. Determine if the BHC has adequately developed and maintains a written Program that is designed to detect, prevent, and monitor transactions to mitigate identity theft in connection with the opening of certain new and existing accounts covered by the FACT Act.
3. Evaluate whether the Program includes reasonable policies and procedures to
   a. identify and detect relevant Red Flags for the BHC's covered accounts and whether it incorporated those Red Flags into its Program,
   b. respond appropriately to any detected Red Flags to prevent and mitigate identity theft, and
   c. ensure that the Program is updated periodically to reflect changes in identity theft risks to the customers and the safety and soundness of the institution.
4. If a required Program has been established by the BHC, ascertain if it has provided for the Program's continued administration, including
   a. involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the continued oversight, development, implementation, and administration of the Program;
   b. training staff, as necessary, to effectively implement the Program; and
   c. appropriate and effective oversight of service provider arrangements.
5. If the BHC has established and maintains a required Program that applies to its covered accounts, determine if the Program includes the relevant and appropriate guidelines within the rule's appendix A (16 C.F.R. 681, appendix A).

Banking organizations should be attentive to the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused and should address those consequences through active model risk management. The key aspects of an effective model risk-management framework are described in more detail below, including robust model development, implementation, and use; effective validation; and sound governance, policies, and controls. (See SR-11-7.)

This guidance describes the key aspects of effective model risk management. Part II explains the purpose and scope of the guidance, and part III gives an overview of model risk management. Part IV discusses robust model development, implementation, and use. Part V describes the components of an effective validation framework. Part VI explains the salient features of sound governance, policies, and controls over model development, implementation, use, and validation. Part VII concludes.

2126.0.1 INTRODUCTION—PART I

Banks rely heavily on quantitative analysis and models in most aspects of financial decision making.[1] They routinely use models for a broad range of activities, including underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many other activities. In recent years, banks have applied models to more complex products and with more ambitious scope, such as enterprise-wide risk measurement, while the markets in which they are used have also broadened and changed. Changes in regulation have spurred some of the recent developments, particularly the U.S. regulatory capital rules for market, credit, and operational risk based on the framework developed by the Basel Committee on Banking Supervision. Even apart from these regulatory considerations, however, banks have been increasing the use of data-driven, quantitative decision making tools for a number of years.

The expanding use of models in all aspects of banking reflects the extent to which models can improve business decisions, but models also come with costs. There is the direct cost of devoting resources to develop and implement models properly. There are also the potential indirect costs of relying on models, such as the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused. Those consequences should be addressed by active management of model risk.

1. Unless otherwise indicated, *banks* refers to national banks and all other institutions for which the Office of the Comptroller of the Currency is the primary supervisor, and to bank holding companies, state member banks, and all other institutions for which the Federal Reserve Board is the primary supervisor.

2126.0.2 PURPOSE AND SCOPE—PART II

The purpose of this section is to provide comprehensive guidance for banks on effective model risk management. Rigorous model validation plays a critical role in model risk management; however, sound development, implementation, and use of models are also vital elements. Furthermore, model risk management encompasses governance and control mechanisms such as board and senior management oversight, policies and procedures, controls and compliance, and an appropriate incentive and organizational structure.

Previous guidance and other publications issued by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve on the use of models pay particular attention to model validation.[2] Based on supervisory and industry experience over the past several years, this document expands on existing guidance—most importantly by broadening the scope to include all aspects of model risk management. Many banks may already have in place a large portion of these practices, but all banks should ensure that internal policies and procedures are consis-

2. For instance, the OCC provided guidance on model risk, focusing on model validation, in OCC 2000-16 (May 30, 2000), other bulletins, and certain subject matter booklets of the *Comptroller's Handbook.* The Federal Reserve issued SR-09-01, "Application of the Market Risk Rule in Bank Holding Companies and State Member Banks," which highlights various concepts pertinent to model risk management, including standards for validation and review, model validation documentation, and back-testing. The Federal Reserve's *Trading and Capital-Markets Activities Manual* also discusses validation and model risk management. In addition, the advanced-approaches risk-based capital rules (12 CFR 3, Appendix C; 12 CFR 208, Appendix F; and 12 CFR 225, Appendix G) contain explicit validation requirements for subject banking organizations.

tent with the risk-management principles and supervisory expectations contained in this guidance. Details may vary from bank to bank, as practical application of this guidance should be customized to be commensurate with a bank's risk exposures, its business activities, and the complexity and extent of its model use. For example, steps taken to apply this guidance at a community bank using relatively few models of only moderate complexity might be significantly less involved than those at a larger bank where use of models is more extensive or complex.

2126.0.3 OVERVIEW OF MODEL RISK MANAGEMENT—PART III

For the purposes of this section, the term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A *model* consists of three components: an information input component, which delivers assumptions and data to the model; a processing component, which transforms inputs into estimates; and a reporting component, which translates the estimates into useful business information. Models meeting this definition might be used for analyzing business strategies; informing business decisions; identifying and measuring risks; valuing exposures, instruments, or positions; conducting stress testing; assessing adequacy of capital; managing client assets; measuring compliance with internal limits; maintaining the formal control apparatus of the bank; meeting financial or regulatory reporting requirements; and issuing public disclosures. The definition of *model* also covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.[3]

Models are simplified representations of real-world relationships among observed characteristics, values, and events. Simplification is inevitable, due to the inherent complexity of those relationships, but also intentional, to focus attention on particular aspects considered to be most important for a given model application. Model quality can be measured in many ways: precision, accuracy, discriminatory power, robustness, stability, and reliability, to name a few. Models are never perfect, and the appropriate metrics of quality, and the effort that should be put into improving quality, depend on the situation. For example, precision and accuracy are relevant for models that forecast future values, while discriminatory power applies to models that rank order risks. In all situations, it is important to understand a model's capabilities and limitations given its simplifications and assumptions.

The use of models invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision making, or damage to a bank's reputation. Model risk occurs primarily for two reasons:

- The model may have fundamental errors and may produce inaccurate outputs when viewed against the design objective and intended business uses. The mathematical calculation and quantification exercise underlying any model generally involves application of theory, choice of sample design and numerical routines, selection of inputs and estimation, and implementation in information systems. Errors can occur at any point from design through implementation. In addition, shortcuts, simplifications, or approximations used to manage complicated problems could compromise the integrity and reliability of outputs from those calculations. Finally, the quality of model outputs depends on the quality of input data and assumptions, and errors in inputs or incorrect assumptions will lead to inaccurate outputs.
- The model may be used incorrectly or inappropriately. Even a fundamentally sound model producing accurate outputs consistent with the design objective of the model may exhibit high model risk if it is misapplied or misused. Models by their nature are simplifications of reality, and real-world events may prove those simplifications inappropriate. This is even more of a concern if a model is used outside the environment for which it was designed. Banks may do this intentionally as they apply existing models to new products or markets, or inadvertently as market conditions or customer behavior changes. Decision makers need to understand the limitations of a model to avoid using it in ways that are not consistent with the original intent. Limitations

3. While outside the scope of this guidance, more qualitative approaches used by banking organizations—i.e., those *not* defined as models according to this guidance—should also be subject to a rigorous control process.

come in part from weaknesses in the model due to its various shortcomings, approximations, and uncertainties. Limitations are also a consequence of assumptions underlying a model that may restrict the scope to a limited set of specific circumstances and situations.

Model risk should be managed like other types of risk. Banks should identify the sources of risk and assess the magnitude. Model risk increases with greater model complexity, higher uncertainty about inputs and assumptions, broader use, and larger potential impact. Banks should consider risk from individual models and in the aggregate. Aggregate model risk is affected by interaction and dependencies among models; reliance on common assumptions, data, or methodologies; and any other factors that could adversely affect several models and their outputs at the same time. With an understanding of the source and magnitude of model risk in place, the next step is to manage it properly.

A guiding principle for managing model risk is "effective challenge" of models, that is, critical analysis by objective, informed parties who can identify model limitations and assumptions and produce appropriate changes. Effective challenge depends on a combination of incentives, competence, and influence. Incentives to provide effective challenge to models are stronger when there is greater separation of that challenge from the model development process and when challenge is supported by well-designed compensation practices and corporate culture. Competence is a key to effectiveness since technical knowledge and modeling skills are necessary to conduct appropriate analysis and critique. Finally, challenge may fail to be effective without the influence to ensure that actions are taken to address model issues. Such influence comes from a combination of explicit authority, stature within the organization, and commitment and support from higher levels of management.

Even with skilled modeling and robust validation, model risk cannot be eliminated, so other tools should be used to manage model risk effectively. Among these are establishing limits on model use, monitoring model performance, adjusting or revising models over time, and supplementing model results with other analysis and information. Informed conservatism, in either the inputs or the design of a model or through explicit adjustments to outputs, can be an effective tool, though not an excuse to avoid improving models.

As is generally the case with other risks, materiality is an important consideration in model risk management. If at some banks the use of models is less pervasive and has less impact on their financial condition, then those banks may not need as complex an approach to model risk management in order to meet supervisory expectations. However, where models and model output have a material impact on business decisions, including decisions related to risk management and capital and liquidity planning, and where model failure would have a particularly harmful impact on a bank's financial condition, a bank's model risk-management framework should be more extensive and rigorous.

Model risk management begins with robust model development, implementation, and use. Another essential element is a sound model validation process. A third element is governance, which sets an effective framework with defined roles and responsibilities for clear communication of model limitations and assumptions, as well as the authority to restrict model usage. Each of these elements is discussed in the following sections.

2126.0.4 MODEL DEVELOPMENT, IMPLEMENTATION, AND USE—PART IV

Model risk management should include disciplined and knowledgeable development and implementation processes that are consistent with the situation and goals of the model user and with bank policy. Model development is not a straightforward or routine technical process. The experience and judgment of developers, as much as their technical knowledge, greatly influence the appropriate selection of inputs and processing components. The training and experience of developers exercising such judgment affects the extent of model risk. Moreover, the modeling exercise is often a multidisciplinary activity drawing on economics, finance, statistics, mathematics, and other fields. Models are employed in real-world markets and events and, therefore, should be tailored for specific applications and informed by business uses. In addition, a considerable amount of subjective judgment is exercised at various stages of model development, implementation, use, and validation. It is important for decision makers to recognize that this subjectivity elevates the importance of sound and comprehensive model risk-management processes.[4]

2126.0.4.1 Model Development and Implementation

An effective development process begins with a clear statement of purpose to ensure that model development is aligned with the intended use. The design, theory, and logic underlying the model should be well documented and generally supported by published research and sound industry practice. The model methodologies and processing components that implement the theory, including the mathematical specification and the numerical techniques and approximations, should be explained in detail with particular attention to merits and limitations. Developers should ensure that the components work as intended, are appropriate for the intended business purpose, and are conceptually sound and mathematically and statistically correct. Comparison with alternative theories and approaches is a fundamental component of a sound modeling process.

The data and other information used to develop a model are of critical importance; there should be rigorous assessment of data quality and relevance, and appropriate documentation. Developers should be able to demonstrate that such data and information are suitable for the model and that they are consistent with the theory behind the approach and with the chosen methodology. If data proxies are used, they should be carefully identified, justified, and documented. If data and information are not representative of the bank's portfolio or other characteristics, or if assumptions are made to adjust the data and information, these factors should be properly tracked and analyzed so that users are aware of potential limitations. This is particularly important for external data and information (from a vendor or outside party), especially as they relate to new products, instruments, or activities.

An integral part of model development is testing, in which the various components of a model and its overall functioning are evaluated to determine whether the model is performing as intended. Model testing includes checking the model's accuracy, demonstrating that the model is robust and stable, assessing potential limitations, and evaluating the model's behavior over a range of input values. It should also assess the impact of assumptions and identify situations where the model performs poorly or becomes unreliable. Testing should be applied to actual circumstances under a variety of market conditions, including scenarios that are outside the range of ordinary expectations, and should encompass the variety of products or applications for which the model is intended. Extreme values for inputs should be evaluated to identify any boundaries of model effectiveness. The impact of model results on other models that rely on those results as inputs should also be evaluated. Included in testing activities should be the purpose, design, and execution of test plans, summary results with commentary and evaluation, and detailed analysis of informative samples. Testing activities should be appropriately documented.

The nature of testing and analysis will depend on the type of model and will be judged by different criteria depending on the context. For example, the appropriate statistical tests depend on specific distributional assumptions and the purpose of the model. Furthermore, in many cases statistical tests cannot unambiguously reject false hypotheses or accept true ones based on sample information. Different tests have different strengths and weaknesses under different conditions. Any single test is rarely sufficient, so banks should apply a variety of tests to develop a sound model.

Banks should ensure that the development of the more judgmental and qualitative aspects of their models is also sound. In some cases, banks may take statistical output from a model and modify it with judgmental or qualitative adjustments as part of model development. While such practices may be appropriate, banks should ensure that any such adjustments made as part of the development process are conducted in an appropriate and systematic manner and are well documented.

Models typically are embedded in larger information systems that manage the flow of data from various sources into the model and handle the aggregation and reporting of model outcomes. Model calculations should be properly coordinated with the capabilities and requirements of information systems. Sound model risk management depends on substantial investment in supporting systems to ensure data

4. Smaller banks that rely on vendor models may be able to satisfy the standards in this guidance without an in-house staff of technical, quantitative model developers. However, even if a bank relies on vendors for basic model development, the bank should still choose the particular models and variables that are appropriate to its size, scale, and lines of business and ensure the models are appropriate for the intended use.

and reporting integrity, together with controls and testing to ensure proper implementation of models, effective systems integration, and appropriate use.

2126.0.4.2 Model Use

Model use provides additional opportunity to test whether a model is functioning effectively and to assess its performance over time as conditions and model applications change. It can serve as a source of productive feedback and insights from a knowledgeable internal constituency with strong interest in having models that function well and reflect economic and business realities. Model users can provide valuable business insight during the development process. In addition, business managers affected by model outcomes may question the methods or assumptions underlying the models, particularly if the managers are significantly affected by, and do not agree with, the outcome. Such questioning can be healthy if it is constructive and causes model developers to explain and justify the assumptions and design of the models.

However, challenge from model users may be weak if the model does not materially affect their results, if the resulting changes in models are perceived to have adverse effects on the business line, or if change in general is regarded as expensive or difficult. User challenges also tend not to be comprehensive because they focus on aspects of models that have the most direct impact on the user's measured business performance or compensation, and thus may ignore other elements and applications of the models. Finally, such challenges tend to be asymmetric because users are less likely to challenge an outcome that results in an advantage for them. Indeed, users may incorrectly believe that model risk is low simply because outcomes from model-based decisions appear favorable to the institution. Thus, the nature and motivation behind model users' input should be evaluated carefully, and banks should also solicit constructive suggestions and criticism from sources independent of the line of business using the model.

Reports used for business decision making play a critical role in model risk management. Such reports should be clear and comprehensible and take into account the fact that decision makers and modelers often come from quite different backgrounds and may interpret the contents in different ways. Reports that provide a range of estimates for different input-value scenarios and assumption values can give decision makers important indications of the model's accuracy, robustness, and stability as well as information on model limitations.

An understanding of model uncertainty and inaccuracy and a demonstration that the bank is accounting for them appropriately are important outcomes of effective model development, implementation, and use. Because they are by definition imperfect representations of reality, all models have some degree of uncertainty and inaccuracy. These can sometimes be quantified, for example, by an assessment of the potential impact of factors that are unobservable or not fully incorporated in the model, or by the confidence interval around a statistical model's point estimate. Indeed, using a range of outputs, rather than a simple point estimate, can be a useful way to signal model uncertainty and avoid spurious precision. At other times, only a qualitative assessment of model uncertainty and inaccuracy is possible. In either case, it can be prudent for banks to account for model uncertainty by explicitly adjusting model inputs or calculations to produce more severe or adverse model output in the interest of conservatism. Accounting for model uncertainty can also include judgmental conservative adjustments to model output, placing less emphasis on that model's output, or ensuring that the model is only used when supplemented by other models or approaches.[5]

While conservative use of models is prudent in general, banks should be careful in applying conservatism broadly or claiming to make conservative adjustments or add-ons to address model risk, because the impact of such conservatism in complex models may not be obvious or intuitive. Model aspects that appear conservative in one model may not be truly conservative compared with alternative methods. For example, simply picking an extreme point on a given modeled distribution may not be conservative if the distribution was misestimated or misspecified in the first place. Furthermore, initially conservative assumptions may not remain conservative over time. Therefore, banks should justify and substantiate claims that model outputs are conservative with a definition and measurement of that conservatism that is communicated to model users. In some cases, sensitivity analysis or other types of stress testing can be used to

5. To the extent that models are used to generate amounts included in public financial statements, any adjustments for model uncertainty must comply with generally accepted accounting principles.

demonstrate that a model is indeed conservative. Another way in which banks may choose to be conservative is to hold an additional cushion of capital to protect against potential losses associated with model risk. However, conservatism can become an impediment to proper model development and application if it is seen as a solution that dissuades the bank from making the effort to improve the model; in addition, excessive conservatism can lead model users to discount the model outputs.

As previously explained, robust model development, implementation, and use is important to model risk management. But it is not enough for model developers and users to understand and accept the model. Because model risk is ultimately borne by the bank as a whole, the bank should objectively assess model risk and the associated costs and benefits using a sound model-validation process.

2126.0.5 MODEL VALIDATION—PART V

Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps ensure that models are sound. It also identifies potential limitations and assumptions and assesses their possible impact. As with other aspects of effective challenge, model validation should be performed by staff with appropriate incentives, competence, and influence.

All model components, including input, processing, and reporting, should be subject to validation; this applies equally to models developed in-house and to those purchased from, or developed by, vendors or consultants. The rigor and sophistication of validation should be commensurate with the bank's overall use of models, the complexity and materiality of its models, and the size and complexity of the bank's operations.

Validation involves a degree of independence from model development and use. Generally, validation should be done by people who are not responsible for development or use and do not have a stake in whether a model is determined to be valid. Independence is not an end in itself but rather helps ensure that incentives are aligned with the goals of model validation. While independence may be supported by separation of reporting lines, it should be judged by actions and outcomes, since there may be additional ways to ensure objectivity and prevent bias. As a practical matter, some validation work may be most effectively done by model developers and users; it is essential, however, that such validation work be subject to critical review by an independent party, who should conduct additional activities to ensure proper validation. Overall, the quality of the process is judged by the manner in which models are subject to critical review. This could be determined by evaluating the extent and clarity of documentation, the issues identified by objective parties, and the actions taken by management to address model issues.

In addition to independence, banks can support appropriate incentives in validation through compensation practices and performance evaluation standards that are tied directly to the quality of model validations and the degree of critical, unbiased review. In addition, corporate culture plays a role if it establishes support for objective thinking and encourages questioning and challenging of decisions.

Staff doing validation should have the requisite knowledge, skills, and expertise. A high level of technical expertise may be needed because of the complexity of many models, both in structure and in application. These staff also should have a significant degree of familiarity with the line of business using the model and the model's intended use. A model's developer is an important source of information but cannot be relied on as an objective or sole source on which to base an assessment of model quality.

Staff conducting validation work should have explicit authority to challenge developers and users and to elevate their findings, including issues and deficiencies. The individual or unit to whom those staff report should have sufficient influence or stature within the bank to ensure that any issues and deficiencies are appropriately addressed in a timely and substantive manner. Such influence can be reflected in reporting lines, title, rank, or designated responsibilities. Influence may be demonstrated by a pattern of actual instances in which models, or the use of models, have been appropriately changed as a result of validation.

The range and rigor of validation activities conducted prior to first use of a model should be in line with the potential risk presented by use of the model. If significant deficiencies are noted as a result of the validation process, use of the model should not be allowed or should be permitted only under very tight constraints until those issues are resolved. If the deficiencies are too severe to be addressed within the model's framework, the model should be rejected. If it is not feasible to conduct necessary validation activities prior to model use because of data paucity or other limitations, that fact should be documented and communicated in reports to users, senior management, and other relevant parties. In such cases, the uncertainty about the results that the model produces should be mitigated by other compensating controls. This is particularly applicable to new models and to the use of existing models in new applications.

Validation activities should continue on an ongoing basis after a model goes into use, to track known model limitations and to identify any new ones. Validation is an important check on model use during periods of benign economic and financial conditions, when estimates of risk and potential loss can become overly optimistic, and when the data at hand may not fully reflect more stressed conditions. Ongoing validation activities help to ensure that changes in markets, products, exposures, activities, clients, or business practices do not create new model limitations. For example, if credit risk models do not incorporate underwriting changes in a timely manner, flawed and costly business decisions could be made before deterioration in model performance becomes apparent.

Banks should conduct a periodic review—at least annually but more frequently if warranted—of each model to determine whether it is working as intended and if the existing validation activities are sufficient. Such a determination could simply affirm previous validation work, suggest updates to previous validation activities, or call for additional validation activities. Material changes to models should also be subject to validation. It is generally good practice for banks to ensure that all models undergo the full validation process, as described in the following section, at some fixed interval, including updated documentation of all activities.

Effective model validation helps reduce model risk by identifying model errors, corrective actions, and appropriate use. It also provides an assessment of the reliability of a given model, based on its underlying assumptions, theory, and methods. In this way, it provides information about the source and extent of model risk. Validation also can reveal deterioration in model performance over time and can set thresholds for acceptable levels of error, through analysis of the distribution of outcomes around expected or predicted values. If outcomes fall consistently outside this acceptable range, then the models should be redeveloped.

2126.0.5.1 Key Elements of Comprehensive Validation

An effective validation framework should include three core elements:

- Evaluation of conceptual soundness, including developmental evidence
- Ongoing monitoring, including process verification and benchmarking
- Outcomes analysis, including back-testing

2126.0.5.1.1 Evaluation of Conceptual Soundness

This first element involves assessing the quality of the model design and construction. It entails review of documentation and empirical evidence supporting the methods used and variables selected for the model. Documentation and testing should convey an understanding of model limitations and assumptions. Validation should ensure that judgment exercised in model design and construction is well informed, carefully considered, and consistent with published research and with sound industry practice. Developmental evidence should be reviewed before a model goes into use and also as part of the ongoing validation process, in particular whenever there is a material change in the model.

A sound development process will produce documented evidence in support of all model choices, including the overall theoretical construction, key assumptions, data, and specific mathematical calculations. As part of model validation, those model aspects should be subjected to critical analysis by both evaluating the quality and extent of developmental evidence and conducting additional analysis and testing as necessary. Comparison to alternative theories and approaches should be included. Key assumptions and the choice of variables should be assessed, with analysis of their impact on model outputs and particular focus on any potential limitations. The relevance of the data used to build the model should be evaluated to ensure that it is reasonably representative of the bank's portfolio or market conditions, depending on the type of model. This is an especially important exercise when a bank uses external data or the model is used for new products or activities.

Where appropriate to the particular model, banks should employ sensitivity analysis in model development and validation to check the impact of small changes in inputs and parameter values on model outputs to make sure they fall within an expected range. Unexpectedly large changes in outputs in response to small changes in inputs can indicate an unstable model. Varying several inputs simultaneously as part of sensitivity analysis can provide evidence of unexpected interactions, particularly if the interactions are complex and not intuitively clear. Banks benefit from conducting model stress testing to check performance over a wide range of inputs and parameter values, including extreme values, to verify that the model is robust. Such testing helps establish the boundaries of model performance by identifying the acceptable range of inputs as well as conditions under which the model may become unstable or inaccurate.

Management should have a clear plan for using the results of sensitivity analysis and other quantitative testing. If testing indicates that the model may be inaccurate or unstable in some circumstances, management should consider modifying certain model properties, putting less reliance on its outputs, placing limits on model use, or developing a new approach.

Qualitative information and judgment used in model development should be evaluated, including the logic, judgment, and types of information used, to establish the conceptual soundness of the model and set appropriate conditions for its use. The validation process should ensure that qualitative, judgmental assessments are conducted in an appropriate and systematic manner, are well supported, and are documented.

2126.0.5.1.2 Ongoing Monitoring

The second core element of the validation process is ongoing monitoring. Such monitoring confirms that the model is appropriately implemented and is being used and is performing as intended.

Ongoing monitoring is essential to evaluate whether changes in products, exposures, activities, clients, or market conditions necessitate adjustment, redevelopment, or replacement of the model and to verify that any extension of the model beyond its original scope is valid. Any model limitations identified in the development stage should be regularly assessed over time, as part of ongoing monitoring. Monitoring begins when a model is first implemented in production systems for actual business use. This monitoring should continue periodically over time, with a frequency appropriate to the nature of the model, the availability of new data or modeling approaches, and the magnitude of the risk involved. Banks should design a program of ongoing testing and evaluation of model performance along with procedures for responding to any problems that appear. This program should include process verification and benchmarking.

Process verification checks that all model components are functioning as designed. It includes verifying that internal and external data inputs continue to be accurate, complete, consistent with model purpose and design, and of the highest quality available. Computer code implementing the model should be subject to rigorous quality and change control procedures to ensure that the code is correct, that it cannot be altered except by approved parties, and that all changes are logged and can be audited. System integration can be a challenge and deserves special attention because the model processing component often draws from various sources of data, processes large amounts of data, and then feeds into multiple data repositories and reporting systems. User-developed applications, such as spreadsheets or ad hoc database applications used to generate quantitative estimates, are particularly prone to model risk. As the content or composition of information changes over time, systems may need to be updated to reflect any changes in the data or its use. Reports derived from model outputs should be reviewed as part of validation to verify that they are accurate, complete, and informative, and that they contain appropriate indicators of model performance and limitations.

Many of the tests employed as part of model development should be included in ongoing monitoring and be conducted on a regular basis to incorporate additional information as it becomes available. New empirical evidence or theoretical research may suggest the need to modify or even replace original methods. Analysis of the integrity and applicability of internal and external information sources, including information provided by third-party vendors, should be performed regularly.

Sensitivity analysis and other checks for robustness and stability should likewise be repeated periodically. They can be as useful during ongoing monitoring as they are during model development. If models only work well for certain ranges of input values, market conditions, or other factors, they should be monitored to identify situations where these constraints are approached or exceeded.

Ongoing monitoring should include the analysis of overrides with appropriate documentation. In the use of virtually any model, there will be cases where model output is ignored, altered, or reversed based on the expert judgment of model users. Such overrides are an indication that, in some respect, the model is not performing as intended or has limitations. Banks should evaluate the reasons for overrides and track and analyze override performance. If the rate of overrides is high, or if the override process consistently improves model performance, it is often a sign that the underlying model needs revision or redevelopment.

Benchmarking is the comparison of a given model's inputs and outputs to estimates from alternative internal or external data or models. It can be incorporated in model development as well as in ongoing monitoring. For credit-risk models, examples of benchmarks include models from vendor firms or industry consortia and data from retail credit bureaus. Pricing models for securities and derivatives often can be compared with alternative models that are more accurate or comprehensive but also too time-consuming to run on a daily basis. Whatever the source, benchmark models should be rigorous, and benchmark data should be accurate and complete to ensure a reasonable comparison.

Discrepancies between the model output and benchmarks should trigger investigation into the sources and degree of the differences, and examination of whether they are within an expected or appropriate range given the nature of the comparison. The results of that analysis may suggest revisions to the model. However, differences do not necessarily indicate that the model is in error. The benchmark itself is an alternative prediction, and the differences may be due to the different data or methods used. If the model and the benchmark match well, that is evidence in favor of the model, but it should be interpreted with caution so the bank does not get a false degree of comfort.

2126.0.5.1.3 Outcomes Analysis

The third core element of the validation process is outcomes analysis, a comparison of model outputs to corresponding actual outcomes. The precise nature of the comparison depends on the objectives of a model and might include an assessment of the accuracy of estimates or forecasts, an evaluation of rank-ordering ability, or other appropriate tests. In all cases, such comparisons help to evaluate model performance by establishing expected ranges for those actual outcomes in relation to the intended objectives and assessing the reasons for observed variation between the two. If outcomes analysis produces evidence of poor performance, the bank should take action to address those issues. Outcomes analysis typically relies on statistical tests or other quantitative measures. It can also include expert judgment to check the intuition behind the outcomes and confirm that the results make sense. When a model itself relies on expert judgment, quantitative outcomes analysis helps to evaluate the quality of that judgment. Outcomes analysis should be conducted on an ongoing basis to test whether the model continues to perform in line with design objectives and business uses.

A variety of quantitative and qualitative testing and analytical techniques can be used in outcomes analysis. The choice of technique should be based on the model's methodology, and its complexity, data availability, and the magnitude of potential model risk to the bank. Outcomes analysis should involve a range of tests because any individual test will have weaknesses. For example, some tests are better at checking a model's ability to rank-order or segment observations on a relative basis, whereas others are better at checking absolute forecast accuracy. Tests should be designed for each situation, as not all will be effective or feasible in every circumstance, and attention should be paid to choosing the appropriate type of outcomes analysis for a particular model.

Models are regularly adjusted to take into account new data or techniques, or because of deterioration in performance. Parallel outcomes analysis, under which both the original and adjusted models' forecasts are tested against realized outcomes, provides an important test of such model adjustments. If the adjusted model does not outperform the original model, developers, users, and reviewers should realize that additional changes—or even a wholesale redesign—are likely necessary before the adjusted model replaces the original one.

Back-testing is one form of outcomes analysis; specifically, it involves the comparison of actual outcomes with model forecasts during a sample time period not used in model development and at an observation frequency that matches the forecast horizon or performance window of the model. The comparison is generally done using expected ranges or statistical confidence intervals around the model forecasts. When outcomes fall outside those intervals, the bank should analyze the discrepancies and investigate the causes that are significant in terms of magnitude or frequency. The objective of the analysis is to determine whether differences stem from the omission of material factors from the model, whether they arise from errors with regard to other aspects of model specification such as interaction terms or assumptions of linearity, or whether they are purely random and thus consistent with acceptable model performance. Analysis of in-sample fit and of model performance in holdout samples (data set aside and not used to estimate the original model) are important parts of model development but are not substitutes for back-testing.

A well-known example of back-testing is the evaluation of value-at-risk (VaR), in which actual profit and loss is compared with a model forecast loss distribution. Significant deviation in expected versus actual performance and unexplained volatility in the profits and losses of trading activities may indicate that hedging and pricing relationships are not adequately measured by a given approach. Along with measuring the frequency of losses in excess of a single VaR percentile estimator, banks should use other tests, such as assessing any clustering of exceptions and checking the distribution of losses against other estimated percentiles.

Analysis of the results of even high-quality and well-designed back-testing can pose challenges, since it is not a straightforward, mechanical process that always produces unambiguous results. The purpose is to test the model, not individual forecast values. Back-testing may entail analysis of a large number of forecasts over different conditions at a point in time or over multiple time periods. Statistical testing is essential in such cases, yet such testing can pose challenges in both the choice of appropriate tests and the interpretation of results; banks should support and document both the choice of tests and the interpretation of results.

Models with long forecast horizons should be back-tested, but given the amount of time it would take to accumulate the necessary data, that testing should be supplemented by evaluation over shorter periods. Banks should employ outcomes analysis consisting of "early warning" metrics designed to measure performance beginning very shortly after model introduction and trend analysis of performance over time. These outcomes analysis tools are not substitutes for back-testing, which should still be performed over the longer time period, but rather are very important complements.

Outcomes analysis and the other elements of the validation process may reveal significant errors or inaccuracies in model development or outcomes that consistently fall outside the bank's predetermined thresholds of acceptability. In such cases, model adjustment, recalibration, or redevelopment is warranted. Adjustments and recalibration should be governed by the principle of conservatism and should undergo independent review.

Material changes in model structure or technique, and all model redevelopment, should be subject to validation activities of appropriate range and rigor before implementation. At times, banks may have a limited ability to use key model validation tools like back-testing or sensitivity analysis for various reasons, such as lack of data or of price observability. In those cases, even more attention should be paid to the model's limitations when considering the appropriateness of model usage, and senior management should be fully informed of those limitations when using the models for decision making. Such scrutiny should be applied to individual models and models in the aggregate.

2126.0.5.2 Validation of Vendor and Other Third-Party Products

The widespread use of vendor and other third-party products—including data, parameter values, and complete models—poses unique challenges for validation and other model risk-management activities because the modeling expertise is external to the user and because some components are considered proprietary. Vendor products should nevertheless be incorporated into a bank's broader model risk-management framework, following the same principles as applied to in-house models, although the process may be somewhat modified.

As a first step, banks should ensure that there are appropriate processes in place for selecting vendor models. Banks should require the vendor to provide developmental evidence explaining the product components, design, and intended use, to determine whether the model is appropriate for the bank's products, exposures, and risks. Vendors should provide appropriate testing results that show their product works as expected. They should also clearly indicate the model's limitations and assumptions and where the product's use may be problematic. Banks should expect vendors to conduct ongoing performance monitoring and outcomes analysis, with disclosure to their clients, and to make appropriate modifications and updates over time.

Banks are expected to validate their own use of vendor products. External models may not allow full access to computer coding and implementation details, so the bank may have to rely more on sensitivity analysis and benchmarking. Vendor models are often designed to provide a range of capabilities and so may need to be customized by a bank for its particular circumstances. A bank's customization choices should be documented and justified as part of validation. If vendors provide input data or assumptions, or use them to build models, their relevance for the bank's situation should be investigated. Banks should obtain information regarding the data used to develop the model and assess the extent to which that data are representative of the bank's situation. The bank also should conduct ongoing monitoring and outcomes analysis of vendor model performance using the bank's own outcomes.

Systematic procedures for validation help the bank to understand the vendor product and its capabilities, applicability, and limitations. Such detailed knowledge is necessary for basic controls of bank operations. It is also very important for the bank to have as much knowledge in-house as possible, in case the vendor or the bank terminates the contract for any reason, or if the vendor is no longer in business. Banks should have contingency plans for instances when the vendor model is no longer available or cannot be supported by the vendor.

2126.0.6 GOVERNANCE, POLICIES, AND CONTROLS—PART VI

Developing and maintaining strong governance, policies, and controls over the model risk-management framework is fundamentally important to its effectiveness. Even if model development, implementation, use, and validation are satisfactory, a weak governance function will reduce the effectiveness of overall model risk management. A strong governance framework provides explicit support and structure to risk-management functions through policies defining relevant risk-management activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified. Notably, the extent and sophistication of a bank's governance function is expected to align with the extent and sophistication of model usage.

2126.0.6.1 Board of Directors and Senior Management

Model risk governance is provided at the highest level by the board of directors and senior management when they establish a bank-wide approach to model risk management. As part of their overall responsibilities, a bank's board and senior management should establish a strong model risk-management framework that fits into the broader risk management of the organization. That framework should be grounded in an understanding of model risk—not just for individual models but also in the aggregate. The framework should include standards for model development, implementation, use, and validation.

While the board is ultimately responsible, it generally delegates to senior management the responsibility for executing and maintaining an effective model risk-management framework. Duties of senior management include establishing adequate policies and procedures and ensuring compliance, assigning competent staff, overseeing model development and implementation, evaluating model results, ensuring effective challenge, reviewing validation and internal audit findings, and taking prompt remedial action when necessary. In the same manner as for other major areas of risk, senior management, directly and through relevant committees, is responsible for regularly reporting to the board on significant model risk, from individual models and in the aggregate, and on compliance with policy. Board members should ensure that the level of model risk is within their tolerance and should direct changes where appropriate. These actions will set the tone for the whole organization about the importance of model risk and the need for active model risk management.

2126.0.6.2 Policies and Procedures

Consistent with good business practices and existing supervisory expectations, banks should formalize model risk-management activities with policies and the procedures to implement them. Model risk-management policies should be consistent with this guidance and also be commensurate with the bank's relative complexity, business activities, corporate culture, and overall organizational structure. The board or its delegates should approve model risk-management policies and review them annually to ensure consistent and rigorous practices across the organization. Those policies should be updated as necessary to ensure that model risk-management practices remain appropriate and keep current with changes in market conditions, bank products and strategies, bank exposures and activities, and practices in the industry. All aspects of model risk management should be covered by suitable policies, including model and model risk definitions; assessment of model risk; acceptable practices for model development, implementation, and use; appropriate model validation activities; and governance and controls over the model risk-management process.

Policies should emphasize testing and analysis and promote the development of targets for model accuracy, standards for acceptable levels of discrepancies, and procedures for review of, and response to, unacceptable discrepancies. They should include a description of the processes used to select and retain vendor models, including the people who should be involved in such decisions.

The prioritization, scope, and frequency of validation activities should be addressed in these policies. They should establish standards for the extent of validation that should be performed before models are put into production and the scope of ongoing validation. The policies should also detail the requirements for validation of vendor models and third-party products. Finally, they should require maintenance of detailed documentation of all aspects of the model risk-management framework, including an inventory of models in use, results of the modeling and validation processes, and model issues and their resolution.

Policies should identify the roles and assign responsibilities within the model risk-management framework with clear detail on staff expertise, authority, reporting lines, and continuity. They should also outline controls on the use of external resources for validation and compliance and specify how that work will be integrated into the model risk-management framework.

2126.0.6.3 Roles and Responsibilities

Conceptually, the roles in model risk management can be divided among ownership, controls, and compliance. While there are several ways in which banks can assign the responsibilities associated with these roles, it is important that reporting lines and incentives be clear, with potential conflicts of interest identified and addressed.

Business units are generally responsible for the model risk associated with their business strategies. The role of model owner involves ultimate accountability for model use and performance within the framework set by bank policies and procedures. Model owners should be responsible for ensuring that models are properly developed, implemented, and used. The model owner should also ensure that models in use have undergone appropriate validation and approval processes, promptly identify new or changed models, and provide all necessary information for validation activities.

Model risk taken by business units should be controlled. The responsibilities for risk controls may be assigned to individuals, committees, or a combination of the two, and include risk measurement, limits, and monitoring. Other responsibilities include managing the independent validation and review process to ensure that effective challenge takes place. Appropriate resources should be assigned for model validation and for guiding the scope and prioritization of work. Issues and problems identified through validation and other forms of oversight should be communicated by risk-control staff to relevant individuals and business users throughout the organization, including senior management, with a plan for corrective action. Control staff should have the authority to restrict the use of models and monitor any limits on model usage. While they may grant exceptions to typical procedures of model validation on a temporary basis, that authority should be subject to other control mechanisms, such as timelines for completing validation work and limits on model use.

Compliance with policies is an obligation of model owners and risk-control staff, and there should be specific processes in place to ensure that these roles are being carried out effectively and in line with policy. Documentation and tracking of activities surrounding model development, implementation, use, and validation are needed to provide a record that makes compliance with policy transparent.

2126.0.6.4 Internal Audit

A bank's internal audit function should assess the overall effectiveness of the model risk-management framework, including the framework's ability to address both types of model risk for individual models and in the aggregate. Findings from internal audit related to models should be documented and reported to the board or its appropriately delegated agent. Banks should ensure that internal audit operates with the proper incentives, has appropriate skills, and has adequate stature in the organization to assist in model risk management. Internal audit's role is not to duplicate model risk-management activities. Instead, its role is to evaluate whether model risk management is comprehensive, rigorous, and effective. To accomplish this evaluation, internal audit staff should possess sufficient expertise in relevant modeling concepts as well as their use in particular business lines. If some internal audit staff perform certain validation activities, then they should not be involved in the assessment of the overall model risk-management framework.

Internal audit should verify that acceptable policies are in place and that model owners and control groups comply with those policies. Internal audit should also verify records of model use and validation to test whether validations are performed in a timely manner and whether models are subject to controls that appropriately account for any weaknesses in validation activities. Accuracy and completeness of the model inventory should be assessed. In addition, processes for establishing and monitoring limits on model usage should be evaluated. Internal audit should determine whether procedures for updating models are clearly documented and test whether those procedures are being carried out as specified. Internal audit should check that model owners and control groups are meeting documentation standards, including risk reporting. Additionally, internal audit should perform assessments of supporting operational systems and evaluate the reliability of data used by models.

Internal audit also has an important role in ensuring that validation work is conducted properly and that appropriate effective challenge is being carried out. It should evaluate the objectivity, competence, and organizational standing of the key validation participants, with the ultimate goal of ascertaining whether those participants have the right incentives to discover and report deficiencies. Internal audit should review validation activities conducted by internal and external parties with the same rigor to see if those activities are being conducted in accordance with this guidance.

2126.0.6.5 External Resources

Although model risk management is an internal process, a bank may decide to engage external resources to help execute certain activities related to the model risk-management framework. These activities could include model validation and review, compliance functions, or other activities in support of internal audit. These resources may provide added knowledge and another level of critical and effective challenge, which may improve the internal model development and risk-management processes. However, this potential benefit should be weighed against the added costs for such resources and the added time that external parties require to understand internal data, systems, and other relevant bank-specific circumstances.

Whenever external resources are used, the bank should specify the activities to be conducted in a clearly written and agreed-upon scope of work. A designated internal party from the bank should be able to understand and evaluate the results of validation and risk-control activities conducted by external resources. The internal party is responsible for verifying that the agreed upon scope of work has been completed; evaluating and tracking identified issues and ensuring they are addressed; and making sure that completed work is incorporated into the bank's overall model risk-management framework. If the external resources are only utilized to do a portion of validation or compliance work, the bank should coordinate internal resources to complete the full range of work needed. The bank should have a contingency plan in case an external resource is no longer available or is unsatisfactory.

2126.0.6.6 Model Inventory

Banks should maintain a comprehensive set of information for models implemented for use, under development for implementation, or recently retired. While each line of business may maintain its own inventory, a specific party should also be charged with maintaining a firm-wide inventory of all models, which should assist a bank in evaluating its model risk in the aggregate. Any variation of a model that warrants a separate validation should be included as a separate model and cross-referenced with other variations.

While the inventory may contain varying levels of information, given different model complexity and the bank's overall level of model usage, the following are some general guidelines. The inventory should describe the purpose and products for which the model is designed, actual or expected usage, and any restrictions on use. It is useful for the inventory to list the type and source of inputs used by a given model and underlying components (which may include other models), as well as model outputs and their intended use. It should also indicate whether models are functioning properly, provide a description of when they were last updated, and list any exceptions to policy. Other items include the names of individuals responsible for various aspects of the model development and validation; the dates of completed and planned validation activities; and the time frame during which the model is expected to remain valid.

2126.0.6.7 Documentation

Without adequate documentation, model risk assessment and management will be ineffective. Documentation of model development and validation should be sufficiently detailed so that parties unfamiliar with a model can understand how the model operates, its limitations, and its key assumptions. Documentation provides for continuity of operations, makes compliance with policy transparent, and helps track recommendations, responses, and exceptions. Developers, users, control and compliance units, and supervisors are all served by effective documentation. Banks can benefit from advances in information and knowledge management systems and electronic documentation to improve the organization, timeliness, and accessibility of the various records and reports produced in the model risk-management process.

Documentation takes time and effort, and model developers and users who know the models well may not appreciate its value. Banks should therefore provide incentives to produce effective and complete model documentation. Model developers should have responsibility during model development for thorough documentation, which should be kept up-to-date as the model and application environment changes. In addition, the bank should ensure that other participants in model risk-management activities document their work, including ongoing monitoring, process verification, benchmarking, and outcomes analysis. Also, line of business or other decision makers should document information leading to selection of a given model and its subsequent validation. For cases in which a bank uses models from a vendor or other third party, it should ensure that appropriate documentation of the third-party approach is available so that the model can be appropriately validated.

Validation reports should articulate model aspects that were reviewed, highlighting potential deficiencies over a range of financial and economic conditions, and determining whether adjustments or other compensating controls are warranted. Effective validation reports include clear executive summaries, with a statement of model purpose and an accessible synopsis of model and validation results, including major limitations and key assumptions.

2126.0.7 CONCLUSION—PART VII

This section provides comprehensive guidance on effective model risk management. Many of the activities described are common industry practice. But all banks should confirm that their practices conform to the principles in this guidance for model development, implementation, and use, as well as model validation. Banks should also ensure that they maintain strong governance and controls to help manage model risk, including internal policies and procedures that appropriately reflect the risk-management principles described in this guidance. Details of model risk-management practices may vary from bank to bank, as practical application of this guidance should be commensurate with a bank's risk exposures, its business activities, and the extent and complexity of its model use.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2013, this section was revised to acknowledge and to include minor changes relating to the issuance of SR-12-15, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organizations," and its OCC attachment . (See section 2126.2 of this manual.) The section also updates the cited accounting standards references.

2126.1.0 SOUND RISK-MANAGEMENT PRACTICES FOR PORTFOLIO INVESTMENT

On April 23, 1998, the Federal Financial Institutions Examination Council (FFIEC) issued a Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities that became effective on May 25, 1998. The statement was adopted by the Board of Governors and provides guidance on sound practices for managing the risks of investment activities. The guidance focuses on risk-management practices of state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, recognizing the legal distinctions and potential obstacles to cash movements among subsidiaries. The statement's risk-management principles should also be incorporated into the policies of U.S. branches and agencies of foreign banks.[1]

The statement's principles set forth sound risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within the institution's holdings and the impact of those holdings on aggregate portfolio risk.

The statement focuses on managing the market, credit, liquidity, operational, and legal risks of investment and end-user activities. When managing the interest-rate-risk component of market risk, institutions are informed of the merits of developing internal policies that specify the type of pre-acquisition analysis (stress testing) that is consistent with the scope, sophistication, and complexity of their investment securities and end-user derivative holdings. Such analyses should be conducted for certain types of instruments, including those that have complex or potentially volatile risk profiles. Institutions are advised to periodically monitor the price sensitivity of their portfolios, ensuring that they meet the established limits of the board of directors. Institutions are further advised to fully assess the creditworthiness of their counterparties, including brokers and issuers. Institutions are to ensure that they take proper account of the liquidity of the instruments held. (See SR-98-12.)

2126.1.1 SUPERVISORY POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

2126.1.1.1 Purpose

This policy statement (statement) provides guidance to financial institutions (institutions) on sound practices for managing the risks of investment securities and end-user derivatives activities.[2] The FFIEC agencies—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration—believe that effective management of the risks associated with securities and derivative instruments represents an essential component of safe and sound practices. This guidance describes the practices that a prudent manager normally would follow and is not intended to be a checklist. Management should establish practices and maintain documentation appropriate to the institution's individual circumstances, consistent with this statement.

1. Appropriate adaptations should be made to reflect the fact that (1) those offices are an integral part of a foreign bank that must also manage its consolidated risks and recognize possible obstacles to cash movement among branches and (2) the foreign bank is subject to overall supervision by its home-country supervisory authority.

2. The 1998 statement does not supersede any other requirements of the respective agencies' statutory rules, regulations, policies, or supervisory guidance.

2126.1.1.2 Scope

This guidance applies to all securities in *held-to-maturity* and *available-for-sale* accounts. See FASB Accounting Standards Codification section 320-10-35, ‘‘Investment Debt and Equity Securities—Overall—Subsequent Measurement’’ (formerly FAS 115, *‘‘Accounting for Certain Debt and Equity Securities’’*). It also applies to certificates of deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. Similarly, this guidance covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options.[3] This statement applies to all federally insured commercial banks, savings banks, savings associations, and federally chartered credit unions.

As a matter of sound practice, institutions should have programs to manage the market, credit, liquidity, legal, operational, and other risks of investment securities and end-user derivatives activities (investment activities). While risk-management programs will differ among institutions, there are certain elements that are fundamental to all sound risk-management programs. These elements include board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, monitors, and controls risk. This statement describes sound principles and practices for managing and controlling the risks associated with investment activities.

Institutions should fully understand and effectively manage the risks inherent in their investment activities. *Failure to understand and adequately manage the risks in these areas constitutes an unsafe and unsound practice.*

3. Natural-person federal credit unions are not permitted to purchase nonresidential mortgage asset-backed securities and may participate in derivative programs only if authorized by the National Credit Union Administration.

2126.1.1.3 Board and Senior Management Oversight

Board of director and senior management oversight is an integral part of an effective risk-management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. The board should ensure that management has the requisite skills to manage the risks associated with such activities. To properly discharge its oversight responsibilities, the board should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits. Boards should have an adequate understanding of investment activities. Boards that do not should obtain professional advice to enhance its understanding of investment-activity oversight, so as to enable it to meet its responsibilities under this statement.

Senior management is responsible for the daily management of an institution’s investments. Management should establish and enforce policies and procedures for conducting investment activities. Senior management should have an understanding of the nature and level of various risks involved in the institution’s investments and how such risks fit within the institution’s overall business strategies. Management should ensure that the risk-management process is commensurate with the size, scope, and complexity of the institution’s holdings. Management should also ensure that the responsibilities for managing investment activities are properly segregated to maintain operational integrity. Institutions with significant investment activities should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

2126.1.1.4 Risk-Management Process

An effective risk-management process for investment activities includes (1) policies, procedures, and limits; (2) the identification, measurement, and reporting of risk exposures; and (3) a system of internal controls.

2126.1.1.4.1 Policies, Procedures, and Limits

Investment policies, procedures, and limits provide the structure to effectively manage investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance. Policies should identify relevant investment objectives, constraints, and guidelines for the acquisition and ongoing management of securities and derivative instruments. Potential investment objectives include generating earnings, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements, if applicable. Policies should also identify the risk characteristics of permissible investments and should delineate clear lines of responsibility and authority for investment activities.

An institution's management should understand the risks and cash-flow characteristics of its investments. This is particularly important for products that have unusual, leveraged, or highly variable cash flows. An institution should not acquire a material position in an instrument until senior management and all relevant personnel understand and can manage the risks associated with the product.

An institution's investment activities should be fully integrated into any institution-wide risk limits. In so doing, some institutions rely only on the institution-wide limits, while others may apply limits at the investment portfolio, subportfolio, or individual instrument level.

The board and senior management should review, at least annually, the appropriateness of its investment strategies, policies, procedures, and limits.

2126.1.1.4.2 Risk Identification, Measurement, and Reporting

Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual-instrument level. Prudent management of investment activities entails examination of the risk profile of a particular investment in light of its impact on the risk profile of the institution. To the extent practicable, institutions should measure exposures to each type of risk, and these measurements should be aggregated and integrated with similar exposures arising from other business activities to obtain the institution's overall risk profile.

In measuring risks, institutions should conduct their own in-house pre-acquisition analyses, or to the extent possible, make use of specific third-party analyses that are independent of the seller or counterparty. Irrespective of any responsibility, legal or otherwise, assumed by a dealer, counterparty, or financial advisor regarding a transaction, the acquiring institution is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction.

Reports to the board of directors and senior management should summarize the risks related to the institution's investment activities and should address compliance with the investment policy's objectives, constraints, and legal requirements, including any exceptions to established policies, procedures, and limits. Reports to management should generally reflect more detail than reports to the board of the institution. Reporting should be frequent enough to provide timely and adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

2126.1.1.4.3 Internal Controls

An institution's internal control structure is critical to the safe and sound functioning of the organization generally and the management of investment activities in particular. A system of internal controls promotes efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. An effective system of internal controls includes enforcing official lines of authority, maintaining appropriate separation of duties, and conducting independent reviews of investment activities.

For institutions with significant investment activities, internal and external audits are integral to the implementation of a risk-management process to control risks in investment activities. An institution should conduct periodic independent reviews of its risk-management program to ensure its integrity, accuracy, and reasonableness. Items that should be reviewed include—

1. compliance with and the appropriateness of investment policies, procedures, and limits;
2. the appropriateness of the institution's risk-measurement system given the nature, scope, and complexity of its activities; and
3. the timeliness, integrity, and usefulness of reports to the board of directors and senior management.

The review should note exceptions to policies, procedures, and limits and suggest corrective actions. The findings of such reviews should be reported to the board and corrective actions taken on a timely basis.

The accounting systems and procedures used for public and regulatory reporting purposes are critically important to the evaluation of an organization's risk profile and the assessment of its financial condition and capital adequacy. Accordingly, an institution's policies should provide clear guidelines regarding the reporting treatment for all securities and derivatives holdings. This treatment should be consistent with the organization's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards.

2126.1.1.5 Risks of Investment Activities

The following discussion identifies particular sound practices for managing the specific risks involved in investment activities. In addition to these sound practices, institutions should follow any specific guidance or requirements from their primary supervisor related to these activities.

2126.1.1.5.1 Market Risk

Market risk is the risk to an institution's financial condition resulting from adverse changes in the value of its holdings arising from movements in interest rates, foreign-exchange rates, equity prices, or commodity prices. An institution's exposure to market risk can be measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. For most institutions, the most significant market risk of investment activities is interest-rate risk.

Investment activities may represent a significant component of an institution's overall interest-rate-risk profile. It is a sound practice for institutions to manage interest-rate risk on an institution-wide basis. This sound practice includes monitoring the price sensitivity of the institution's investment portfolio (changes in the investment portfolio's value over different interest-rate/yield curve scenarios). Consistent with agency guidance, institutions should specify institution-wide interest-rate-risk limits that appropriately account for these activities and the strength of the institution's capital position. These limits are generally established for economic value or earnings exposures. Institutions may find it useful to establish price-sensitivity limits on their investment portfolio or on individual securities. These sub-institution limits, if established, should also be consistent with agency guidance.

It is a sound practice for an institution's management to fully understand the market risks associated with investment securities and derivative instruments prior to acquisition and on an ongoing basis. Accordingly, institutions should have appropriate policies to ensure such understanding. In particular, institutions should have policies that specify the types of market-risk analyses that should be conducted for various types or classes of instruments, including that conducted prior to their acquisition (pre-purchase analysis) and on an ongoing basis. Policies should also specify any required documentation needed to verify the analysis.

It is expected that the substance and form of such analyses will vary with the type of instrument. Not all investment instruments may need to be subjected to a pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.[4]

For relatively more complex instruments, less familiar instruments, and potentially volatile instruments, institutions should fully address pre-purchase analyses in their policies. Price-sensitivity analysis is an effective way to perform the pre-purchase analysis of individual instruments. For example, a pre-purchase analysis should show the impact of an immediate parallel shift in the yield curve of plus and minus 100, 200, and 300 basis points. Where appropriate, such analysis should encompass a wider range of scenarios, including nonparallel changes in the yield curve. A comprehensive analysis may also take into account other relevant factors, such as changes in interest-rate volatility and changes in credit spreads.

When the incremental effect of an investment position is likely to have a significant effect on the risk profile of the institution, it is a sound practice to analyze the effect of such a position on the overall financial condition of the institution.

Accurately measuring an institution's market risk requires timely information about the cur-

4. Federal credit unions must comply with the investment-monitoring requirements of 12 C.F.R. 703.90. See 62 *Fed. Reg.* 32,989 (June 18, 1997).

rent carrying and market values of its investments. Accordingly, institutions should have market-risk-measurement systems commensurate with the size and nature of these investments. Institutions with significant holdings of highly complex instruments should ensure that they have the means to value their positions. Institutions employing internal models should have adequate procedures to validate the models and to periodically review all elements of the modeling process, including its assumptions and risk-measurement techniques. Managements relying on third parties for market-risk-measurement systems and analyses should ensure that they fully understand the assumptions and techniques used.

Institutions should provide reports to their boards on the market-risk exposures of their investments on a regular basis. To do so, the institution may report the market-risk exposure of the whole institution. Alternatively, reports should contain evaluations that assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Institutions should have mechanisms to detect and adequately address exceptions to limits and guidelines. Management reports on market risk should appropriately address potential exposures to yield curve changes and other factors pertinent to the institution's holdings.

2126.1.1.5.2 Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. For many financial institutions, credit risk in the investment portfolio may be low relative to other areas, such as lending. However, this risk, as with any other risk, should be effectively identified, measured, monitored, and controlled.

An institution should not acquire investments or enter into derivative contracts without assessing the creditworthiness of the issuer or counterparty. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution as comprehensively as practicable. Institutions are to meet certain creditworthiness standards for security purchases. Many institutions may maintain and update internal credit-rating reports and assessments that can be supplemented by reports from major external credit-rating services. For nonrated securities, institutions should establish guidelines to ensure that the securities meet legal requirements and that the institution fully understands the risk involved. Institutions should establish limits on individual counterparty exposures. Policies should also provide credit-risk and concentration limits. Such limits may define concentrations relating to a single or related issuer or counterparty, a geographical area, or obligations with similar characteristics.

In managing credit risk, institutions should consider settlement and presettlement credit risk. These risks are the possibility that a counterparty will fail to honor its obligation at or before the time of settlement. The selection of dealers, investment bankers, and brokers is particularly important in effectively managing these risks. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. This includes review of information from state or federal securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

The board of directors is responsible for supervision and oversight of investment portfolio and end-user derivatives activities, including the approval and periodic review of policies that govern relationships with securities dealers.

Sound credit-risk management requires that credit limits be developed by personnel who are as independent as practicable of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures.

2126.1.1.5.3 Liquidity Risk

Liquidity risk is the risk that an institution cannot easily sell, unwind, or offset a particular position at a fair price because of inadequate market depth. In specifying permissible instruments for accomplishing established objectives, institutions should ensure that they take into account the liquidity of the market for those instruments and the effect that such characteristics have on achieving their objectives. The liquidity of certain types of instruments may make them inappropriate for certain objectives. Institutions should ensure that they consider the effects that market risk can have on the liquidity of different types of instruments under various scenarios. Accordingly, institutions should articulate clearly the liquidity characteristics of instruments to be used in accomplishing institutional objectives.

Complex and illiquid instruments can often involve greater risk than actively traded, more liquid securities. Oftentimes, this higher potential risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for such instruments can evaporate, decreasing the market value of the instrument below the modeled value.

2126.1.1.5.4 Operational (Transaction) Risk

Operational (transaction) risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in investment activities.

Effective internal controls are the first line of defense in controlling the operating risks involved in an institution's investment activities. Of particular importance are internal controls that ensure the separation of duties and supervision of persons executing transactions from those responsible for processing contracts, confirming transactions, controlling various clearing accounts, preparing or posting the accounting entries, approving the accounting methodology or entries, and performing revaluations.

Consistent with the operational support of other activities within the financial institution, securities operations should be as independent as practicable from business units. Adequate resources should be devoted, such that systems and capacity are commensurate with the size and complexity of the institution's investment activities. Effective risk management should also include, at least, the following:

1. *Valuation.* Procedures should ensure independent portfolio pricing. For thinly traded or illiquid securities, completely independent pricing may be difficult to obtain. In such cases, operational units may need to use prices provided by the portfolio manager. For unique instruments where the pricing isbeing provided by a single source (e.g., the dealer providing the instrument), the institution should review and understand the assumptions used to price the instrument.
2. *Personnel.* The increasingly complex nature of securities available in the marketplace makes it important that operational personnel have strong technical skills. This will enable them to better understand the complex financial structures of some investment instruments.
3. *Documentation.* Institutions should clearly define documentation requirements for securities transactions, saving and safeguarding important documents, as well as maintaining possession and control of instruments purchased.

An institution's policies should also provide guidelines for conflicts of interest for employees who are directly involved in purchasing and selling securities for the institution from securities dealers. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with these same securities firms without specific prior board approval. The board may also wish to adopt a policy applicable to directors, officers, and employees restricting or prohibiting the receipt of gifts, gratuities, or travel expenses from approved securities dealer firms and their representatives.

2126.1.1.5.5 Legal Risk

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Institutions should adequately evaluate the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has authority to enter into the transaction and that the terms of the agreement are legally enforceable. Institutions should further ascertain that netting agreements are adequately documented, executed properly, and are enforceable in all relevant jurisdictions. Institutions should have knowledge of relevant tax laws and interpretations governing the use of these instruments.

On November 15, 2012, state member banks were advised, effective January 1, 2013, that they may no longer rely solely on credit ratings issued by nationally recognized statistical rating organizations (NRSROs) or external credit ratings to determine whether a particular security is an "investment security" that is permissible for investment by a state member bank. Under the regulations of the Office of the Comptroller of the Currency (OCC), securities qualify for investment by national banks only if they are determined by the bank to be "investment grade" and not predominantly speculative in nature. (See SR-12-15 and its attachment.) The basic sound risk-management principles of this policy and other referenced guidance that follows also applies to bank holding companies (BHCs) and savings and loan holding companies (SLHCs). They should manage and control their risk exposures on a consolidated basis and give recognition to the legal distinctions and potential obstacles to the cash movements among their financial institution subsidiaries. Since a BHC's structure can include national banks, state member banks, and other financial institution subsidiaries, the referenced statutory, regulatory, and supervisory guidance is provided.

Under the Federal Reserve Act (12 USC 335) and the Federal Reserve (FR)'s Regulation H (12 CFR 208.21), state member banks are subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as national banks under the National Banking Act (12 USC 24 (Seventh)). Therefore, when investing in securities, state member banks must comply with the provisions of the National Banking Act and the OCC regulations in 12 CFR part 1. In addition to this federal requirement, a state member bank may purchase, sell, underwrite, or hold securities and stock only to the extent permitted under applicable state law.

National banks are to assess a security's creditworthiness to determine if it is "investment grade." A security meets the "investment grade" test only if the issuer has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure. Under this definition, the issuer has an adequate capacity to meet financial commitments if (1) the risk of default by the obligor is low and (2) the full and timely repayment of principal and interest is expected.[1] National banks are expected to consider a number of factors, to the extent appropriate in making this determination. While a national bank may continue to take into account external credit ratings and assessments as a valuable source of information, the bank is expected to supplement these ratings with a degree of due diligence processes and additional analyses appropriate for the bank's risk profile and for the size and complexity of the instrument.[2]

The OCC issued guidance, effective January 1, 2013 (OCC investment guidance), to clarify regulatory expectations with respect to investment purchase decisions and ongoing portfolio due diligence processes. See appendix 1 below (section 2126.2.1). The guidance clarifies that generally, investment securities are expected to have good to very strong credit quality. In the case of structured securities, this determination may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

The OCC also expects national banks to conduct an appropriate level of due diligence to understand the inherent risks of a security and determine that it is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the "investment-grade" standards. The depth of the due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment. Third-party analytics may be part of this analysis, although the national bank's management remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. The guidance also sets forth an expectation that the board of directors should oversee management to make sure appropriate decisionmaking processes are in place.[3]

Investment in securities and stock by state member banks are required under the Federal Reserve Act and Regulation H to comply with the revised 12 CFR part 1 and should also meet the supervisory expectations set forth in the OCC investment guidance and this FR guidance. In addition, state member banks are expected to continue to meet long-established

1. See 77 *Fed. Reg.* 35257 (June 13, 2012).

2. See 77 *Fed. Reg.* 35254 (June 13, 2012).

3. See 77 *Fed. Reg.* 35259 (June 13, 2012).

supervisory expectations for risk-management processes to ensure that the credit risk of the bank, including the credit risk of the investment portfolio, is effectively identified, measured, monitored, and controlled.

2126.2.1 APPENDIX 1—OCC GUIDANCE ON DUE DILIGENCE REQUIREMENTS IN DETERMINING WHETHER SECURITIES ARE ELIGIBLE FOR INVESTMENT

The guidance below was issued by the Office of the Comptroller of the Currency (OCC) on June 13, 2012, and is being included for ease of reference. The official guidance was published in the Federal Register (77 Fed. Reg. 35259), and is available as an attachment to OCC Bulletin 2012-18. As discussed in SR-12-15, the Federal Reserve also expects that state member banks (SMBs) will meet the supervisory expectations set forth in the OCC guidance as this guidance provides further clarification to the OCC rule with which SMBs must comply. (See 12 CFR part 1, and 77 Fed. Reg. 35253, June 13, 2012.)

Purpose

The OCC has issued final rules to revise the definition of "investment grade," as that term is used in 12 CFR parts 1 and 160 in order to comply with section 939A of the Dodd-Frank Act. Institutions, effective January 1, 2013, are to ensure that existing investments comply with the revised "investment grade" standard, as applicable based on investment type, and safety and soundness practices described in 12 CFR 1.5 and this guidance. This implementation period also will provide management with time to evaluate and amend existing policies and practices to ensure new purchases comply with the final rules and guidance. National banks that have established due diligence review processes, and that have not relied exclusively on external credit ratings, should not have difficulty establishing compliance with the new standard.

The OCC is issuing this guidance (Guidance) to clarify steps national banks ordinarily are expected to take to demonstrate they have properly verified their investments meet the newly established credit-quality standards under 12 CFR part 1 and steps national banks are expected to take to demonstrate they are in compliance with due diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios. The standards below describe how national banks may purchase, sell, deal in, underwrite, and hold securities consistent with the authority contained in 12 U.S.C. 24 (Seventh). The activities of national banks must be consistent with safe and sound banking practices, and this Guidance reminds national banks of the supervisory risk-management expectations associated with permissible investment portfolio holdings under parts 1 and 160.

Background

Parts 1 and 160 provide standards for determining whether securities have appropriate credit quality and marketability characteristics to be purchased and held by national banks. These requirements also establish limits on the amount of investment securities an institution may hold for its own account. As defined in 12 CFR part 1, an "investment security" must be "investment grade." For the purpose of part 1, "investment grade" securities are those where the issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard. In the case of a structured security (that is, a security that relies primarily on the cash flows and performance of underlying collateral for repayment, rather than the credit of the entity that is the issuer), the determination that full and timely repayment of principal and interest is expected may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

National banks must be able to demonstrate that their investment securities meet applicable credit-quality standards. This Guidance provides criteria that national banks can use in meeting part 1 credit-quality standards and that national banks can use in meeting due diligence requirements.

Determining Whether Securities Are Permissible Prior to Purchase

The OCC's elimination of references to credit ratings in its regulations, in accordance with the Dodd-Frank Act, does not substantively change the standards institutions should use when deciding whether securities are eligible for purchase under part 1. The OCC's investment securities regulations generally require a national bank to determine whether or not a security is ''investment grade'' in order to determine whether purchasing the security is permissible. Investments are considered ''investment grade'' if they meet the regulatory standard for credit quality. To meet this standard, a national bank must be able to determine that the security has (1) low risk of default by the obligor and (2) the expectation of full and timely repayment of principal and interest over the expected life of the investment.

For national banks, Type I securities, as defined in part 1, generally are government obligations and are not subject to investment grade criteria for determining eligibility to purchase. Typical Type I obligations include U.S. Treasuries, agencies, municipal government general obligations, and for well-capitalized institutions, municipal revenue bonds. While Type I obligations do not have to meet the investment grade criteria to be eligible for purchase, all investment activities should comply with safe and sound banking practices as stated in 12 CFR 1.5 and in previous regulatory guidance. Under OCC rules, Treasury and agency obligations do not require individual credit analysis, but bank management should consider how those securities fit into the overall purpose, plans, and risk and concentration limitations of the investment policies established by the board of directors. Municipal bonds should be subject to an initial credit assessment and then ongoing review consistent with the risk characteristics of the bonds and the overall risk of the portfolio.

Financial institutions should be well acquainted with fundamental credit analysis as this is central to a well-managed loan portfolio. The foundation of a fundamental credit analysis-character, capacity, collateral, and covenants-applies to investment securities just as it does to the loan portfolio. Accordingly, the OCC expects national banks to conduct an appropriate level of due diligence to understand the inherent risks and determine that a security is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the investment grade standards. This may include consideration of internal analyses, third party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as appropriate for the particular security. Some institutions may have the resources to do most or all of the analytical work internally. Some, however, may choose to rely on third parties for much of the analytical work. While analytical support may be delegated to third parties, management may not delegate its responsibility for decisionmaking and should ensure that prospective third parties are independent, reliable, and qualified. The board of directors should oversee management to assure that an appropriate decisionmaking process is in place.

The depth of the due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment. The more complex a security's structure, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high. Management should ensure it understands the security's structure and how the security may perform in different default environments, and should be particularly diligent when purchasing structured securities.[4] The OCC expects national banks to consider a variety of factors relevant to the particular security when determining whether a security is a permissible and sound investment. The range and type of specific factors an institution should consider will vary depending on the particular type and nature of the securities. As a general matter, a national bank will have a greater burden to support its determination if one factor is contradicted by a finding under another factor.

The following matrix provides examples of factors for national banks to consider as part of a robust credit-risk assessment framework for designated types of instruments. The types of securities included in the matrix require a credit-focused pre-purchase analysis to meet the investment grade standard or safety and soundness standards. Again, the matrix is provided as a guide to better inform the credit-risk assessment process. Individual purchases may require more or less analysis dependent on the security's risk characteristics, as previously described.

4. For example, a national bank should be able to demonstrate an understanding of the effects on cash flows of a structured security assuming varying default levels in the underlying assets.

Key factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities
Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality	X	X	X	X
Confirm risk of default is low and consistent with bonds of similar credit quality	X	X	X	X
Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third party analytics, as appropriate for the particular security	X	X	X	X
Evaluate the soundness of a municipal's budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience		X		
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values		X	X	
Assess the source and strength of revenue structure for municipal authorities. Consider obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project			X	
Understand the class or tranche and its relative position in the securitization structure				X
Assess the position in the cash flow waterfall				X
Understand loss allocation rules, specific definition of default, the potential impact of performance and market value triggers, and support provided by credit and/or liquidity enhancements				X
Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations				X
Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the effect of any changes				X
Assess the structural subordination and determine if adequate given current underwriting standards				X
Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions				X

Additional Guidance on Structured Securities Analysis

The creditworthiness assessment for an investment security that relies on the cash flows and collateral of the underlying assets for repayment (i.e., a structured security) is inherently different from a security that relies on the financial capacity of the issuer for repayment. Therefore, a financial institution should demonstrate an understanding of the features of a structured security that would materially affect its performance and that its risk of loss is low even under adverse economic conditions. Management's assessment of key factors, such as those provided in this guidance, will be considered a critical component of any structured security evaluation. Existing OCC guidance, including OCC Bulletin 2002-19, "Supplemental Guidance, Unsafe and Unsound Investment Portfolio Practices," states that it is unsafe and unsound to purchase a complex high-yield security without an understanding of the security's structure and performing a scenario analysis that evaluates how the security will perform in different default environments. Policies that specifically permit this type of investment should establish appropriate limits, and prepurchase due diligence processes should consider the impact of such purchases on capital and earnings under a variety of possible scenarios. The OCC expects institutions to understand the effect economic stresses may have on an investment's cash flows. Various factors can be used to define the stress scenarios. For example, an institution could evaluate the potential impact of changes in economic growth, stock market movements, unemployment, and home values on default and recovery rates. Some institutions have the resources to perform this type of analytical work internally. Generally, analyses of the application of various stress scenarios to a structured security's cash flow are widely available from third parties. Many of these analyses evaluate the performance of the security in a base case and a moderate and severe stress case environment. Even under severe stress conditions, the stress scenario analysis should determine that the risk of loss is low and full and timely repayment of principal and interest is expected.

Maintaining an Appropriate and Effective Portfolio Risk-Management Framework

The OCC has had a long-standing expectation that national banks implement a risk-management process to ensure credit risk, including credit risk in the investment portfolio, is effectively identified, measured, monitored, and controlled. The *1998 Interagency Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* (Policy Statement) contains risk-management standards for the investment activities of banks and savings associations.[5] The Policy Statement emphasizes the importance of establishing and maintaining risk processes to manage the market, credit, liquidity, legal, operational, and other risks of investment securities. Other previously issued guidance that supplements OCC investment standards are OCC 2009-15, "Risk Management and Lessons Learned" (which highlights lessons learned during the market disruption and re-emphasizes the key principles discussed in previously issued OCC guidance on portfolio risk management); OCC 2004-25, "Uniform Agreement on the Classification of Securities" (which describes the importance of management's credit-risk analysis and its use in examiner decisions concerning investment security risk ratings and classifications); and OCC 2002-19, "Supplemental Guidance, Unsafe and Unsound Investment Portfolio Practices" (which alerts banks to the potential risk to future earnings and capital from poor investment decisions made during periods of low levels of interest rates and emphasizes the importance of maintaining prudent credit, interest rate, and liquidity risk-management practices to control risk in the investment portfolio).

National banks must have in place an appropriate risk-management framework for the level of risk in their investment portfolios. Failure to maintain an adequate investment portfolio risk-management process, which includes understanding key portfolio risks, is considered an unsafe and unsound practice.

Having a strong and robust risk-management framework appropriate for the level of risk in an institution's investment portfolio is particularly critical for managing portfolio credit risk. A key role for management in the oversight process is to translate the board of directors' tolerance for risk into a set of internal operating policies and procedures that govern the institution's investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and

5. On April 23, 1998, the FRB, FDIC, NCUA, and OCC issued the "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities."

risk tolerance. Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual instrument level. Investment policies also should provide credit-risk concentration limits. Such limits may apply to concentrations relating to a single or related issuer, a geographical area, and obligations with similar characteristics. Safety-and-soundness principles warrant effective concentration risk-management programs to ensure that credit exposures do not reach an excessive level.

The aforementioned risk-management policies, principles, and due diligence processes should be commensurate with the complexity of the investment portfolio and the materiality of the portfolio to the financial performance and capital position of the institution. Investment review processes, following the pre-purchase analysis, may vary from institution to institution based on the individual characteristics of the portfolio, the nature and level of risk involved, and how that risk fits into the overall risk profile and operation of the institution. Investment portfolio reviews may be risk-based and focus on material positions or specific groups of investments or stratifications to enable analysis and review of similar risk positions.

As with pre-purchase analytics, some institutions may have the resources necessary to do most or all of their portfolio reviews internally. However, some may choose to rely on third parties for much of the analytical work. Third-party vendors offer risk analysis and data benchmarks that could be periodically reviewed against existing portfolio holdings to assess credit-quality changes over time. Holdings where current financial information or other key analytical data is unavailable should warrant more frequent analysis. High-quality investments generally will not require the same level of review as investments further down the credit-quality spectrum. However, any material positions or concentrations should be identified and assessed in more depth and more frequently, and any system should ensure an accurate and timely risk assessment and reporting process that informs the board of material changes to the risk profile and prompts action when needed. National banks should have investment portfolio review processes that effectively assess and manage the risks in the portfolio and ensure compliance with policies and risk limits. Institutions should reference existing regulatory guidance for additional supervisory expectations for investment portfolio risk-management practices.

2126.2.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
State member banks are subject to same limitations and conditions for investments activities as national banks	24 (Seventh), 335	1, 208.21		
Federal financial institution regulatory agencies to remove references to, and requirements of reliance on, external credit ratings in any regulation that requires the assessment of the creditworthiness of a security or money market instrument.	15 U.S.C. 780			
Supervisory and risk expectations		1, 160		
Safety and soundness practices		1.5		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

Bank holding companies should directly manage and control their aggregate risk exposures on a consolidated basis and, if appropriate, for individual subsidiaries, in view of the distinct legal existence of various subsidiaries and possible obstacles to moving cash, other assets, and contractual agreements among subsidiaries.[1] See SR-99-3.

2126.3.1 FUNDAMENTAL ELEMENTS OF COUNTERPARTY CREDIT RISK MANAGEMENT

When conducting bank holding company inspections and supervisory contacts, and when monitoring trading and derivatives activities, supervisors and examiners should fully evaluate the integrity of certain key elements of a banking organization's (BO) counterparty credit risk management process, such as the following:

1. The BO's assessment of counterparty creditworthiness, both initially and on an ongoing basis. A counterparty's creditworthiness can be evidenced by its capital strength, leverage, any on- and off-balance-sheet risk factors, and contingencies. Creditworthiness can also be evidenced by the counterparty's liquidity, operating results, reputation, and ability to understand and manage the risks inherent in its line of business, as well as the risks involved in the particular products and transactions that define a particular customer relationship.
2. The standards, methodologies, and techniques used in measuring counterparty-credit-risk exposures on an individual instrument, counterparty, and portfolio basis.
3. The use and management of credit enhancements to mitigate counterparty credit risks, including collateral arrangements and collateral-management systems, contractual downgrades or material-change triggers, and contractual "option-to-terminate" or close-out provisions.
4. The risk-limit and -monitoring systems that involve (1) setting meaningful limits on counterparty credit risk, (2) monitoring exposures against those limits, and (3) initiating meaningful risk assessments and risk-controlling actions in the event that exposures exceed limits.

The confluence of competitive pressures, pursuit of earnings, and overreliance on customer reputation can lead to substantive lapses in fundamental risk-management principles regarding counterparty risk assessment, exposure monitoring, and the management of credit-risk limits. Policies governing these activities may be unduly general so as to compromise their usefulness in managing the risks involved with particular types of counterparties. Practices may not conform to the stated policies or their intent. Situations may also exist where internal controls, including documentation and independent review, may be inadequate or lack rigor. For some larger BOs, regimes for measuring and monitoring counterparty-credit-risk exposure may be effective in more traditional areas of credit extension, but may need enhancements when used in trading and derivatives activities.

2126.3.2 TARGETING SUPERVISORY RESOURCES

When risk focusing their supervisory initiatives, examiners should continue to target those activities and areas with significant growth and above-normal profitability profiles—especially in trading and derivatives activities where the press of business and competitive pressures may invite a BO to offer new product lines before the approval of counterparties and the necessary risk-management infrastructure or procedures are fully in place. Supervisors and examiners should encourage a BO to adopt growth, profitability, and size criteria for their audit and independent risk-management functions to use in targeting their reviews.

1. These basic principles are also to be employed in the supervision of U.S. branches and agencies of foreign banks, with appropriate adaptations to reflect that (1) those offices are an integral part of a foreign bank that should be managing its risks on a consolidated basis and recognizing possible obstacles to cash movements among branches, and (2) the foreign bank is subject to overall supervision by its home-country authorities.

2126.3.3 ASSESSMENT OF COUNTERPARTY CREDITWORTHINESS

Supervisors and examiners should increase their focus on the appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities. BOs should have extensive written policies covering their assessment of counterparty creditworthiness for both the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring. Examiners should focus particular attention on how such policies are structured and implemented. Broadly structured, general policies that apply to all types of counterparties may prove inadequate for directing staff in the proper review of the risks posed by particular types of counterparties. For example, although most policies call for the assessment and monitoring of the capital strength and leverage of customers, the assessment of hedge-fund counterparties should not rely exclusively on simple balance-sheet measures and traditional assessments of financial condition. This information may be insufficient for those counterparties whose off-balance-sheet positions are a source of significant leverage and whose risk profiles are narrowly based on concentrated business lines (such as with hedge funds and similar institutional investors). General policies calling for periodic counterparty credit reviews over significant intervals (such as annually) are another example of broad policies that may compromise the integrity of the assessment of individual counterparties or types of counterparties—a counterparty's risk profile can change significantly over much shorter time horizons.

Credit-risk-assessment policies should also properly define the types of analyses to be conducted for particular types of counterparties based on the nature of their risk profiles. Stress testing and scenario analysis may be needed, in addition to customizing fundamental analyses based on industry and business-line characteristics. Customized analyses are particularly important when a counterparty's creditworthiness may be adversely affected by short-term fluctuations in financial markets, especially when potential credit exposure to a counterparty increases at the same time the counterparty's credit quality deteriorates.

Examiners should continue to pay special attention to areas where banking organization practices may not conform to stated policies. Such supervisory efforts may be especially difficult when the BO's policies are not specificic enough for it to properly focus its counterparty risk assessments. Therefore, examiners must ensure that the banking organization's policies sufficiently address the risk profiles of particular types of counterparties and instruments. The policies should specify (1) the types of counterparties that may require special consideration; (2) the types and frequency of information to be obtained from such counterparties; (3) the types and frequency of analyses to be conducted, including the need for and type of any stress-testing analysis; and (4) how such information and analyses appropriately address the risk profile of the particular type of counterparty. This specificity in credit-assessment policies is particularly important when limited transparency may hinder market discipline on the risk-taking activities of counterparties—as may be the case with hedge funds.

Examiners should also place increasing emphasis on ensuring that a BO's existing practice conforms both with its stated objectives and the intent of its established policies. For example, some BOs may not obtain and evaluate all the information on the financial strength, condition, and liquidity of some types of counterparties that may be required by their own policies. In highly competitive and fast-moving transaction areas, organizations should be sufficiently rigorous in conducting the analyses specified in their policies, such as the review of a counterparty's ability to manage the risks of its business.

Necessary internal controls for ensuring that practices conform with stated policies include actively enforced documentation standards and periodic independent reviews by internal auditors or other risk-control units, particularly for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability. Using targeted inspections and reviews, examiners should evaluate the integrity of a BO's internal controls. Examiners should thus conduct their own transaction testing of such situations. This testing should include robust sampling of transactions with major counterparties in the targeted area, as well as sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.

2126.3.4 CREDIT-RISK-EXPOSURE MEASUREMENT

Financial market turbulence emphasizes the important interrelationships between market movements and the credit-risk exposures involved in derivatives activities. Accordingly, supervisors and examiners should be alert to situations where a BO may need to be more diligent in conducting current computations of the loan equivalents and potential future exposures (PFE) that are used to measure, monitor, and control its derivatives counterparty credit exposure.

Most BOs fully recognize that the credit risk of derivatives positions includes both the current replacement cost of a contract as well as the contract's PFE. PFEs are generally calculated using statistical techniques to estimate the worst potential loss over a specified time horizon at some specified confidence interval (for example, 95 percent, 97.5 percent, and 99 percent), which is generally derived in some manner from historically observed market fluctuations. Together with the current replacement cost, such PFEs are used to convert derivatives contracts to "loan equivalents" for aggregating credit exposures across products and instruments.

The time horizon used to calculate PFEs can vary depending on the banking organization's risk tolerance, collateral protection, and ability to terminate its credit exposure. Some BOs may use a time horizon equal to the life of the respective instrument. While such a time horizon may be appropriate for unsecured positions, for collateralized exposures, the use of lifetime, worst-case-estimate PFEs may be ineffective to measure the true nature of counterparty risk exposure. While life-of-contract PFE measures provide an objective and conservative long-term exposure estimate, they bear little relationship to the actual credit exposures typically incurred in the case of collateralized relationships. In such cases, a banking organization's actual credit exposure is the PFE from the time a counterparty fails to meet a collateral call until the time the bank liquidates its collateral and closes out the derivative contract—a period which is typically much shorter than the contract's life. The lack of realism in conservative measurement can cause managers and traders to discount them and may result in inappropriate limits being set, thereby compromising the entire risk-management process.

More realistic measures of collateralized credit-risk exposures should also take into account the shorter time horizons over which action can be taken to mitigate losses in times of market stress. These measures should incorporate estimates of collateral-recovery rates given the potential market liquidity impacts of stress events on collateral values. Some BOs already do stress tests, calculating measures that assess the worst-case value of positions over a time horizon of one or two weeks—their estimate of a reasonable liquidation period in times of stress. They also perform scenario analyses of counterparty credit exposures. Stress testing and scenario analyses should evaluate the impact of large market moves on the credit exposure to individual counterparties, and they should assess the implications inherent in liquidating positions under such conditions. Analyses should consider the effects of market liquidity on the value of positions and any related collateral. The use of meaningful scenario analyses is particularly important since stress tests derived from simple applications of higher confidence intervals or longer time horizons to PFE, value-at-risk, and other measures may not adequately capture the market and exposure dynamics under turbulent market conditions, particularly as they relate to the interaction between market, credit, and liquidity risk.

The results of stress testing and scenario analyses should be incorporated into senior management reports. Such reports should provide sufficient information to ensure an adequate understanding of the nature of the exposure and the analyses conducted. Information should also be sufficient to trigger risk-controlling actions where necessary.

Other BOs are moving to build the capability of estimating portfolio-based PFEs by any one of several different time horizons or buckets, depending on the liquidity and breadth of the underlying instrument or risk factor. Based on management's opinion of the appropriate workout timeframe, different time horizons can be used for different counterparties, transactions, or collateral types to more precisely define exposures. Supervisors and examiners should be alert to situations where collateralized exposures may be inaccurately estimated, and should encourage management at these BOs to enhance their exposure-measurement systems accordingly.

Supervisors should also be cognizant of the manner in which the credit exposures are aggregated for individual counterparties. Some BOs may take a purely transactional approach to aggregation and *not incorporate the netting of long and short derivatives contracts*, even when legally enforceable bilateral netting agreements are available. In such cases, *simple sum estimates of positive exposures may seriously overestimate true credit exposure*, and examiners should monitor and encourage a BO's movement toward more realistic measures of counterparty exposure. Other BOs may take a portfolio approach, in which information systems allow and incorporate netting (both within and across products, business lines, or risk factors) and portfolio correlation effects to construct more comprehensive counterparty exposure measures. In such cases, supervisors should ensure that a BO has adequate internal controls governing exposure estimation, including robust model-review processes and data-integrity checks.

When stratifying samples and selecting the counterparties and transactions to use for their targeted testing of practices and internal controls, supervisors and examiners should incorporate measures of potential future exposure regardless of the collateralization of current market-value exposures. As recent events have shown, meaningful counterparty credit risks that surface during periods of stress can go undetected when too much emphasis is placed on collateralization of current market values and only unsecured current market exposures are used for targeting transaction testing.

2126.3.5 CREDIT ENHANCEMENTS

BOs continue to rely increasingly on different types of credit enhancements to mitigate counterparty credit risks. These enhancements include the use of collateral arrangements, contractual downgrades or material-change triggers that enable the alteration of collateral or margining arrangements, or the activation of contractual "option to terminate" or closeout provisions.

Collateralization of exposures has become an industry standard for many types of counterparties. Collateralization mitigates but does not eliminate credit risks. BOs therefore should ensure that overreliance on collateral does not compromise other elements of sound counterparty credit-risk management, such as the due-diligence process. Clear policies should govern the determination of loss thresholds and margining requirements for derivatives counterparties of BOs. Such policies should not be so broad that they compromise the risk-reducing nature of collateral agreements with specific types of counterparties. Policies governing collateral arrangements should specifically define those cases in which initial and variation margin is required, and they should explicitly identify situations in which the lack of transparency, business-line risk profiles, and other counterparty characteristics merit special treatment—as may be the case with some highly leveraged counterparties such as hedge funds. Where consistent with the risk profile of the counterparty and instruments involved, policies should specify when margining requirements based on estimates of potential future exposures might be warranted.

Adequate policies should also govern the use of material-change triggers and closeout provisions, which should take into account counterparty-specific situations and risk profiles. For example, closeout provisions based on annual events or material-change triggers based on long-term performance may prove ineffective for counterparties whose risk profiles can change rapidly. Also, such material-change triggers, closeout provisions, and related covenants should be designed to adequately protect against deterioration in a counterparty's creditworthiness. They should ensure that a BO is made aware of adverse financial developments on a timely basis and should facilitate action as counterparty risk increases—well in advance of the time when termination of a relationship is appropriate.

Internal assessments of potential risk exposures sometimes dictate loss thresholds, margining requirements, and closeout provisions with some counterparties. Insufficient internal controls may unduly expose certain BOs to these as well as other types of trading and derivatives counterparties. When evaluating the management of collateral arrangements and other credit enhancements, examiners should not only assess the adequacy of a banking organization's policies but should also determine whether internal controls are sufficient to ensure that practices comply with these policies. Examiners should identify the types of credit enhancements and contractual covenants that are being used when reviewing areas of counterparty risk management, and then determine whether the banking organization has sufficiently assessed the adequacy of these enhancements and covenants relative to the risk profile of the counterparty.

2126.3.6 CREDIT-RISK-EXPOSURE LIMIT-SETTING AND MONITORING SYSTEMS

Exposure-monitoring and limit systems are critical to the effective management of counterparty credit risk. Examiners should focus special attention on the policies, practices, and internal controls employed within such systems at large, complex BOs. An effective exposure-monitoring system consists of (1) establishing meaningful limits on the risk exposures a BO is willing to take, (2) independent, ongoing monitoring of exposures against such limits, and (3) adequate controls to ensure that meaningful risk-controlling action takes place when limits are exceeded. An effective exposure-monitoring and limit process depends on meaningful exposure-measurement methodologies, so supervisors should closely evaluate measurement methodologies, especially for the estimation of PFEs. Inaccurate measurement can easily compromise well-structured policies and procedures. Such situations can lead to limits driven primarily by customer demand and used only to define and monitor customer facilities, rather than limits that serve as strict levels defined by credit management and that initiate risk-controlling actions.

Supervisors and examiners should also assess the procedures used for controlling credit-risk exposures when they become large, when a counterparty's credit standing weakens, or when the market comes under stress. Management should demonstrate its clear ability to reduce large positions. Such actions can include "capping" current exposures, curtailing new business, assigning transactions to another counterparty (where feasible), and restructuring the transaction to limit potential exposure or make it less sensitive to market volatility. BOs can also use various credit-enhancement tools to manage exposures that have become unduly large or highly sensitive to market volatility.

2126.3.7 INSPECTION OBJECTIVES

1. To determine if sufficient resources are devoted and adequate attention is given to the management of the risks involved in growing, highly profitable, or potentially high-risk activities and product lines.
2. To ascertain if the banking organization's internal audit and independent risk-management functions adequately focus on growth, profitability, and risk criteria when targeting their reviews.
3. To determine if there is an appropriate balance among all elements of credit-risk management. This balance includes both qualitative and quantitative assessments of counterparty creditworthiness; measurement and evaluation of on- and off-balance sheet exposures, including potential future exposure; adequate stress testing; reliance on collateral and other credit enhancements; and the monitoring of exposures against meaningful limits.
4. To ascertain whether the banking organization employs policies that are sufficiently calibrated to the risk profiles of particular types of counterparties and instruments, which ensures adequate credit-risk assessment, exposure measurement, limit setting, and use of credit enhancements.
5. To ensure that the banking organization's actual business practices conform with their stated policies and the intent of these policies.
6. To establish if the banking organization is moving in a timely fashion to enhance its measurement of counterparty credit-risk exposures, including refining potential future exposure measures and establishing stress-testing methodologies to better incorporate the interaction of market and credit risks.
7. To accomplish the above inspection objectives by using sufficient, targeted transaction testing on those activities, business lines, and products experiencing significant growth, above-normal profitability, or large potential future exposures.

2126.3.8 INSPECTION PROCEDURES

1. Give increased focus to the adequacy, appropriateness, specificity, and rigor of the policies, procedures, and internal controls that a BO currently uses to assess the counterparty credit risks arising from its trading and derivatives activities.
   a. Determine if sufficient written policies cover the assessment of counterparty creditworthiness for the initial due-diligence process (that is, before conducting business with a customer) and for ongoing monitoring.
   b. Give particular attention to how such policies are structured, their adequacy, and how they are implemented.

2. Focus special attention on areas where a BO's practices may not conform to its stated policies.
   a. Determine if the banking organization's policies sufficiently address the risk profiles of its particular types of counterparties and instruments.
   b. Ascertain whether existing practices conform to the stated objectives and the intent of the organization's established policies.
3. Evaluate the banking organization's documentation standards.
4. Determine whether the internal reviews are adequately conducted for business lines, products, and exposures to particular groups of counterparties and individual customers that exhibit significant growth or above-normal profitability.
5. Evaluate the integrity of the internal controls that the banking organization uses to assess its own transaction testing during internal reviews.
6. Conduct independent targeted reviews of the internal controls.
   a. Use robust sampling when testing transactions of major counterparties within a targeted area.

   b. Employ sufficient stratification to ensure that practices involving smaller relationships also adhere to stated policies.
   c. Be alert to situations whereby the current computations of loan equivalents and potential exposures—that are used to measure, monitor, and control derivatives counterparty credit exposures—could be deliberately enhanced.
7. Determine if the banking organization needs to develop more meaningful measures of credit-risk exposures, such as using stress testing and scenario analyses, under volatile market conditions.

2126.5.1 PURPOSE AND BACKGROUND

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new section 13 to the Bank Holding Company Act of 1956 (BHC Act),[1] commonly referred to as the Volcker rule, which generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (covered fund), subject to certain exemptions. In 2014, the Board, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission, and Commodity Futures Trading Commission (collectively, the agencies) jointly adopted a final rule implementing these provisions.

The term "banking entity" is defined by statute to include, with limited exceptions

1. any insured depository institution (IDI) (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813));
2. any company that controls an IDI (including a bank holding company (BHC), savings and loan holding company (SLHC), and any other company that controls an IDI but that is not a BHC or SLHC, such as the parent company of an industrial loan company);
3. any company that is treated as a BHC for purposes of section 8 of the International Banking Act of 1978 (for example, any foreign bank operating a branch or agency in the United States); and
4. any affiliate or subsidiary of any of the foregoing (for example, a broker-dealer subsidiary of a BHC) (12 U.S.C. 1851(h)(1)).[2]

The enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) in 2018 amended the statutory definition of banking entity to exclude certain community banks and their affiliates from the Volcker rule restrictions. Accordingly, in 2019, the agencies adopted amendments to their regulations to exclude IDIs that do not have, and are not controlled by a company that has (1) more than $10 billion in total consolidated assets; and (2) total trading assets and liabilities, as of the most recent calendar quarter, that are more than 5 percent of total consolidated assets.[3]

In 2019 and 2020, the agencies amended their regulations to clarify the proprietary trading and compliance program requirements of the rule, and to clarify the covered funds requirements of the rule, respectively.[4]

2126.5.2 REGULATION VV

Regulation VV, "Proprietary Trading and Certain Interests in and Relationships with Covered Funds," (12 CFR part 248) is the Board's implementing regulation for the Volcker rule. The regulation defines terms used in the statute and related terms, establishes general prohibitions and restrictions on proprietary trading and on investments in or relationships with covered funds, and provides certain compliance program requirements.

Consistent with the statute, Regulation VV exempts from the general prohibitions of the Volcker rule certain activities (for example, market making, underwriting, risk-mitigating hedging, trading in certain government obligations, and organizing and offering a covered fund). However, both the statute and Regulation VV prohibit a banking entity from relying on any exemption to the prohibition on proprietary trading if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

1. The BHC Act is codified at 12 U.S.C. 1851.

2. Section 13 of the BHC Act also provides that a nonbank financial company designated by the Financial Stability Oversight Council for supervision by the Board (while not a banking entity under section 13 of the BHC Act) would be subject to additional capital requirements, quantitative limits, or other restrictions if the company engages in certain proprietary trading or covered fund activities.

3. See 84 Fed. Reg. 35,008 (July 22, 2019). Consistent with EGRRCPA, the regulation permits an investment adviser that is a banking entity to share a name with a hedge fund or private equity fund that the banking entity organizes and offers under certain circumstances.

4. See 84 Fed. Reg. 61,974 (November 14, 2019) and 85 Fed. Reg. 46,422 (July 31, 2020).

2126.5.3 CAPITAL RULE IMPLICATIONS

Regulation VV provides that a banking entity's aggregate investments in all covered funds pursuant to the exemption for organizing and offering a covered fund may not exceed 3 percent of the banking entity's applicable tier 1 capital (the aggregate funds limitation). Additionally, and consistent with the statute, the regulation requires that a banking entity's investment in a covered fund, including retained earnings, be deducted from tier 1 capital of the banking entity for purposes of determining compliance with applicable regulatory capital standards (the capital deduction requirement).[5] In 2015, the Board, OCC, and FDIC issued guidance to clarify the interaction between the agencies' regulatory capital rules and their regulations implementing the Volcker rule. Refer to SR-15-13, "Supervisory Guidance on the Capital Treatment of Certain Investments in Covered Funds under the Regulatory Capital Rule and the Volcker Rule," and its attachment, "Deduction Methodology for Investments in Covered Funds."

2126.5.4 REQUESTING AN EXTENDED TRANSITION PERIOD FOR ILLIQUID FUNDS

The Board's July 7, 2016, statement entitled, "Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act," explains that the Board would generally follow a simplified and streamlined process for granting extensions of the holding period for "illiquid funds," as described in this subsection.[6] That process is outlined in SR-16-18, "Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds."

As discussed in the statement, the restrictions and prohibitions of the Volcker rule became effective on July 21, 2012;[7] however, the statute provided banking entities a period of two years until July 21, 2014, to conform their activities and investments to the requirements of the statute and any rule issued by the agencies. Further, the statute provides that the Board may, by rule or order, extend this general conformance period "for not more than one year at a time," up to three times, if in the judgment of the Board, an extension would be consistent with the purposes of the Volcker rule and would not be detrimental to the public interest.[8] On July 7, 2016, the Board issued an order extending the final one-year conformance period for banking entities to conform investments in and relationships with covered funds and foreign funds that were in place prior to December 31, 2013 (legacy covered funds) until July 21, 2017.

The Board also is permitted, upon the application of a banking entity, to provide an additional transition period of up to five years to conform investments in a limited class of legacy illiquid funds.[9] An illiquid fund is defined by the statute as a fund that is "principally invested" in illiquid assets and holds itself out as employing a strategy to invest principally in illiquid assets.[10] The statute provides that this extension applies only to the extent that the banking entity's retention of the ownership interest in the fund, or provision of additional capital to the fund, is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.[11] The statute provides that the Board may grant an extension for each illiquid fund only once and for a period of up to five years.[12] The Board's conformance rule sets forth provisions governing the submission and review of extension requests.[13]

2126.5.5 REQUESTING AN EXTENSION OF THE ONE-YEAR SEEDING PERIOD FOR A COVERED FUND

In 2017, the Board provided guidance to banking entities on the procedures for submitting an application for an extension of the one-year seeding period for a covered fund under the

5. 12 U.S.C. 1851(d)(4)(B); see also 12 CFR 248.12.
6. See Board press release and attachment from July 7, 2016.
7. See 12 U.S.C. 1851(c)(1).

8. See 12 U.S.C. 1851(c)(2). The Board issued rules implementing the Volcker rule conformance provisions in 2011. See "Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," 76 Fed. Reg. 8265 (February 14, 2011) (12 CFR part 225, subpart K, "Proprietary Trading and Relationships With Hedge Funds and Private Equity Funds," referred to as the "conformance rule").
9. See 12 U.S.C. 1851(c)(3)-(4) and (h)(7).
10. See 12 U.S.C. 1851(h)(7).
11. See 12 U.S.C. 1851(c)(3)(A). In addition, the statute provides that a banking entity may not engage in a prohibited covered fund investment after the date on which the contractual obligation to invest in the illiquid fund terminates. See 12 U.S.C. 1851(c)(4)(A).
12. See 12 U.S.C. 1851(c)(3)(B).
13. See 12 CFR part 225, subpart K.

Volcker rule. Under the statute, a banking entity, regardless of its primary federal financial regulatory agency, must apply to the Board for an extension of the seeding period.

Under the Volcker rule, a banking entity is permitted to acquire and retain an ownership interest in a covered fund in connection with organizing and offering the covered fund as long as certain requirements are met.[14] Section 13(d)(4)(A) of the BHC Act and the Board's Regulation VV permit a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers for the purpose of (1) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (2) making a de minimis investment, subject to several limitations.[15]

The statute and Regulation VV require a banking entity to actively seek unaffiliated investors to reduce its investment in the covered fund, no later than one year after the date of establishment of the fund,[16] to an amount that is not more than 3 percent of the total outstanding ownership interests in the fund (the per-fund limitation).[17] A banking entity may request the Board's approval for an extension of time beyond the one-year period, for up to two additional years, to conform an investment to the per-fund limitation (the seeding period).[18] Under the statute, the Board may grant an extension of the seeding period if the Board finds that the extension would be consistent with safety and soundness and in the public interest.[19]

SR-17-5, "Procedures for a Banking Entity to Request an Extension of the One-Year Seeding Period for a Covered Fund," provides more detailed information on the requirements for submitting such requests and procedures for filing an extension request.

14. See 12 U.S.C. 1851(d)(1)(G) and (d)(4); 12 CFR 248.11(a)-(b).

15. 12 U.S.C. 1851(d)(4)(A); 12 CFR 248.12(a)(1).

16. Regulation VV defines "date of establishment" of a covered fund to mean the date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund. In the case of an issuing entity of asset-backed securities, the date of establishment is the date on which the assets are initially transferred into the issuing entity of the asset-backed securities. See 12 CFR 248.12(a)(2)(iv).

17. See 12 U.S.C. 1851(d)(4)(B); see 12 CFR 248.12(a)(2). Regulation VV permits a banking entity to hold a greater amount of a covered fund under the per-fund limitation if required in order to meet the risk retention requirements of section 15G of the Securities Exchange Act and implementing regulations. See 12 CFR 248.12(a)(2)(ii)(B).

18. See 12 U.S.C. 1851(d)(4)(C); 12 CFR 248.12(e).

19. See 12 U.S.C. 1851(d)(4)(C). In their regulations, the agencies recognized the potential for evasion of the restrictions contained in the Volcker rule through misuse of requests for extensions of the seeding period for covered funds and stated that the Board and the other agencies would monitor requests for extensions of the seeding period for activity in covered funds that is inconsistent with the requirements of the Volcker rule. See 79 Fed. Reg. 5725 and 5736 (January 31, 2014).

WHAT NEW IN THIS REVISED SECTION

Effective January 2010 this section was revised to include a brief overview of the January 6, 2010, interagency advisory on interest-rate risk management that targets interest-rate risk management at insured depository institutions. The advisory does not constitute new guidance. The principles and supervisory expectations discussed within the guidance apply also to bank holding companies, which should manage and control aggregate risk exposures on a consolidated basis. See SR-10-1.

2127.0.1 ASSESSING THE MANAGEMENT AND INTERNAL CONTROLS OVER INTEREST-RATE RISK

Interest-rate risk (IRR) is the exposure of a banking organization's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to a bank's or bank holding company's (BHC's) earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the organization's safety and soundness.

Evaluating a BHC's exposure to changes in interest rates is an important element of any full-scope inspection and may be the sole topic for specialized or targeted inspections. This evaluation includes assessing both the adequacy of the management process used to control IRR and the organization's quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on a BHC's consolidated financial condition including its capital adequacy; earnings; liquidity; and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of an organization's IRR that pose the greatest threat to its financial condition. This targeting requires an inspection process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined inspection scope, and a comprehensive program for following up on inspection findings and ongoing monitoring.

2127.0.2 JOINT AGENCY POLICY STATEMENT: INTEREST-RATE RISK

The Board, together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, adopted a May 23, 1996, Joint Agency Policy Statement on Interest-Rate Risk, effective June 26, 1996. (See SR-96-13.) It provides guidance to examiners and bankers on sound practices for managing IRR, which form the basis for ongoing evaluation of the adequacy of IRR management at supervised institutions.

The policy statement outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing IRR.[1] Specifically, the guidance emphasizes the need for active board and senior management oversight and a comprehensive risk-management process that effectively identifies, measures, and controls IRR.

Although the guidance targets IRR management at commercial banks and Edge Act corporations, the basic principles presented in the policy statement are to be applied to bank holding companies (BHCs). BHCs should manage and control aggregate risk exposure on a consolidated basis by recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. The assessment of interest-rate risk management made by examiners in accordance with the 1996 Joint Policy Statement will be incorporated into a BHC's overall

1. Guidance to examiners identifying fundamental elements of sound risk management includes SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations"; SR-96-14 (see section 2124.0), "Risk-Focused Safety and Soundness Examinations and Inspections"; SR-96-13, "Joint Policy Statement on Interest-Rate Risk"; SR-96-10, "Risk-Focused Fiduciary Examinations"; SR-95-51 (see section 4070.1), "Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; and SR-93-69 (see section 2125.0), "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations."

risk-management rating. BHC examiners should refer to section 4090.1 of the *Commercial Bank Examination Manual* for more detailed inspection guidance on the joint policy statement on IRR.

2127.0.3 INTERAGENCY ADVISORY ON INTEREST RATE RISK MANAGEMENT

A January 6, 2010, interagency advisory was issued by the Board of Governors of the Federal Reserve System and other federal regulators[2] that reminds institutions of supervisory expectations on sound practices for managing IRR. The advisory does not constitute new guidance. It reiterates basic principles of sound IRR management that each of the regulators has codified in its existing guidance, as well as in the interagency guidance on IRR management issued by the banking agencies in SR-96-13. The advisory highlights also the need for active board and senior management oversight and a comprehensive risk-management process that effectively measures, monitors, and controls IRR.

The advisory targets IRR management at insured depository institutions. However, the principles and supervisory expectations articulated also apply to BHCs, which are reminded of long-standing supervisory guidance that they should manage and control aggregate risk exposures on a consolidated basis while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. See SR-10-1.

2 The other financial regulators include the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee (collectively, the regulators).

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2009, this section was revised to delete a reference to SR-95-17 that was superseded by SR-98-12 (see section 2126.1).

2128.0.1 SUPERVISORY POLICY—STRUCTURED NOTES

This section discusses supervisory policy with regard to structured notes and their increased use by banking organizations. Examiners should be mindful of these instruments, whether they are used in the banking organization's trading, investment, or trust activities. Some of these instruments can expose investors to significant losses as interest rates, foreign-exchange rates, and other market indices change. Consequently, during examinations or inspections, examiners need to ensure that banks and bank holding companies that hold structured notes do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cash flows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium-term maturities and reflect a wide variety of cash-flow characteristics that can be tailored to the needs of individual investors.

As such, these notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and more specifically address an institution's risk exposures. Risk to principal is typically small. Accordingly, when structured notes are analyzed and managed properly, they can be acceptable investments and trading products for banks.

However, structured notes can also have characteristics that cause them to be inappropriate holdings for many banking organizations, including depository institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed-income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, banking organizations considering the purchase of structured notes should determine whether these factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cash flows, which can involve both principal and interest payments. Some notes employ "trigger levels" at which cash flows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to satisfactorily manage the market risks of their institution. Therefore, examiners should evaluate the appropriateness of these securities institution by institution, with a knowledge of management's expertise in evaluating such instruments, the quality of the relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the stress-test capabilities. Failure of management to adequately understand the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banking organizations.

When making investment decisions, some banking organizations may focus only on the low credit risk and favorable yields of structured notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the organization's risk-management process and assess management's recognition of their potential volatility.

The risks inherent in such complex instruments and relevant risk-management standards have been addressed in a variety of previously issued supervisory guidance, including SR-letters and supervisory manuals. This guidance includes SR-90-16, standards for investing in asset-backed securities (see section 2128.02);

SR-93-69 (see section 2125.0) and SR-98-12 (see section 2126.1), examination guidance for reviewing investment securities and end-user derivatives activities and the *Trading and Capital-Markets Activities Manual.* Although these documents may not specifically cite structured notes, they all help to highlight the following important supervisory and risk-management practices that are relevant to these instruments:

1. the importance of policies, approved by the board of directors, that address the goals and objectives expected to be achieved with such products and that set limits on the amount of funds that may be committed to them
2. the need for management to fully understand the risks these instruments can present, including their potentially reduced liquidity in secondary markets and the price volatility that any embedded options, leveraging, or other characteristics can create
3. the need for adequate information systems and internal controls for managing the risks under changing market conditions
4. the importance of clear lines of authority for making investment decisions and for evaluating and managing the institution's securities activities that involve such instruments

For additional information, see SR-97-21 and SR-91-4. See also sections 3010.3 and 4040.1 of the *Trading and Capital-Markets Activities Manual* for more-detailed guidance.

Asset securitization typically involves the transfer of potentially illiquid on-balance-sheet assets (for example, mortgages, loans, leases, other assets) to a third party or trust who, in turn, issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes issued by the trust. Firms use asset securitization to access alternative funding sources, manage loan concentrations, improve financial-performance ratios, and more efficiently meet customers' financing needs. Assets that typically are securitized include credit card receivables and automobile receivable paper, commercial and residential first mortgages, commercial loans, home-equity loans, and student loans.

See section 4030.1, "Asset Securitization," of the *Commercial Bank Examination Manual* for more information on

- why firms engage in securitization activities;
- the securitization process;
- the risks associated with various types of asset securitizations;
- risk-management concerns associated with asset securitizations;
- capital considerations related to asset securitizations;
- accounting and reporting considerations (see also the instructions for completing the FR Y-9C, "Consolidated Financial Statements for Holding Companies"); and
- supervisory considerations.

For community and regional banking organizations, the Securitization Examination Documentation (ED) module provides more detailed examination procedures for examination staff.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2015, section 2128.03.3.3 is revised to delete a footnote reference to SR-05-13 and its attachment, "Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Program Liquidity Facilities and the Resulting Risk-Based Capital Treatment," which is superseded by SR-15-6, "Interagency Frequently Asked Questions on the Regulatory Capital Rule." Subsection 2128.03.4 is also revised to delete a reference to SR-05-13.

2128.03.1 CREDIT-SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER AS AN ALTERNATIVE FUNDING SOURCE

The issuance of commercial paper provides an alternative to bank borrowing for large corporations (nonfinancial and financial) and municipalities. Generally, commercial paper issuers are those with high credit ratings. Some corporations with lower credit ratings have been able to issue commercial paper by obtaining credit enhancements[1] (credit support from a firm with a high credit rating) or other high-quality asset collateral (asset-backed commercial paper) to allow them to enter the market as issuers. An example of credit-supported commercial paper is one supported by a letter of credit (LOC), the terms of which specify that the bank issuing the LOC guarantees that the bank will pay off the commercial paper if the issuer fails to pay off the commercial paper upon maturity.[2] A credit enhancement could also consist of a surety bond from an insurance company.

2128.03.2 COMMERCIAL BANK INVOLVEMENT IN CREDIT-ENHANCED AND ASSET-BACKED COMMERCIAL PAPER

A number of commercial banks have become involved in credit-enhanced and asset-backed commercial paper programs. These securitization programs enable banks to help arrange short-term financing support for their customers without having to extend credit directly. This arrangement provides borrowers with an alternative source of funding and allows banks to earn fee income for managing the programs. Fees are earned for providing credit and liquidity enhancements to these programs.

Involvement in credit-enhanced and asset-backed commercial paper programs, however, can have potentially significant implications for organizations' credit- and liquidity-risk exposure. Therefore, examiners need to be fully informed on the fundamentals of these programs, on the risks associated with these programs, and on the examination and inspection procedures for banking organizations engaged in this activity.

Asset-backed commercial paper programs have been in existence since the early 1980s and have grown substantially since then. These programs use a special-purpose entity (SPE) to acquire receivables generally originated either by corporations or sometimes by the advising bank itself.[3] The SPEs, which are owned by third parties,[4] fund their acquisitions of receivables by issuing commercial paper that is to be repaid from the cash flow of the receivables.

Bank involvement in an ABCP program can range from advising the program to advising and providing all of the required credit and liquidity enhancements in support of the SPE's commercial paper. Typically, the advising bank or an affiliate performs a review to determine if the receivables of potential program participants (that is, corporate sellers) are eligible for purchase by the SPE. The scope of the review is similar to that used in structuring securitizations collateralized by credit card receivables or automobile-secured loans.

Once the bank (or its affiliate) determines that a receivables portfolio has an acceptable credit-risk profile, it approves the purchase of the portfolio at a discounted price by the SPE. The bank or its affiliate may also act as the operating agent for the SPE, which entails structuring the sale of receivable pools to the SPE and then

1. This paper is usually called *credit-supported commercial paper.*
2. This arrangement is usually referred to as *LOC paper.*

3. To date, the type of receivables that have been included in the programs are trade receivables, installment sales contracts, financing leases, and noncancelable portions of operating leases and credit card receivables.
4. Employees of an investment banking firm or some other third party generally own the equity of the SPE. The advising bank can specifically avoid owning the stock if it does not want to raise the issue of whether it must consolidate the SPE for accounting purposes.

overseeing the performance of the pools on an ongoing basis.

The SPE pays for the receivables by issuing commercial paper in an amount equal to the discounted price paid for the receivables. The difference between the face value of the receivables and the discounted price paid provides, as discussed below, the first level of credit protection for the commercial paper. The individual companies selling their receivables traditionally act as the servicer for receivables sold to an SPE; that is, they are responsible for collecting principal and interest payments from the obligors and passing these funds on to the SPE on a periodic basis. The SPE then distributes the proceeds to the holders of the commercial paper.

Asset-backed commercial paper programs typically have several levels of credit enhancement cushioning the commercial paper purchaser from potential loss. As noted above, the first level of loss protection is provided by the difference between the face value of the receivables purchased and the discounted price paid for them, known as "holdback" or "overcollateralization." In some cases, the terms of the sale also give the SPE recourse back to the seller if there are defaults on the receivables. The amount of overcollateralization and recourse varies from pool to pool and depends, in part, on the quality of the receivables in the pool and the desired credit rating for the paper to be issued. Usually, the level of credit protection provided by overcollateralization is specified in terms of some multiple of historical loss experience for similar assets.

In addition to overcollateralization and recourse, secondary credit enhancements are also customarily provided. Secondary credit enhancements include letters of credit, surety bonds, or other backup facilities that obligate a third party to purchase pools of receivables from the SPE at a specified price. In addition to credit enhancements, the programs generally have liquidity enhancements to ensure that the SPE can meet maturing-paper obligations.

The rating agencies typically require an SPE's commercial paper to have secondary enhancements aggregating 100 percent of the amount outstanding in order to receive the highest credit rating. These enhancements are generally structured in one of two ways. In the first, a commercial bank enters into a single agreement under which it is unconditionally obligated to provide funding for all or any portion of maturing commercial paper that an SPE cannot pay from other sources. The obligation to fund may be triggered by credit losses, a liquidity shortfall, or both. In the second, two separate agreements that jointly cover 100 percent of an SPE's outstanding commercial paper are established.

The first agreement, typically an irrevocable letter of credit, is primarily intended to absorb credit losses that exceed the first tier of credit enhancement for the commercial paper. The second arrangement is a "liquidity" facility that may or may not provide credit support. This second structure will often have a letter of credit equaling 10 percent to 15 percent of outstandings, with the liquidity facility covering the remaining 90 to 85 percent.

2128.03.3 RISK-BASED CAPITAL ASSET-BACKED COMMERCIAL PAPER PROGRAM ASSETS

An asset-backed commercial paper (ABCP) program typically is a program through which a banking organization provides funding to its corporate customers by sponsoring and administering a bankruptcy-remote special-purpose entity that purchases asset pools from, or extends loans to, those customers.[5] The asset pools in an ABCP program might include, for example, trade receivables, consumer loans, or asset-backed securities. The ABCP program raises cash to provide funding to the banking organization's customers through the issuance of externally rated commercial paper into the market. Typically, the sponsoring banking organization provides liquidity and credit enhancements to the ABCP program. These enhancements aid the program in obtaining high credit ratings that facilitate the issuance of the commercial paper.[6] (See SR-05-13 and SR-92-11.)

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards no. 166, "Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140" (FAS 166) and Statement of Financial Account-

5. The definition of *ABCP program* generally includes structured investment vehicles (entities that earn a spread by issuing commercial paper and medium-term notes and using the proceeds to purchase highly rated debt securities) and securities arbitrage programs.

6. A bank is considered the "sponsor of an ABCP program" if it establishes the program; approves the sellers permitted to participate in the program; approves the asset pools to be purchased by the program; or administers the program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

ing Standards no. 167, "Amendments to FASB Interpretation no. 46 (R)" (FAS 167). FAS 166 and FAS 167 modified the accounting treatment under U.S. generally accepted accounting principles (GAAP) of certain structured financing transactions involving a special purpose entity. Under FAS 167, banking organizations should consolidate assets, liabilities, and equity in certain variable interest entities (VIEs) that were not consolidated under the standards that FAS 166 and FAS 167 replaced, or FIN 46 (January 2003) and FIN 46-R (December 2003).[7] The agencies'[8] risk-based capital and leverage rules require banking organizations to include consolidated assets that are held by VIEs under the leveraged and risk-based capital rules and, therefore, included in their leveraged and risk-based capital ratios. FIN 46-R required the consolidation of many ABCP programs onto the balance sheets of banking organizations. Banking organizations that are required to consolidate ABCP program assets must include all of the program assets (mostly receivables and securities) and liabilities (mainly commercial paper) on their balance sheets for purposes of the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report) or the bank Reports of Condition and Income (Call Reports).

An ABCP program is defined as a program that primarily issues (that is, more than 50 percent) externally rated commercial paper backed by assets or other exposures held in a bankruptcy-remote, special-purpose entity. Thus, a banking organization sponsoring a program issuing ABCP must continue to include the program's assets on a consolidated basis in the institution's risk-weighted asset base.

2128.03.3.1 Liquidity Facilities Supporting ABCP

Liquidity facilities supporting ABCP often take the form of commitments to lend to, or to purchase assets from, the ABCP programs in the event that funds are needed to repay maturing commercial paper. Typically, this need for liquidity is due to a timing mismatch between cash collections on the underlying assets in the program and scheduled repayments of the commercial paper issued by the program.

7. These standards are now included in the FASB Accounting Standards Codification Topic 810, "Consolidation."

8. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

A banking organization that provides liquidity facilities to ABCP is exposed to credit risk regardless of the term of the liquidity facilities. For example, an ABCP program may require a liquidity facility to purchase assets from the program at the first sign of deterioration in the credit quality of an asset pool, thereby removing such assets from the program. In such an event, a draw on the liquidity facility exposes the banking organization to credit risk.

Short-term commitments with an original maturity of one year or less expose banking organizations to a lower degree of credit risk than longer-term commitments. This difference in the degree of credit risk is reflected in the risk-based capital requirement for the different types of exposures through liquidity facilities. The Board's risk-based capital guidelines impose a 10 percent credit-conversion factor on unused portions of eligible short-term liquidity facilities supporting ABCP. A 50 percent credit-conversion factor applies to eligible ABCP liquidity facilities having a maturity of greater than one year. To be an eligible ABCP liquidity facility and qualify for the 10 or 50 percent credit-conversion factor, the facility must be subject to an asset-quality test at the time of inception that does not permit funding against (1) assets that are 90 days or more past due, (2) assets that are in default, and (3) assets or exposures that are externally rated below investment grade at the time of funding if the assets or exposures were externally rated at the inception of the facility. However, a liquidity facility may also be an eligible liquidity facility if it funds against assets that are guaranteed—either conditionally or unconditionally—by the U.S. government, U.S. government agencies, or by an OECD central government, regardless of whether the assets are 90 days past due, in default, or externally rated investment grade.

The 10 or 50 percent credit-conversion factor applies regardless of whether the structure issuing the ABCP meets the rule's definition of an ABCP program. For example, a capital charge would apply to an eligible short-term liquidity facility that provides liquidity support to ABCP when the ABCP constitutes less than 50 percent of the securities issued by the program, thus causing the issuing structure not to meet the rule's definition of an ABCP program. If a banking organization (1) does not meet this definition, it must include the program's assets in its risk-weighted asset base or (2) it chooses to include the program's assets in risk-weighted assets, then no risk-based capital requirement will be assessed against any liquidity facilities provided by the banking organization that supports the program's ABCP. Ineligible liquidity facilities will be treated as recourse obligations or direct-credit substitutes for the purposes of the Board's risk-based capital guidelines.

The resulting credit-equivalent amount would then be risk-weighted according to the underlying assets or the obligor, after considering any collateral or guarantees, or external credit ratings, if applicable. For example, if an eligible short-term liquidity facility providing liquidity support to ABCP covered an asset-backed security (ABS) externally rated AAA, then the notional amount of the liquidity facility would be converted at 10 percent to an on-balance-sheet credit-equivalent amount and assigned to the 20 percent risk-weight category appropriate for AAA-rated ABS.[9]

2128.03.3.2 Overlapping Exposures to an ABCP Program

A banking organization may have multiple overlapping exposures to a single ABCP program (for example, both a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program that is not consolidated for risk-based capital purposes). A banking organization must hold risk-based capital only once against the assets covered by the overlapping exposures. Where the overlapping exposures are subject to different risk-based capital requirements, the banking organization must apply the risk-based capital treatment that results in the highest capital charge to the overlapping portion of the exposures.

For example, assume a banking organization provides a program-wide credit enhancement that would absorb 10 percent of the losses in all of the underlying asset pools in an ABCP program and also provides pool-specific liquidity facilities that cover 100 percent of each of the underlying asset pools. The banking organization would be required to hold capital against 10 percent of the underlying asset pools because it is providing the program-wide credit enhancement. The banking organization would also be required to hold capital against 90 percent of the liquidity facilities it is providing to each of the underlying asset pools. For risk-based capital purposes, the banking organization would not be required to hold capital against any credit enhancements or liquidity facilities that compromise the same program assets.

If different banking organizations have overlapping exposures to an ABCP program, however, each organization must hold capital against the entire maximum amount of its exposure. As a result, while duplication of capital charges will not occur for individual banking organizations, some systemic duplication may occur where multiple banking organizations have overlapping exposures to the same ABCP program.

2128.03.3.3 Asset-Quality Test

In order for a liquidity facility, either short- or long-term, that supports ABCP *not* to be considered a recourse obligation or a direct-credit substitute, it must meet the rule's risk-based capital definition of an *eligible ABCP liquidity facility*. An eligible ABCP liquidity facility must meet a reasonable asset-quality test that, among other things, precludes funding assets that are 90 days or more past due or in default. When assets are 90 days or more past due, they typically have deteriorated to the point where there is an extremely high probability of default. Assets that are 90 days past due, for example, often must be placed on nonaccrual status in accordance with the agencies' Uniform Retail Credit Classification and Account Management Policy.[10] Further, they generally must also be classified Substandard under that policy.

In addition to the above, if the assets covered by the liquidity facility are initially externally rated (at the time the facility is provided) the facility can be used to fund only those assets that are externally rated investment grade at the time of funding. The practice of purchasing assets that are externally rated below investment grade out of an ABCP program is considered to be the equivalent of providing credit protection to the commercial paper investors. Thus, liquidity facilities permitting purchases of below-investment-grade securities will be considered either recourse obligations or direct-credit substitutes.

However, neither the "90-days-past-due" limitation nor the "investment grade" limitation apply to the asset-quality test with respect to assets that are conditionally or unconditionally guaranteed by the U.S. government or its agencies or by another OECD central government.

9. See section III.B.3.c. of the guidelines (12 C.F.R. 225, appendix A).

10. See 65 *Fed. Reg.* 36904 (June 12, 2000).

An ABCP liquidity facility is considered to be in compliance with the requirement for an asset-quality test if (1) the liquidity provider has access to certain types of acceptable credit enhancements and (2) the notional amount of such credit enhancements available to the liquidity facility provider exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade for which the liquidity provider may be obligated to fund under the facility. In this circumstance, the liquidity facility may be considered "eligible" for purposes of the risk-based capital rule because the provider of the credit enhancement generally bears the credit risk of the assets that are 90 days or more past due, in default, or below investment grade rather than the banking organization providing liquidity.

The following forms of credit enhancements are generally acceptable for purposes of satisfying the asset quality test:

- "funded" credit enhancements that the banking organization may access to cover delinquent, defaulted, or below-investment-grade assets, such as overcollateralization, cash reserves, subordinated securities, and funded spread accounts;
- surety bonds and letters of credit issued by a third party with a nationally recognized statistical rating organization rating of single A or higher that the banking organization may access to cover delinquent, defaulted, or below-investment-grade assets, provided that the surety bond or letter of credit is irrevocable and legally enforceable; and
- one month's worth of excess spread that the banking organization may access to cover delinquent, defaulted, or below-investment-grade assets if the following conditions are met: (1) excess spread is contractually required to be trapped when it falls below 4.5 percent (measured on an annualized basis) and (2) there is no material adverse change in the banking organization's ABCP underwriting standards. The amount of available excess spread may be calculated as the average of the current month's and the two previous months' excess spread.

Recourse directly to the seller, other than the funded credit enhancements enumerated above, regardless of the seller's external credit rating, is not an acceptable form of credit enhancement for purposes of satisfying the asset quality test. Seller recourse—for example, a seller's agreement to buy back nonperforming or defaulted loans or downgraded securities—may expose the liquidity provider to an increased level of credit risk. A decline in the performance of assets sold to an ABCP conduit may signal impending difficulties for the seller.

If the amount of acceptable credit enhancement associated with the pool of assets is less than the current amount of assets that are 90 days or more past due, in default, or below investment grade that the liquidity facility provider may be obligated to fund against, the liquidity facility should be treated as recourse or a direct credit substitute. The full amount of assets supported by the liquidity facility would be subject to a 100 percent credit conversion factor.[12] The Federal Reserve Board reserves the right to deem an otherwise eligible liquidity facility to be, in substance, a direct credit substitute if a banking organization uses the liquidity facility to provide credit support.

The banking organization is responsible for demonstrating to the Federal Reserve Board whether acceptable credit enhancements cover the 90 days or more past due, defaulted, or below-investment-grade assets that the organization may be obligated to fund against in each seller's asset pool. If the banking organization cannot adequately demonstrate satisfaction of the conditions in the above-referenced interagency guidance, the Federal Reserve Board further reserves the right to determine that a credit enhancement is unacceptable for purposes of the requirement for an asset quality test and, therefore, it may deem the liquidity facility to be ineligible.

2128.03.3.4 Market Risk Capital Requirements for ABCP Programs

Any facility held in the trading book whose primary function, in form or in substance, is to provide liquidity to ABCP—even if the facility does not qualify as an eligible ABCP liquidity facility under the rule—will be subject to the banking-book risk-based capital requirements. Specifically, banking organizations are required to convert the notional amount of all trading-book positions that provide liquidity to ABCP to credit-equivalent amounts by applying the appropriate banking-book credit-conversion factors. For example, the full amount of all eligible

11. Reserved footnote.

12. See 12 CFR 208, appendix A, section III.B.3.b.i.

ABCP liquidity facilities with an original maturity of one year or less will be subject to a 10 percent conversion factor, regardless of whether the facility is carried in the trading account or the banking book.

2128.03.4 BOARD-OF-DIRECTORS POLICIES PERTAINING TO CREDIT-ENHANCED OR ASSET-BACKED COMMERCIAL PAPER

A banking organization (that is, a bank or a bank holding company) participating in an asset-backed commercial paper program should ensure that such participation is clearly and logically integrated into its overall strategic objectives. Furthermore, management should ensure that the risks associated with the various roles that the institution may play in such programs are fully understood and that safeguards are in place to manage the risks properly.

Appropriate policies, procedures, and controls should be established by a banking organization before it participates in asset-backed commercial paper programs. Significant policies and procedures should be approved and reviewed periodically by the organization's board of directors. These policies and procedures should ensure that the organization follows prudent standards of credit assessment and approval regardless of the role an institution plays in an asset-backed commercial paper program. Such policies and procedures would be applicable to all pools of receivables to be purchased by the SPE as well as to the extension of any credit enhancements and liquidity facilities. Procedures should include an initial, thorough credit assessment of each pool for which the banking organization had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. Furthermore, the policies and procedures should outline the credit-approval process and establish in-house exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves. Controls should include well-developed management information systems and monitoring procedures.

Institutions should analyze the receivables pools underlying the commercial paper as well as the structure of the arrangement. This analysis should include a review of—

1. the characteristics, credit quality, and expected performance of the underlying receivables;
2. the banking organization's ability to meet its obligations under the securitization arrangement; and
3. the ability of the other participants in the arrangement to meet their obligations.

Banking organizations providing credit enhancements and liquidity facilities should conduct a careful analysis of their funding capabilities to ensure that they will be able to meet their obligations under all foreseeable circumstances. The analysis should include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.

Examiners should carefully review the asset-backed commercial paper facilities provided by banking organizations to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs. In addition, examiners should determine whether the previously discussed policies are operative and that institutions are adequately managing their risk exposure. If not appropriate for the open section, a discussion of the size, effectiveness, and risks associated with asset-backed commercial paper programs should be included in the confidential section of the examination or inspection report. See SR-92-11.

2128.03.5 INSPECTION OBJECTIVES

1. To determine whether the banking organization (that is, a bank or a bank holding company) participating in an asset-backed commercial paper program has included this participation in its overall strategic objectives.
2. To determine whether management fully understands the risks associated with the banking organization's involvement in credit-enhancement and asset-backed commercial paper programs and whether appropriate safeguards are in place to properly manage those risks.
3. To ascertain that the appropriate policies, procedures, and controls have been established by the banking organization before participating in asset-backed commercial paper programs.
4. To verify whether existing managerial and internal controls include well-developed

management information systems and monitoring procedures.
5. To determine whether the banking organization has conducted a careful analysis of its funding capabilities to ensure that it will be able to meet its obligations under all foreseeable circumstances.
6. To ensure that all asset-backed securities owned, any assets sold with recourse, retained interests, and variable interest entities (VIEs) (for example, asset-backed commercial paper [ABCP] programs, those that are defined as VIEs under generally accepted accounting principles) are properly accounted for on the banking organization's books and are correctly reported on its regulatory reports.
7. To determine that capital is commensurate with, and that there are accurate determinations of the risk weights for, the risk exposures arising from recourse obligations, direct-credit substitutes, asset- and mortgage-backed securities, ABCP programs and ABCP liquidity facilities, and other asset-securitization transactions.

2128.03.6 INSPECTION PROCEDURES

1. Review the minutes of board of directors or executive committee meetings. Establish whether the significant policies and procedures for credit-enhanced or asset-backed commercial paper have been approved and reviewed periodically by the organization's board of directors.
   a. Determine whether the policies are operative and whether institutions are adequately managing their risk exposure.
   b. Determine whether the policies and procedures are applicable to all pools of receivables to be purchased by the SPE as well as to the extension of any credit enhancements and liquidity facilities.
2. Determine if the organization follows prudent standards of credit assessment and approval.
   a. Ascertain whether the procedures include an initial, thorough credit assessment of each pool for which the organization had assumed credit risk. The initial review should be followed by periodic credit reviews to monitor performance throughout the life of the exposure.
   b. Determine if the policies and procedures outline the credit-approval process and establish in-house exposure limits, on a consolidated basis, with respect to particular industries or organizations, that is, companies from which the SPE purchased the receivables as well as the receivable obligors themselves.
   c. Determine whether the organization analyzes the receivables pools underlying the commercial paper as well as analyzes the structure of the arrangement. Does the analysis include a review of—
      - the characteristics, credit quality, and expected performance of the underlying receivables;
      - the ability of the banking organization to meet its obligations under the securitization arrangement; and
      - the ability of the other participants in the arrangement to meet their obligations?
3. Review the organization's funding obligations and commitments, and determine whether there is sufficient liquidity to satisfy those funding requirements. Include a determination of the impact that fulfillment of these obligations would have on their interest-rate risk exposure, asset quality, liquidity position, and capital adequacy.
4. Review carefully the risk-based capital calculations for ABCP facilities to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting the asset-backed commercial paper programs.
5. Determine if the banking organization consolidates, in accordance with GAAP, the assets of any ABCP program or other such program that it sponsors.
   a. Determine if the banking organization's ABCP program met the definition of a sponsored ABCP program under the risk-based capital guidelines.
   b. Verify that the assets of the banking organization's eligible ABCP program and any associated minority interest were included in the banking organization's calculation of its risk-based capital ratios.
   c. Ascertain whether the liquidity facilities the banking organization extends to the ABCP program satisfy the risk-based capital requirements, including the appropriate asset-quality test, of an eligible ABCP program liquidity facility. (See 12 C.F.R. 225, appendix A, section III.B.3.a.iv.)
   d. Determine whether the banking organization applied the correct credit-conversion

factor to the eligible ABCP liquidity facilities when it determined the amount of risk-weighted assets for its risk-based capital ratios. (See 12 C.F.R. 225, appendix A, section III.D.)

e. Determine if all ineligible ABCP liquidity facilities were treated as either direct-credit substitutes or as recourse obligations, as required by the risk-based capital guidelines.

f. If the banking organization had multiple overlapping exposures, determine if the banking organization applied the risk-based capital treatment that resulted in the highest capital charge. (See 12 CFR 225, appendix A, section III.B.6.c.)

6. Include in the inspection report a discussion of the size, effectiveness, and risks associated with ABCP programs (include the discussion in the confidential section of the inspection report if not appropriate for the open section).

Implicit recourse arises when a bank holding company[1] provides credit support to one of more of its securitizations beyond its contractual obligation. Implicit recourse, like contractual recourse, exposes a bank holding company to the risk of loss arising from deterioration in the credit quality of the underlying assets of the securitization. Implicit recourse is of supervisory concern because it demonstrates that the securitizing bank holding company is reassuming risk associated with the securitized assets—risk that the bank holding company initially transferred to the marketplace. For risk-based capital purposes, bank holding companies deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though the assets remained on the bank holding company's books.

Banking organizations have typically provided implicit recourse in situations where the originating banking organization perceived that the failure to provide this support, even though not contractually required, would damage its future access to the asset-backed securities market. An originating bank holding company can provide implicit recourse in a variety of ways. The ultimate determination as to whether implicit recourse exists depends on the facts. The following actions point to a finding of implicit recourse:

1. selling assets to a securitization trust or other special-purpose entity (SPE) at a discount from the price specified in the securitization documents, which is typically par value
2. purchasing assets from a trust or other SPE at an amount greater than fair value
3. exchanging performing assets for nonperforming assets in a trust or other SPE
4. funding credit enhancements[2] beyond contractual requirements

By providing implicit recourse, a bank holding company signals to the market that it still holds the risks inherent in the securitized assets, and, in effect, the risks have not been transferred. Accordingly, examiners must be attentive to bank holding companies that provide implicit support, given the risk these actions pose to a bank holding company's financial condition. Increased attention should be given to situations where a bank holding company is more likely to provide implicit support.

Particular attention should be paid to revolving securitizations, such as those used for credit card lines and home equity lines of credit, in which receivables generated by the lines are sold into the securitizations. These securitizations typically provide that, when certain performance criteria hit specified thresholds, no new receivables can be sold into the securitization, and the principal on the bonds issued will begin to pay out. These early-amortization events are intended to protect investors from further deterioration in the underlying asset pool. Once an early-amortization event has occurred, the bank holding company could have difficulties using securitization as a continuing source of funding and, at the same time, have to fund the new receivables generated by the lines of credit on its balance sheet. Thus, bank holding companies have an incentive to avoid early amortization by providing implicit support to the securitization.

Examiners should be alert for securitizations that are approaching early-amortization triggers, such as a decrease in the excess spread[3] below a certain threshold or an increase in delinquencies beyond a certain rate. Providing implicit recourse can pose a degree of risk to a bank holding company's financial condition and to the integrity of its regulatory and public financial statements and reports. Examiners should review securitization documents (for example, pooling and servicing agreements) to ensure that the selling institution limits any post-sale support to that specified in the terms and conditions in the securitization documents. Examiners should also review a sample of receivables transferred between the seller and the trust to ensure that these transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated. While bank hold-

1. The reference to implicit-recourse activities of bank holding companies is intended to include all of a bank holding company's domestic and foreign subsidiaries supervised by the Federal Reserve, as well as its federally insured depository institutions and other entities that are subject to this interpretation and guidance of the Federal Financial Institutions Examination Council (FFIEC).

2. Credit enhancements include retained subordinated interests, asset-purchase obligations, overcollateralization, cash-collateral accounts, spread accounts, and interest-only strips.

3. Excess spread generally is defined as finance-charge collections minus certificate interest, servicing fees, and charge-offs allocated to the series.

ing companies are not prohibited from providing implicit recourse, such support will generally result in higher capital requirements.

Examiners should recommend that prompt supervisory action be taken when implicit recourse is identified. To determine the appropriate action, examiners need to understand the bank holding company's reasons for providing support and the extent of the impact of this support on the bank holding company's earnings and capital. As with contractual recourse, actions involving noncontractual post-sale credit enhancement generally result in the requirement that the bank holding company hold risk-based capital against the entire outstanding amount of the securitized assets. The Federal Reserve may require the bank holding company to bring all assets in existing securitizations back on the balance sheet for risk-based capital purposes, as well as require the bank holding company to increase its minimum capital ratios. The Federal Reserve may prevent a bank holding company from removing assets from its risk-weighted asset base on future transactions until the bank holding company demonstrates its intent and ability to transfer risk to the marketplace. The Federal Reserve may consider other actions to ensure that the risks associated with implicit recourse are adequately reflected in the capital ratios. For example, supervisors may require the bank holding company to deduct residual interests from tier 1 capital as well as hold risk-based capital on the underlying assets. (See SR-02-15.)

The following examples illustrate post-sale actions that banking organizations may take with respect to assets they have securitized. These examples are intended to provide guidance on whether these actions would be considered implicit recourse for risk-based capital and other supervisory purposes. A key factor in each scenario and analysis is the potential risk of loss a bank holding company's earnings and capital may be exposed to as a result of its actions.

Account Removal: Example 1a

Facts. A bank holding company originates and services credit card receivables throughout the country. The bank holding company decides to divest those credit card accounts of customers who reside in specific geographic areas where the bank holding company lacks a significant market presence. To achieve the maximum sales price, the sale must include both the credit card relationships and the receivables. Because many of the credit card receivables are securitized through a master-trust structure, the bank holding company needs to remove the receivables from the trust. The affected receivables are not experiencing any unusual performance problems. In that respect, the charge-off and delinquency ratios for the receivables to be removed from the trust are substantially similar to those for the trust as a whole.

The bank holding company enters into a contract to sell the specified credit card accounts before the receivables are removed from the trust. The terms of the transaction are arm's length, wherein the bank holding company will sell the receivables at market value. The bank holding company separately agrees to purchase the receivables from the trust at this same price. Therefore, no loss is incurred as a result of removing the receivables from the trust. The bank holding company will remove from the trust only those receivables that are due from customers located in the geographic areas where the bank holding company lacks a significant market presence, and it will remove all such receivables from the trust.

Analysis. The removal of the above-described receivables from the trust does not constitute implicit recourse for regulatory capital purposes. Supporting factors for this conclusion include the following:

1. The bank holding company's earnings and capital are not exposed to actual or potential risk of loss as a result of removing the receivables from the trust.
2. There is no indication that the receivables are removed from the trust because of performance concerns.
3. The bank holding company is removing the receivables from the trust for a legitimate business purpose other than to systematically improve the quality of the trust's assets. The legitimate business purpose is evidenced by the bank holding company's prearranged, arm's-length sale agreement that facilitates exiting the business in identified geographic locations.

Examiners should review the terms and conditions of the transaction to ensure that the market value of the receivables is documented and well supported before concluding that this transaction does not represent implicit recourse. Examiners should also ensure that the selling bank holding company has not provided the purchaser with any guarantees or credit enhancements on the sold receivables.

Account Removal: Example 1b

Facts. After the establishment of a master trust for a pool of credit card receivables, the receivables in the trust begin to experience adverse performance. A combination of lower-than-expected yields and higher-than-anticipated charge-offs on the pool causes spreads to compress significantly (although not to zero). The bank holding company's internally generated forecasts indicate that spreads will likely become negative in the near future. Management takes action to support the trust by purchasing the low-quality (delinquent) receivables from the trust at par, although their market value is less than par. The receivables purchased from the trust represent approximately one-third of the trust's total receivables. This action improves the overall performance of the trust and avoids a potential early-amortization event.

Analysis. The purchase of low-quality receivables from a trust at par constitutes implicit recourse for regulatory capital purposes. The purchase of low-quality receivables at an above-market price exposes the bank holding company's earnings and capital to potential future losses from assets that had previously been sold. Accordingly, the bank holding company is required to hold risk-based capital for the remaining assets in the trust as if they were retained on the balance sheet, as well as hold capital for the assets that were repurchased.

Additions of Future Assets or Receivables: Example 2a

Facts. Months after the issuance of credit card asset-backed securities, charge-offs and delinquencies on the underlying pool of receivables rise dramatically. A rating agency places the securities on watch for a potential rating downgrade. The securitization documents require the bank holding company to transfer new receivables to the securitization trust at par value. However, to maintain the rating on the securities, the bank holding company begins to sell replacement receivables into the trust at a discount from par value.

Analysis. The sale of receivables to the trust at a discount constitutes implicit recourse for regulatory capital purposes. The sale of assets at a discount from the price specified in the securitization documents, par value in this example, exposes the bank holding company's earnings and capital to future losses. The bank holding company must hold regulatory capital against the outstanding assets in the trust.

Additions of Future Assets or Receivables: Example 2b

Facts. A bank holding company established a credit card master trust. The receivables from the accounts placed in the trust were, on average, of lesser quality than the receivables from certain affinity accounts retained on the bank holding company's balance sheet. Under the criteria for selecting the receivables to be transferred to the master trust, the bank holding company was prevented from including the better-performing affinity accounts in the initial pool of accounts because the affinity-relationship contract was expiring. The bank holding company and the affinity client subsequently revised the terms of their contract, enabling the affinity accounts to meet the selection criteria and be included in future securitization transactions. Later, rising charge-offs within the pool of receivables held by the trust caused spread compression in the trust. To improve the performance of the assets in the trust, the bank holding company begins to include the better-performing and now-eligible receivables from the affinity accounts among the receivables sold to the trust. This action improves the trust's performance, including its spread levels and charge-off ratios. However, the replacement assets were sold at par in accordance with the terms of the trust agreement, so no current or future charge to the bank holding company's earnings or capital will result from these asset sales. As another result of this action, the performance of the trust's assets closely tracks the credit card receivables that remain on the bank holding company's balance sheet.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. The bank holding company did not incur any additional risk to earnings or capital after the affinity accounts met the selection criteria for replacement assets and after the associated receivables were among the receivables sold to the trust. The replacement assets were sold at par in accordance with the terms of the trust agreement, so no future charge to earnings or capital will result from these asset sales. The sale of replacement assets into a master-trust structure is part of normal trust management.

In this example, the credit card receivables that remain on the bank holding company's balance sheet closely track the performance of the trust's assets. Nevertheless, examiners should ascertain whether a securitizing bank holding company sells disproportionately higher-quality assets into securitizations while retaining comparatively lower-quality assets on its books. If a bank holding company engages in this practice, examiners should consider its effect on the bank holding company's capital adequacy.

Additions of Future Assets or Receivables: Example 2c

Facts. A bank holding company establishes a credit card master trust composed of receivables from accounts that were generally of lower quality than the receivables retained on the bank holding company's balance sheet. The difference in the two portfolios is primarily due to logistical and operational problems that prevent the bank holding company from including certain better-quality affinity accounts in the initial pool from which accounts were selected for securitization. Rising charge-offs and other factors later result in margin compression on the assets in the master trust, which causes some concern in the market regarding the stability of the outstanding asset-backed securities. A rating agency places several tranches of the securities on its watch list for a potential rating downgrade. In response to the margin compression, as part of the bank holding company's contractual obligations, spread accounts are increased for all classes by trapping excess spread in conformance with the terms and conditions of the securitization documents. To stabilize the quality of the receivables in the master trust, as well as to preclude a downgrade, the bank holding company takes several actions beyond its contractual obligations:

1. Affinity accounts are added to the pool of receivables eligible for inclusion in the trust. This change results in improved overall trust performance. However, these receivables are sold to the trust at par value, consistent with the terms of the securitization documents, so no current or future charge to the bank holding company's earnings or capital will result from these asset sales.
2. The charge-off policy for cardholders that have filed for bankruptcy is changed from criteria that were more conservative than industry standards, the applicable Federal Reserve classification policy for bank holding companies, and the FFIEC Uniform Retail Credit Classification and Account Management Policy to criteria that conform to industry standards, the Federal Reserve's standards, and the FFIEC's policy.
3. Charged-off receivables held by the trust are sold to a third party. The funds generated by this sale, effectively accelerating the recovery on these receivables, improve the trust's spread performance.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. None of the noncontractual actions result in a loss or expose the bank holding company's earnings or capital to the risk of loss. Because of the margin compression, the bank holding company is obligated to increase the spread accounts in conformance with the terms and conditions of the securitization documents. To the extent this results in an increase in the value of the subordinated spread accounts (residual interests) on the bank holding company's balance sheet, the bank holding company will need to hold additional capital on a dollar-for-dollar basis for the additional credit risk it retains. In contrast, if the bank holding company increased the spread accounts beyond its contractual obligation under the securitization documents, this action would be considered a form of implicit recourse. None of the other actions the bank holding company took would affect its earnings or capital:

1. Like other additions to credit card trusts, the additions of receivables from the new affinity accounts were made at par value, in accordance with the securitization documents. Therefore, the additions of receivables from the new affinity accounts would not affect the bank holding company's earnings or capital.
2. The trust's policy on the timing of charge-offs on accounts of cardholders who have filed for bankruptcy was changed to meet the less stringent standards of the industry and those required under the Federal Reserve's policy in order to improve trust performance, at least temporarily. Nonetheless, this would not affect the bank holding company's earnings or capital.

3. In accordance with the securitization documents, proceeds from recoveries on charged-off accounts are the property of the trust. These and other proceeds would continue to be paid out in accordance with the pooling and servicing agreement. No impact on the bank holding company's earnings or capital would result.

Modification of Loan-Repayment Terms: Example 3

Facts. In performing the role of servicer for its securitization, a bank holding company is authorized under its pooling and servicing agreement to modify loan-repayment terms when it appears that this action will improve the likelihood of repayment on the loan. These actions are part of the bank holding company's process of working with customers who are delinquent or otherwise experiencing temporary financial difficulties. All of the modifications are consistent with the bank holding company's internal loan policy. However, in modifying the loan terms, the contractual maturity of some loans may be extended beyond the final maturity date of the most junior class of securities sold to investors. When this occurs, the bank holding company repurchases these loans from the securitization trust at par.

Analysis. The combination of the loan-term modification for securitized assets and the subsequent repurchase constitutes implicit recourse for regulatory capital purposes. While the modification of loan terms is permitted under the pooling and servicing agreement, the repurchase of modified loans with extended maturities at par exposes the bank holding company's earnings and capital to potential risk of loss.

Servicer's Payment of Deficiency Balances: Example 4

Facts. A wholly owned subsidiary of a bank holding company originates and services a portfolio of home equity loans. After liquidation of the collateral for a defaulted loan, the subsidiary makes the trust whole in terms of principal and interest if the proceeds from the collateral are not sufficient. However, there is no contractual commitment that requires the subsidiary to support the pool in this manner. The payments made to the trust to cover deficient balances on the defaulted loans are not recoverable under the terms of the pooling and servicing agreement.

Analysis. The subsidiary's action constitutes implicit recourse to the bank holding company for regulatory capital purposes. This action is considered implicit recourse because it adversely affects the bank holding company's earnings and capital since the bank holding company absorbs losses on the loans resulting from the actions taken by its subsidiary. Further, no mechanism exists to provide for and ensure that the subsidiary will be reimbursed for the payments made to the trust. In addition, examiners will consider any servicer advance a credit enhancement if the servicer is not entitled to full reimbursement[4] or if the reimbursement is subordinate to other claims.

Reimbursement of Credit Enhancer's Actual Losses: Example 5

Facts. A bank holding company sponsoring a securitization arranges for an unrelated third party to provide a first-loss credit enhancement, such as a financial standby letter of credit, that will cover losses up to the first 10 percent of the securitized assets. The bank holding company agrees to pay a fixed amount as an annual premium for this credit enhancement. The third party initially covers actual losses that occur in the underlying asset pool in accordance with its contractual commitment under the letter of credit. Later, the bank holding company agrees not only to pay the credit enhancer the annual premium on the credit enhancement, but also to reimburse the credit enhancer for the losses it absorbed during the preceding year. This reimbursement for actual losses was not originally provided for in the contractual arrangement between the bank holding company and the credit-enhancement provider.

Analysis. The bank holding company's subsequent reimbursement of the credit-enhancement provider's losses constitutes implicit recourse because the bank holding company's reimbursement of losses went beyond its contractual obligations. Furthermore, the Federal Reserve would consider any requirement contained in the original credit-enhancement contract that obligates the bank holding company to reim-

4. A servicer advance will also be considered a form of credit enhancement if, for any one loan, nonreimbursable advances are not contractually limited to an insignificant amount of that loan's outstanding principal.

burse the credit-enhancement provider for its losses to be a recourse arrangement.

2128.04.1 INSPECTION OBJECTIVES

1. To identify asset-securitization transactions in which the bank holding company has provided implicit recourse.
2. To ascertain whether implicit recourse provided to asset-securitization transactions may be detrimental to the bank holding company's earnings performance, capital adequacy, and financial condition.
3. To initiate quick supervisory action, which may include increased minimum-capital requirements, when implicit recourse is identified.

2128.04.2 INSPECTION PROCEDURES

1. Be attentive to situations in which the bank holding company may have provided implicit support to an asset-securitization transaction.
2. Be alert for securitizations that are approaching early-amortization triggers, such as a decrease in the excess spread below a certain threshold or an increase in delinquencies beyond a certain rate.
3. Review securitization documents to ensure that the selling institution limits any post-sale support to that specified in the terms and conditions in the securitization documents.
4. Review a sample of receivables transferred between the seller and the trust to ensure that the transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated.
5. Review the terms and conditions of the securitization transactions reviewed to ensure that the market value of the receivables is documented and well supported.
6. Ascertain that the selling bank holding company has not provided a purchaser with any guarantees or credit enhancements on the sold receivables.
7. Ascertain whether a securitizing bank holding company sells disproportionately higher-quality assets into securitizations while retaining comparatively lower-quality assets on its books. Evaluate the effect of this practice on the bank holding company's earnings and capital adequacy.
8. Provide appropriate written documentation and recommend that prompt supervisory action be taken when implicit recourse is identified.

A bank holding company's board of directors and senior management are responsible for initiating policies and procedures, and for monitoring processes and internal controls, that will provide reasonable assurance that the bank holding company's contracts and commitments do not include detrimental covenants that affect its safety and soundness. When examiners review a bank holding company's securitization contracts and related documentation, they should be alert to any covenants that use adverse supervisory actions or the breach of supervisory thresholds as triggers for early-amortization events or the transfer of servicing. Examples of such supervisory actions can include a downgrade in the banking organization's RFI/C(D) or CAMELS rating, an enforcement action, or a downgrade in a depository institution's prompt-corrective-action capital category. The inclusion of supervisory-linked covenants in securitization documents is considered to be an "unsafe and unsound banking practice" that undermines the objective of supervisory actions and thresholds. An early amortization or transfer of servicing triggered by such events can create or exacerbate liquidity and earnings problems for a bank holding company that may lead to further deterioration in its financial condition.

Covenants that contain triggers tied, directly or indirectly, to supervisory actions or thresholds can also result in the early amortization of a securitization at a time when the sponsoring organization's ability to access other funding sources is limited. If an early-amortization event occurs, investors may lose confidence in the stability of the sponsoring organization's asset-backed securities, thus limiting its ability to raise new funds through securitization. At the same time, the organization must fund new receivables on the balance sheet, potentially resulting in liquidity problems. Moreover, the existence of a supervisory-linked trigger potentially could inhibit supervisors from taking action intended to address problems at a troubled organization because the action could trigger an event that worsens its condition or causes its failure.

The Federal Reserve is concerned that covenants related to supervisory actions may obligate a bank holding company's management to disclose confidential information, such as RFI/C(D) or CAMELS ratings. Disclosure of such information by a banking organization's directors, officers, employees, attorneys, or independent auditors, without explicit authorization by its primary regulator, violates supervisory information disclosure rules and policies and may result in follow-up supervisory action.

Because of the supervisory concerns about covenants that are linked to supervisory actions, a federal bank interagency advisory was issued on May 23, 2002. (See SR-02-14.) The advisory emphasizes that a banking organization's management and board of directors should ensure that covenants related to supervisory actions or thresholds are not included in securitization documents. Covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event will be criticized, under appropriate circumstances, as an unsafe and unsound banking practice. The Federal Reserve (and other supervisors) may also take other supervisory actions, such as requiring additional capital or denying capital relief for risk-based capital calculations, regardless of the treatment under generally accepted accounting principles (GAAP).

Examiners should consider the potential impact of such covenants in existing transactions when evaluating both the overall condition of the bank holding company and the specific component ratings of capital, liquidity, and management. Early-amortization triggers will specifically be considered in the context of the bank holding company's overall liquidity position and contingency funding plan. For organizations with limited access to other funding sources or a significant reliance on securitization, the existence of these triggers presents a greater degree of supervisory concern. Any bank holding company that uses securitization as a funding source should have a viable contingency funding plan in the event it can no longer access the securitization market. Examiners should encourage bank holding company management to amend, modify, or remove covenants linked to supervisory actions from existing transactions. Any impediments a bank holding company may have to taking such actions should be documented and discussed with the appropriate supervisory staff of its responsible Reserve Bank.

2128.05.1 INSPECTION OBJECTIVES

1. During the review of securitization activities and contracts, to be alert to securitization

documents containing covenants that have triggers tied, directly or indirectly, to supervisory actions or thresholds.
2. Under appropriate circumstances, to criticize as an unsafe and unsound banking practice the inclusion of covenants in a securitization-transaction document when the covenants provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event.
3. To determine if the bank holding company has a viable contingency funding plan that it can use if it can no longer access the securitization market.

2128.05.2 INSPECTION PROCEDURES

1. Review a sample of the bank holding company's securitization contracts and related documentation.
2. Evaluate the overall condition of the bank holding company, as well as the specific component ratings of capital, liquidity, and management.
3. If the bank holding company uses securitization as a funding source, determine its overall liquidity position and whether it has an adequate and viable contingency funding plan that can be used if the bank holding company can no longer access the securitization market.
4. Determine the potential impact of any early-amortization triggers or transfer of servicing within the asset-securitization contracts (any covenants that use adverse supervisory actions or the crossing of supervisory thresholds as triggers for early-amortization events or the transfer of servicing).
5. Encourage bank holding company management to amend, modify, or remove from existing transactions any securitization covenants linked to supervisory actions.
6. Report to and consult with Reserve Bank supervisory staff on any impediments the directors and senior management of the bank holding company have to amending, modifying, or removing any such detrimental securitization convenants.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to replace, as appropriate, the references to FAS 125 with either FAS 140 or FAS 157. The Financial Accounting Standards Board (FASB), issued in September 2000, FAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FAS No. 125)." FAS 157, "Fair Value Measurements," was issued in September 2006 and was made effective on November 15, 2007.

2128.06.05 RETAINED INTERESTS FROM SECURITIZATION ACTIVITIES

Securitization activities present unique and sometimes complex risks that require the attention of senior management and the board of directors. Retained interests from securitization activities, including interest-only strips receivable, arise when a banking organization (BO) keeps an interest in the assets sold to a securitization vehicle that, in turn, issues bonds to investors.[1]

The methods and models BOs use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under generally accepted accounting principles (GAAP), a BO recognizes an immediate gain (or loss) on the sale of assets, in part, by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle.[2]

Determinations of fair value should be based on reasonable assumptions about factors such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests, for regulatory reporting purposes, should not be carried as assets on a BO's books, but should be charged off. Other supervisory concerns include failure to recognize and hold sufficient capital against recourse obligations generated by securitizations, and the absence of an adequate independent audit function.

The supervisory guidance focuses on and incorporates important fundamental concepts of risk-management and risk-focused supervision: active oversight by senior management and the board of directors, the use of effective policies and limits, accurate and independent procedures to measure and assess risk, and the maintenance of strong internal controls.[3] The guidance stresses sound risk-management, modeling, valuation, and disclosure practices for asset securitization; complements previous supervisory guidance issued on this subject; and supplements existing policy statements and examination-inspection procedures.[4] Emphasis is placed on the expectation that a BO's securitization-related retained interest must be supported by documentation of the interest's fair value, using reasonable valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet these supervisory standards will be classified as loss and disallowed for inclusion as assets of the BO for regulatory capital purposes. See SR-99-37 and the more complete text of its referenced interagency guidance on the risk mangement and valuation of retained interests arising from asset securitization activities. See also SR-03-4 and its attachment and section 3071.0.

Examiners will review a BO's valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, BOs may be required, on a case-by-case basis, to hold additional capital commensurate with their risk exposures.[5] An

1. The term "banking organization" (BO) refers to any federally supervised banking organization. This includes federally insured, federally chartered financial institutions that are supervised by a federal bank or savings association supervisory authority, as well as bank holding companies and their nonbank subsidiaries.

2. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement No. 125)."

3. See SR-96-14, "Risk-Focused Safety-and-Soundness Examinations and Inspections" (section 2124.0 of this manual), and SR-95-51, "Rating the Adequacy of Risk-Management Processes and Internal Controls at State Member Banks and Bank Holding Companies" (section 4070.1 of this manual).

4. See SR-97-21, "Risk Management and Capital Adequacy of Exposures Arising from Secondary-Market Credit Activities," and SR-96-30, "Risk-Based Capital Treatment for Spread Accounts That Provide Credit Enhancement for Securitized Receivables."

5. For instance, a BO has high concentrations of retained

excessive dependence on securitizations for day-to-day core funding can present significant liquidity problems during times of market turbulence or if there are difficulties specific to the BO.

2128.06.1 ASSET SECURITIZATION

Asset securitization typically involves the transfer of on-balance-sheet assets to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. BOs use asset securitization to access alternative funding sources, manage concentrations, improve financial-performance ratios, and more efficiently meet customer needs. Assets typically securitized include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

Senior management and directors must have the requisite knowledge of the effect of securitization on the BO's risk profile and must be fully aware of the accounting, legal, and risk-based capital nuances of this activity. BOs must fully and accurately distinguish and measure the risks that are transferred versus those retained, and must adequately manage the retained portion. It is essential that BOs engaging in securitization activities have appropriate front- and back-office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Appropriate valuation and modeling methodologies must be used. They must be able to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale, in part, through booking a "retained interest." The carrying value, however, of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent impairment in value. The best evidence of fair value is a quoted market price in an active market. When quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances."[6] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports. (See FAS 140, para. 71.)

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, a BO that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring BO's capital, the BO's demise. BO managers and directors need to ensure the following:

1. Independent risk-management processes are in place to monitor securitization-pool performance on an aggregate and individual transaction level. An effective risk-management function includes appropriate information systems to monitor securitization activities.
2. Appropriate valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
3. Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets the BO retains. The findings of such reviews should be reported directly to the board or an appropriate board committee.
4. Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.
5. Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.
6. A realistic liquidity plan is in place for the BO in case of market disruptions.

interests relative to its capital or is otherwise at risk from impairment of these assets.

6. See FAS 157, "Fair Value Measurements."

2128.06.2 INDEPENDENT RISK-MANAGEMENT FUNCTION

BOs engaged in securitizations should have an independent risk-management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the BO's circumstances. A sound asset securitization policy should include or address, at a minimum—

1. a written and consistently applied accounting methodology;
2. regulatory reporting requirements;
3. valuation methods, including FAS 157 valuation assumptions, and procedures to formally approve changes to those assumptions;
4. a management reporting process; and
5. exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk-management function monitor origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss-recognition practices. Because the securitization of assets can result in the current recognition of *anticipated income*, the risk-management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher-risk assets to sustain ongoing income needs. Such pressures can lead to a compromise of credit-underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

The risk-management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool-performance information will help well-managed BOs ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of quality MIS will hinder management's ability to monitor specific pool performance and securitization activities.

At a minimum, MIS reports should address the following:

1. *Securitization summaries for each transaction.* The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure that the summaries for each transaction are distributed to all personnel associated with securitization activities.
2. *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.
3. *Vintage analysis for each pool using monthly data.* Vintage analysis will help management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends with underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained-interest valuation assumptions.
4. *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare monthly the timing and amount of cash flows received from the trust with those projected as part of the FAS 157 retained-interest valuation analysis. Some master-trust structures allow excess cash flow to be

shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.

5. *Sensitivity analysis.* A sensitivity analysis measures the effect of changes in default rates, prepayment or payment rates, and discount rates to assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine ''best,'' ''probable,'' and ''worst case'' scenarios for each event. Other factors that need to be considered are the impact of increased defaults on collections staffing, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher-than-expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors. Management should incorporate this analysis into their overall interest-rate risk measurement system.[7] Examiners will review the BO-conducted analysis and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating (the ''S'' in the CAMELS rating system for banks or the ''M'' for the BHC rating system[8]).
6. *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

2128.06.3 VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss-severity factors, and discount rates. BOs are expected to take a logical appropriate approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and make appropriate adjustments going forward, the BO must implement a reasonable modeling process to comply with FAS 157. Management is expected to employ appropriate valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the model builders' possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulner-

7. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13 and section 2127.0) advises institutions with a high level of exposure to interest-rate risk relative to capital that they will be directed to take corrective action.
8. See sections 4070.0 and 4070.1.

ability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the BO's circumstances and executed consistent with its asset securitization policy.

2128.06.4 USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding a BO's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly the management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks retained interests present, and to have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

2128.06.5 INTERNAL CONTROLS

Effective internal controls are essential to a BO's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the BO's resources; ensure that financial information and reports are reliable; and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, and assist in their timely detection. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including testing.

Operational and managerial standards have been established for internal control and information systems.[9] A system of internal controls should be maintained that is appropriate to the BO's size and the nature, scope, and risk of its activities.[10]

2128.06.6 AUDIT FUNCTION OR INTERNAL REVIEW

A BO's board of directors is responsible for ensuring that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 140), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the BO's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

2128.06.7 REGULATORY REPORTING OF RETAINED INTERESTS

The securitization and subsequent removal of assets from a BO's balance sheet requires additional reporting as part of the regulatory reporting process. Common regulatory reporting errors stemming from securitization activities may include—

9. See the safety-and-soundness standards for national banks at 12 CFR 30 (OCC), and for savings associations at 12 CFR 570 (OTS).

10. BOs that are subject to the requirements of FDIC regulation 12 CFR 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

1. failure to include off-balance-sheet assets subject to recourse treatment when calculating risk-based capital ratios;
2. failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
3. failure to report loans sold with recourse in the appropriate section of the regulatory report; and
4. overvaluing retained interests.

A BO's directors and senior management are responsible for the accuracy of its regulatory reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

2128.06.8 MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the BO's asset securitization activities should be disclosed. The information in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the BO. Well-informed investors, depositors, creditors, and other counterparties can provide a BO with strong incentives for maintaining sound risk-management systems and internal controls. Adequate disclosure allows market participants to better understand the BO's financial condition and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk-management practices. Examples of sound disclosures include—

1. accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
2. the process and methodology used to adjust the value of retained interests for changes in key assumptions;
3. risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
4. the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
5. sensitivity analyses or stress-testing conducted by the BO, showing the effect of changes in key assumptions on the fair value of retained interests.

2128.06.9 RISK-BASED CAPITAL FOR RECOURSE AND LOW-LEVEL-RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets.[11] In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a BO's earnings and capital at risk. These enhancements should generally be *aggregated* to determine the extent of a BO's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for ''low-level-recourse'' treatment.[12] Risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a BO is contractually liable. The low-level-recourse treatment applies to transactions accounted for as sales under GAAP in which a BO contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low-level-recourse principle, the BO holds

11. See the risk-based capital treatment for sales with recourse at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (OCC), and 12 CFR 567.6(a)(2)(i)(c) (OTS). For a further explanation of recourse, see the glossary of the Call Report instructions, ''Sales of Assets for Risk-Based Capital Purposes.''

12. See 60 *Fed. Reg.* 8177, February 13, 1995 (FRB).

capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

If a BO does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low-level-recourse treatment does not apply. Instead, the BO must hold risk-based capital against the securitized assets as if those assets had not been sold. Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set forth in this section will be classified as loss and disallowed as assets of the BO for regulatory capital purposes.

2128.06.10 CONCENTRATION LIMITS IMPOSED ON RETAINED INTERESTS

The creation of a retained interest asset (the debit) typically also results in an offsetting "gain on sale" (the credit). BOs that securitize high-yielding assets with long durations may create a retained-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over 8 percent of the securitized assets). Serious problems can arise for those BOs that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

As an example, a BO could sell $100 in subprime home-equity loans and book a retained interest of $20 using innapropriate valuation assumptions. Under the current capital rules, the BO is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (8 percent of $100 = $8). However, the institution is still exposed to substantially all the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to the inappropriate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder a BO's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. A BO's board of directors and management is expected to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for a BO's personnel to engage in activities designed to generate near-term "paper profits" that may be at the expense of its long-term financial position and reputation.

2128.06.11 INSPECTION OBJECTIVES

1. To determine whether the BO's retained interests from asset securitization are properly documented, valued, and accounted for.
2. To verify that the amount of those retained interests not supported by adequate documentation has been charged off for regulatory reporting purposes and that the involved assets are not used for risk-based calculation purposes.
3. To ascertain the existence of sound risk modeling, management information systems (MIS), and disclosure practices for asset securitization.
4. To obtain assurances that the board of directors and management oversee sound policies and internal controls concerning the recording and valuation of retained interests derived from asset securitization activities.
5. To determine if liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
6. To determine that sufficient capital is held commensurate with the risk exposures arising from recourse obligations generated by asset securitizations.
7. To determine whether there is an independent audit function that is capable of evaluating retained interests involving asset securitization activities.

2128.06.12 INSPECTION PROCEDURES

1. Determine the existence of independent risk-management processes and MIS, and whether they are being used to monitor

securitization-pool performance on an aggregate and individual transaction level.

2. Review the MIS reports and determine whether the reports provide—
   a. securitization summaries for each transaction;
   b. performance reports by portfolio and specific product type;
   c. vintage analysis for each pool using monthly data;
   d. static-pool cash-collection analysis;
   e. sensitivity analysis; and
   f. a statement of covenant compliance.
3. Review the BO's valuation assumptions and modeling methodologies, and determine if they are appropriate and are being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
4. Determine if audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the BO retains.
5. Review the risk-based capital calculations, and determine if they include recognition and reporting of any recourse obligation resulting from securitization activities.
6. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
7. Establish that an adequate liquidity contingency plan is in place and that it will be used in the event of market disruptions. Determine further whether liquidity problems may arise as the result of an overdependence on asset securitization activities for day-to-day core funding.
8. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset securitization activities are made commensurate with the volume of securitizations and the complexities of the BO.
9. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.

Subprime lending presents unique and significantly greater risk to banking organizations (BOs) associated with the activity,[1] raising issues about how well they are prepared to manage and control those risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. BOs considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization's financial condition, asset size, level of capital support, and staff size.

In response to concerns about subprime lending, the statement Interagency Guidance on Subprime Lending was issued on March 1, 1999.[2] The statement's objective is to increase awareness among examiners and financial institutions of some of the pitfalls and hazards of this type of lending. (See SR-99-06.) Additional interagency examination guidance was issued on January 31, 2001, to further strengthen the supervision of certain institutions, primarily those institutions having subprime-lending programs with an aggregate credit exposure equaling or exceeding 25 percent of their tier 1 capital.[3] (See SR-01-04.) The aggregate credit exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual interests[4] relating to securitized subprime loans. The Federal Reserve may also apply the additional guidelines to certain smaller subprime portfolios, such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, and those with inadequate or weak controls. The subprime-lending policy statements are directed primarily to insured depository institutions and their subsidiaries. As such, the guidance applies to bank holding companies with regard to their oversight and supervision of insured depository institutions. Bank holding companies should also consider the statements' guidance as they supervise the lending activities of their nonbanking subsidiaries. Bank holding company examiners should consider this guidance in conjunction with the loan-administration and lending-standards inspection guidance in section 2010.2 and with the guidance for asset securitization in section 2128.02. The interagency subprime-lending policy statements are described below.

2128.08.1 INTERAGENCY GUIDANCE ON SUBPRIME LENDING

Insured depository institutions traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, some lenders[5] extend their risk-selection standards to attract lower-credit-quality accounts. Moreover, previous turmoil in the equity and asset-backed securities markets has caused some nonbank subprime specialists to exit the market, which created increased opportunities for financial institutions to enter, or expand their participation in, the subprime-lending business

The term ''subprime lending'' is defined for this statement as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.[6] Subprime borrowers represent a broad spectrum of debtors, ranging from those who have repayment problems because of an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They

1. The term ''banking organizations'' refers to bank holding companies and their banking and nonbanking subsidiaries.

2. The statement was adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

3. The March 1999 and January 2001 subprime-lending interagency guidance is consolidated within this section. To focus on the supervisory guidance that applies primarily to institutions having subprime-lending programs equaling or exceeding 25 percent of tier 1 capital, see the January 2001 release specifically. The March 1999 interagency supervisory guidance applies to all institutions that engage in subprime lending.

4. Residual interests are on-balance-sheet assets that represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets. They are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit-enhancement techniques.

5. The terms ''lenders,'' ''financial institutions,'' and ''institutions'' refer to insured depository institutions and their subsidiaries.

6. For purposes of this statement, loans to customers who are not subprime borrowers are referred to as ''prime.''

may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Generally, subprime borrowers will display a range of one or more credit-risk characteristics, such as—

1. two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
2. judgment, foreclosure, repossession, or charge-off in the prior 24 months;
3. bankruptcy in the last five years;
4. relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral), or by other bureau or proprietary scores with an equivalent default-probability likelihood; or
5. debt-service-to-income ratio of 50 percent or greater, or an otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

This guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing "paper" from lenders or dealers; and the purchase of loan companies that originate subprime loans. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. Also, the subprime-lending guidance does not generally apply to prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded, as a result of their performance, to programs targeted to prime borrowers; and community development loans as defined in the Community Reinvestment Act (CRA) regulations that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk-mitigation techniques.

Subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. Subprime loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Some financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. The losses have attracted greater supervisory attention to subprime lending and the ability of an insured depository institution to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk.

2128.08.1.1 Risk Management

The following items are essential components of a well-structured risk-management program for subprime lenders:

1. *Planning and strategy.* Before engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets or customers, as well as set performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and

cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal-control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

2. *Staff expertise*. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus, it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. The experience, or seasoning, of staff and loans should be taken into account as performance is assessed over time.
3. *Lending policy*. A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:
   a. types of products offered as well as those that are not authorized
   b. portfolio targets and limits for each credit grade or class
   c. lending and investment authority clearly stated for individual officers, supervisors, and loan committees
   d. a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative or servicing costs, expected charge-offs, and capital
   e. evaluation of collateral and appraisal standards
   f. well-defined and specific underwriting parameters (that is, acceptable loan term, debt-to-income ratios, and loan-to-collateral-value ratios for each credit grade and a minimum acceptable credit score) that are consistent with any applicable supervisory guidelines[7]
   g. procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
   h. credit-file documentation requirements, such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision
   i. a correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

   If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.
4. *Purchase evaluation*. As they evaluate expected profits, institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and to the loan losses that may be experienced. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides an incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (that is, the quality of the loan may be less than the loan documents indicate).

   Institutions should perform a thorough due-diligence review before committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and they should regularly review loans offered to ensure that loans purchased continue to meet

7. Extensions of credit secured by real estate, whether the credit is subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. (See 12 C.F.R. 208, appendix C.)

those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or to adjust underwriting and dealer or lender selection criteria.

5. *Loan-administration procedures*. After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts, such as calling delinquent borrowers frequently, investing in technology (for example, using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can be a tradeoff with future loss expectations, when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business. Subprime-loan-administration procedures should be in writing and at a minimum should detail—
   a. billing and statement procedures;
   b. collection procedures;
   c. content, format, and frequency of management reports;
   d. asset-classification criteria;
   e. methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
   f. criteria for allowing loan extensions, deferrals, and re-agings;
   g. foreclosure and repossession policies and procedures; and
   h. loss-recognition policies and procedures.
6. *Loan review and monitoring*. Once an institution books the loans, designated staff must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Information systems should be in place to segment and stratify the institution's portfolio (for example, by originator, loan-to-value, debt-to-income ratios, or credit scores), and assigned staff should produce reports that management can use to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

   When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL-adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.
7. *Consumer protection*. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

   Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 C.F.R. 226.32), Regulation X, and the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601) and should adopt policies and implement practices that ensure compliance.

   The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate–related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited-basis characteristic (for example, race, sex, or age). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

8. *Securitization and sale*. To increase their loan-production and -servicing income, some subprime lenders originate loans and then securitize and sell them in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

   Institutions should recognize the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

   Institutions should refer to the Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as by predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

9. *Reevaluation*. Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause, and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include the following:
   a. Have cost and profit projections been met?
   b. Have projected loss estimates been accurate?
   c. Has the institution been called upon to provide support to enhance the quality

and performance of loan pools it has securitized?

d. Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?

e. Has the program met the credit needs of the community that it was designed to address?

2128.08.1.2 Examination Review and Analysis

The following supervisory guidance (up to the inspection objectives) applies only to the examination of a bank holding company's federally insured subsidiary banks that have subprime-lending programs equaling or exceeding 25 percent of tier 1 capital and to those insured banks that have other designated subprime programs referenced in SR-01-4.

The heightened risk levels and potential volatility in delinquency and loss rates posed by subprime-lending programs warrant examiners' increased ongoing attention. The risks inherent in subprime-lending programs call for frequent reviews. There are generally two levels of review appropriate for subprime activities:

1. *Portfolio-level reviews* include assessments of underwriting standards, marketing practices, pricing, management information and control systems (quality control, audit and loan review, vendor management, compliance), portfolio performance, and the appropriate application of regulatory and internal allowance and capital policies.
2. *Transaction-level testing* includes the testing of individual loans for compliance with underwriting and loan-administration guidelines; the appropriate treatment of loans under delinquency, re-aging, and cure programs; and the appropriate application of regulatory and internal allowance and capital policies.

Examiners should perform a portfolio-level review and some transaction testing at each institution engaged in subprime lending, during each regularly scheduled examination cycle. The Federal Reserve will perform regular off-site supervisory monitoring and may require subprime lenders to supply supplementary information about their subprime portfolios between examinations. The examiner's findings from transaction-level testing and portfolio-level reviews should be incorporated into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.

2128.08.1.2.1 Transaction-Level Testing

Subprime-loan portfolios contain elevated risks, and actual subprime-lending practices often can deviate from stated policy and procedural guidance. Therefore, examiners should supplement the portfolio-level examination procedures with transaction-level testing to determine whether—

1. individual loans adhere to existing policy, underwriting, risk-selection, and pricing standards;
2. individual loans and portfolios are classified in accordance with the subprime-lending guidelines described in this section, or in other Federal Reserve credit-extending supervisory guidance;
3. management, board, and regulatory reporting is accurate and timely;
4. existing loans conform to specified account-management standards (such as over-limits, line increases, reductions, cancellations, re-scoring, or collections);
5. key risk controls and control processes are adequate and functioning as intended;
6. roll rates and other loss-forecasting methods used to determine ALLL levels are accurate and reliable; and
7. lending practices exist that may appear unsafe, unsound, or abusive and unfair.

2128.08.1.3 Adequacy of the ALLL

Examiners should assess the adequacy of the ALLL to ensure that the portion allocated to the subprime portfolio is sufficient to absorb estimated credit losses for this portfolio. Consistent with interagency policy,[8] the term "estimated credit losses" means an estimate of the amount that is not likely to be collected; that is, net charge-offs that are likely to be realized given the facts and circumstances as of the evaluation date.[9] These estimated losses should meet the

8. The Interagency Policy Statement on the Allowance for Loan and Lease Losses was issued December 21, 1993, and the ALLL methodologies and documentation standards were issued July 2, 2001.

9. Estimates of credit losses should include accrued interest and other accrued fees (for example, uncollected credit card fees or uncollected late fees) that have been added to the

criteria for accrual of loss contingency, as set forth under generally accepted accounting principles (GAAP), consistent with supervisory ALLL policy.

2128.08.1.3.1 New Entrants to the Business

In some instances, an institution (for example, a newly chartered institution or an existing institution entering the subprime-lending business) may not have sufficient previous loss experience to estimate an allowance for subprime-lending activities. In such cases, industry statistics or another institution's loss data for similar loans may be a better starting point to determine the ALLL than the institution's own data for developing loss rates. When an institution uses loss rates developed from industry statistics or from other institutions to determine its ALLL, it should demonstrate and document that the attributes of the loans in its portfolio or portfolio segment are similar to those in the other institution's (or industry's) portfolio.

2128.08.1.3.2 Pools of Subprime Loans—Not Classified

The ALLL required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. The board of directors and management are expected to ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive and adequately documented analysis of all significant factors. The consideration factors should include historical loss experience, ratio analysis, peer-group analysis, and other quantitative analysis as a basis for the reasonableness of the ALLL. To the extent that the historical net charge-off rate is used to estimate expected credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account-management practices, and current economic or business conditions that may alter such experience. The allowance should represent a prudent, conservative estimate of losses that allows a reasonable margin for imprecision. Institutions should clearly document loss estimates and the allowance methodology in writing. This documentation should describe the analytical process used, including—

1. portfolio-segmentation methods applied;
2. loss-forecasting techniques and assumptions employed;
3. definitions of terms used in ratios and model computations;
4. relevance of the baseline loss information used;
5. rationale for adjustments to historical experience; and
6. a reconciliation of forecasted loss rates to actual loss rates, with significant variances explained.

2128.08.1.4 Classification Guidelines for Subprime Lending

Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well before the time frames outlined in the retail classification policy issued by the Federal Financial Institutions Examination Council (FFIEC) on June 12, 2000. Examiners should classify subprime loans and portfolios in accordance with the guidelines in this section and other applicable Federal Reserve supervisory guidelines. Classified loans are loans that are not protected adequately by the current sound worth and paying capacity of the borrower or the collateral pledged. As such, full liquidation of the debt may be in jeopardy. Pools of classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an adequate allowance should be established consistent with existing interagency policy.

2128.08.1.4.1 Individual Loans

Examiners should not automatically classify or place loans in special mention merely because they are subprime. Rather, classifications should

loan balances and, as a result, that are reported as part of the institution's loans on the balance sheet. An institution may include these types of estimated losses in either the ALLL or a separate valuation allowance, which would be netted against the aggregated loan balance for regulatory reporting purposes. When accrued interest and other accrued fees are not added to the loan balances and are not reported as part of loans on the balance sheet, the collectibility of these accrued amounts should nevertheless be evaluated to ensure that the institution's income is not overstated.

reflect the borrower's capacity and willingness to repay and the adequacy of collateral pledged. Loans to borrowers that do not have the capacity to service their loans generally will be classified substandard. When repayment capacity is insufficient to support the orderly liquidation of the debt, and the collateral pledged is insufficient to mitigate risk of loss, then a more severe classification and nonaccrual is warranted. Subprime loans that are past due 90 days or more should be classified at least substandard based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience of a particular institution. Classification of other subprime loans as doubtful or loss will be based on examiners' analysis of the borrower's capacity to repay, and on the quality of institution underwriting and account-management practices as evidenced in the loan file or by other documentation.

In some cases, the repayment of principal, interest, and fees on some subprime loans may be overly dependent on collateral pledged. This occurs when the risk of default is so high that an abundance of collateral is taken to mitigate risk of loss in the event of default. From a safety-and-soundness perspective, institutions should be discouraged from lending solely on the basis of collateral pledged. Such loans will generally be classified substandard. Further, when the borrower does not demonstrate the capacity to service the loan from sources other than collateral pledged, the loan may be placed on nonaccrual.

2128.08.1.4.2 Portfolios

When the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire portfolio or segments of the portfolio. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems. Some subprime-lending portfolios may pose very high risk. These may include portfolios of unsecured loans or secured, high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame. Most such portfolios should be classified at least substandard.

2128.08.1.5 Required Documentation for Cure Programs

Cure programs, including such practices as re-aging, extensions, renewals, rewrites, or other types of account restructuring, are subject to the standards outlined in the retail classification policy. In accordance with that policy, cure programs should be used only when the institution has substantiated the customer's renewed willingness and ability to repay. Examiners will expect institutions to maintain documentation supporting their analysis of the customer's renewed ability and willingness to repay the loan at the time it is extended, renewed, or deferred. When the institution cannot demonstrate both the willingness and ability of the customer to repay, the loan should not be renewed, extended, deferred, or rewritten, and the loan should be moved back to its pre-cure delinquency status. Documentation should include one or more of the following:

1. a new verification of employment
2. a recomputed debt-to-income ratio indicating sufficient improvement in the borrower's financial condition to support orderly repayment
3. a refreshed credit score or updated bureau report
4. a file memo evidencing discussion with the customer

When documentation of the customer's renewed willingness and ability to repay the loan is absent or deficient, management practices should be criticized.

2128.08.1.6 Predatory or Abusive Lending Practices

The term ''subprime'' is often misused to refer to certain predatory or abusive lending practices. Lending practices can be designed to responsibly provide service to customers and enhance credit access for borrowers with special credit needs. Subprime lending that is appropriately underwritten, priced, and administered can serve these goals.

Some forms of subprime lending may be abusive or predatory, however. Lending practices may be designed to transfer wealth from the borrower to the lender or loan originator without a commensurate exchange of value. This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure or repossession to induce duress on the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:

1. making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
2. inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (that is, ''loan flipping'')
3. engaging in fraud or deception to conceal the true nature of the loan obligation or ancillary products from an unsuspecting or unsophisticated borrower

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the examination report as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to Federal Reserve consumer compliance/fair lending specialists for additional review.

2128.08.1.7 Capitalization

The Federal Reserve's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than those that exist in subprime-loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios.

Subprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime-lending activities and for fully documenting the methodology and analysis supporting the amount specified.

The amount of additional capital necessary will vary according to the volume and type of subprime activities conducted and the adequacy of the institution's risk-management program. An institution's overall capital adequacy will be evaluated on a case-by-case basis through on-site examinations and off-site monitoring procedures, considering, among other factors, the institution's own documented analysis of the capital needed to support subprime lending. Institutions that are determined to have insufficient capital must correct the deficiency within a reasonable time frame or be subject to supervisory action. In light of the higher risks associated with this type of lending, higher minimum-capital requirements may be imposed on institutions engaging in subprime lending.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime-lending activities and should consider the following elements:

1. portfolio-growth rates
2. trends in the level and volatility of expected losses
3. the level of subprime-loan losses incurred over one or more economic downturns, if such data or analyses are available
4. the impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets
5. any deterioration in the average credit quality over time due to adverse selection or retention
6. the amount, quality, and liquidity of collateral securing the individual loans
7. any asset, income, or funding-source concentrations
8. the degree of concentration of subprime credits
9. the extent to which current capitalization consists of residual assets or other potentially volatile components
10. the degree of legal or reputation risk associated with the subprime business lines pursued
11. the amount of capital necessary to support the institution's other risks and activities

Given the higher risk inherent in subprime-lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that *is one and one-half to three times greater* than what is appropriate for nonsubprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and on the amount, quality, and liquidity of collateral securing the loans. Institutions should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared with prime loans, and they may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100 percent of the loans outstanding, depending on the level and volatility of risk.

2128.08.1.7.1 Stress Testing

An institution's capital adequacy analysis should include stress testing as a tool for estimating unexpected losses in its subprime-lending pools. Institutions should project the performance of their subprime-loan pools under conservative stress-test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing should include "shock" testing of basic assumptions, such as delinquency rates, loss rates, and recovery rates on collateral. Stress tests should also consider other potentially adverse scenarios, such as changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit score distribution; and changes in the capital-market demand for whole loans or asset-backed securities supported by subprime loans. These are representative examples; actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress tests are performed manually, or through automated modeling techniques, it is expected that—

1. the process is clearly documented, rational, and easily understood by the institution's board and senior management;
2. the inputs are reliable and relate directly to the subject portfolios (for example, baseline loss history or default probabilities should reflect each segment of the institution's portfolio and not just a blend of prime and subprime borrowers);
3. assumptions are well documented and conservative; and
4. any models are subject to a comprehensive validation process.

The results of the stress-test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime-lending programs without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime-lending activities, examiners should consult with their Reserve Bank supervisory official to determine the appropriate course of action. Such actions may include requiring additional capital in accordance with the Federal Reserve's capital adequacy rules or requiring the institution to submit an acceptable capital plan in accordance with safety-and-soundness guidelines.

2128.08.1.8 Subprime-Lending Examiner Responsibilities

Using the interagency guidance and any supplemental Federal Reserve guidelines, examiners should assess carefully management's ability to administer the higher risk in subprime portfolios. The examiner should judge management's ability to manage the risk involved in the subprime-lending program, in particular, the quality of the risk-management and control processes in place, and more importantly, the extent to which management is adhering to those processes. When examiners determine that risk-management practices are deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement actions or a plan to achieve adequate capitalization. When a primary supervisor determines that an institution's risk-management practices are materially deficient, the primary supervisor may instruct the institution to discontinue its subprime-lending programs.

2128.08.1.9 Appendix—Questions and Answers for Examiners Regarding the Expanded Guidance for Subprime-Lending Programs

To assist examiners who review subprime-lending activities, the following questions and answers were developed to provide additional guidance on the expanded interagency guidance that was issued on January 31, 2001.

2128.08.1.9.1 Applicability of the Guidance

Question 1: Does the guidance apply to all institutions?

No. The guidance will not affect the vast majority of insured institutions engaged in traditional consumer lending. The guidance applies to institutions that systematically target the subprime market through programs that employ tailored marketing, underwriting standards, and risk selection.

The guidance does not address traditional consumer lending that has historically been the mainstay of community banking. It does not apply to institutions extending credit to subprime borrowers as part of their standard community-lending process, or making loans to subprime borrowers as an occasional exception to a prime-lending program, even if the aggregate of these loans totals more than 25 percent of tier 1 capital. Such institutions continue to be subject to the normal supervisory process.

Institutions engaging in subprime-lending programs generally have knowingly and purposefully focused on the subprime-lending markets through planned business strategies, tailored products, and explicit borrower targeting. In instances where significant exposures to subprime borrowers are identified, examiners should consider the institution's marketing program, loan products, pricing, underwriting standards and practices, and portfolio performance to determine if the institution has a program that warrants the supervision and safeguards outlined in the guidance.

Question 2: Does the guidance apply when an institution offers a product that attracts a disproportionate number of subprime borrowers, but which the institution does not explicitly identify as subprime?

A subprime program commonly features products specifically tailored to borrowers with weakened credit histories. Such products often differ substantially in pricing and terms from products offered to prime borrowers, and they usually have separate and distinctly different underwriting standards. An institution offering a product that attracts a disproportionate number of borrowers with weakened credit histories likely has a subprime program whether or not the activity is called a subprime program. The guidance will apply to these programs when the resultant aggregate credit exposure is at least 25 percent of the institution's tier 1 capital.

Institutions with significant programs are expected to have the necessary risk-management and internal-control systems in place to properly identify, measure, monitor, and control the inherent risks in their subprime portfolios. Risk management and controls for these programs typically involve enhanced performance monitoring, intensive collection activities, and other loss-mitigation strategies. If an institution systematically targets the subprime market but does not segregate these loans from its prime portfolio, it is doubtful that the institution has the necessary risk-management and control systems in place to safely engage in the activity.

2128.08.1.9.2 Subprime Characteristics

Question 3: Why does the Expanded Guidance for Subprime Lending Programs use a credit bureau risk score (FICO) of 660 as a cutoff point for subprime lending?

The guidance does not use credit scores, or any other single risk factor, as a definitive cutoff point for subprime lending. The characteristics listed are not explicit, bright-line definitions. The range of credit characteristics used to describe subprime borrowers is intended to help examiners identify lenders that are engaged in subprime-lending programs. These characteristics describe borrowers with varying, but significantly higher, probabilities of default than prime borrowers. The guidance states that "this list is illustrative rather than exhaustive and is not meant to define specific parameters for all borrowers."

A credit bureau score of 660 (FICO) is used only as an example to illustrate a credit score that generally indicates a higher default probability. The guidance indicates the probability of default, as evidenced by the credit score, will vary by product and collateral. The subprime guidance lists several characteristics that denote a higher probability of default. Examiners are directed to use these characteristics as a starting point to expand their review of lending programs targeting subprime borrowers in accordance with risk-focused examination procedures. The severity of risk may vary significantly for the different characteristics listed, as well as for the type and quality of collateral. Examiners should take this into consideration when reviewing the portfolio and determining the adequacy of loan-loss reserves and capital.

The characteristics used in the guidance are well recognized in the investment and lending industries. A number of public debt rating agencies and financial institutions, including the government-sponsored enterprises (GSEs), use similar credit characteristics to differentiate risk among borrowers. Specific examples include the following:

1. Fitch defines a subprime borrower as "...one with a credit profile worse than that of a prime A quality borrower, whose credit report would typically reveal no recent mortgage delinquencies and whose credit profile would yield a credit score in the range above 680." Fitch's mortgage credit grade matrix lists the following credit-history elements for A- the highest subprime grade: one 30-day delinquency in the last 12 months on a mortgage debt; one 30-day delinquency in the last 24 months on installment debt, or two 30-day delinquencies in the last 24 months on revolving debt; bankruptcy in past five years; chargeoff or judgments exceeding $500 in the past 24 months; and/or a debt-to-income ratio of 45 percent.[10]
2. Standard & Poor's subprime-mortgage underwriting guidelines define subprime A- characteristics as two or more 30-day delinquencies on mortgage and consumer credit, one 60-day delinquency on consumer credit, debt-to-income ratio of 45 percent, and no bankruptcy in the past five years. Standard & Poor's also "...considers subprime borrowers to have a FICO credit score of 659 or below."[11]
3. Standard & Poor's has classified nonprime B auto securitization pools as having occasional delinquencies and minor charge-offs on revolving debt, static pool net losses of 3.1 percent to 7.5 percent, and FICO credit scores ranging from 620–679.[12]
4. Freddie Mac has used the FICO score of 660 or below to designate higher-risk borrowers requiring more comprehensive review. Freddie Mac views a score in the 620–660 range as an indication that the "borrower's willingness to repay debt as agreed is uncertain." FICO scores below 620 are placed in the "cautious-review category," and Freddie Mac considers scores below 620 "as a strong indication that the borrower's credit reputation is not acceptable..."[13]

2128.08.1.9.3 Capital Guidance

Question 4: If an institution is engaged in subprime lending as described by the guidance, does the 1.5-to-3-times capital described in the guidance automatically apply?

No. The expanded interagency guidance on subprime lending is flexible examination guidance; the capital range does not automatically apply because the guidance is not a capital rule or regulation. Rather, the guidance describes an expectation that subprime lenders hold sufficient loan-loss reserves and capital to offset the additional risks that may exist in subprime activities. The agencies expect institutions to have methodologies and analyses in place to support and document the level of reserves and capital needed for the additional risks assumed. The higher the risk, the more reserves and capital needed to support the activity. Institutions with lower-risk subprime portfolios may not need additional reserves and capital. In addition, examiners are reminded that subprime lending is only one element in the evaluation of the institution's overall capital adequacy. If the analysis shows that the institution has adequate capital for all its assets and activities, including subprime lending, there is no additional capital requirement arising from the guidance.

Examiners are instructed not to unilaterally require additional reserves and capital based on the guidance. Any determination made by an examiner that an institution's reserves or capital are deficient will be discussed with the institu-

10. Fitch IBCA, Duff & Phelps, "Rating U.S. Residential Subprime Mortgage Securities," March 16, 2001: 2.
11. Standard & Poor's, "U.S. Residential Subprime Mortgage Criteria," Structured Finance, 1999: 12, 169.
12. Standard & Poor's, "Auto Loan Criteria and Market Overview 1998," Structured Finance Ratings Asset-Backed Securities, 6.
13. Freddie Mac, Single-Family Seller/Servicer Guide, chapter 37, section 37.6, "Using FICO Scores in Underwriting," March 7, 2001.

tion's management and with each agency's appropriate supervisory office before a final decision is made.

Question 5: Are the regulatory expectations for higher capital levels consistent with capital levels supporting subprime assets outside the insured banking industry?

Yes. The regulatory expectations of higher capital maintenance are consistent with expectations in the capital markets. The 1.5-to-3-times-capital multiple is risk based, for example, the level of additional capital varies by relative loan quality and is applied only to the subprime portfolio, not the institution's entire asset structure. This is consistent with the financial marketplace's assessment of relative risk in subprime assets outside the banking industry. For example, the amount of credit enhancement required for subprime securitization structures varies according to the level and volatility of perceived credit risk in the underlying assets. In addition, publicly traded subprime-finance companies (that are not currently suffering from adverse ratings) maintain equity-capital-to-managed-asset ratios that are 1.5 to as much as 6 times (depending on loan type and relative quality) those of finance companies that do not specialize in subprime loans.

2128.08.2 INSPECTION OBJECTIVES

1. To assess and evaluate the extent of subprime-lending activities; whether management has adequately planned for these activities; and whether management has developed and maintains board-approved policies and procedures, systems, and internal controls that identify, measure, monitor, and control the additional risks in a manner that is commensurate with the risks associated with the subprime-lending program.
2. To conduct portfolio-level reviews and transaction-level testing of the subprime-lending activities, assessing the quality and performance of the subprime-loan portfolios and subprime-lending program, including its profitability, delinquency, and potential and actual loss experience.
3. To assess the adequacy of the ALLL for the subprime-loan portfolio.

2128.08.3 INSPECTION PROCEDURES

1. Determine whether the subprime-lending activities are consistent with the bank holding company's overall business strategy and risk tolerances, and that critical business risks have been identified and considered.
2. Assess whether the bank holding company has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely, without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources, including, in particular, technology and skilled personnel, to manage and control the risks associated with the volume and complexity of the bank holding company's subprime-lending programs.
4. Determine whether the bank holding company's contingency plans (including those of its banking and nonbanking subsidiaries) are adequate to address alternative funding sources, including back-up purchasers of any subprime loan–backed securities issued by the bank holding company or of the attendant servicing functions, and methods of raising additional capital during an economic downturn or when financial markets become volatile.
5. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the bank holding company's operations, including those of its subsidiaries, and if management is maintaining proper controls over the program. (See in section 2128.08.1.1 for the lending standards that should be included in the subprime-loan program.)
6. Incorporate the results of the loan-administration portfolio-level and transaction-level testing reviews into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.
7. Review securitization transactions for compliance with FAS 140 and this guidance, including whether the bank holding company and its subsidiaries have provided any support to maintain the credit quality of loan pools they have securitized.
8. Evaluate the ALLL and regulatory capital allocated to support subprime-lending programs, including whether the total protection for subprime-asset programs and the levels for each component are adequate.
9. Ascertain that a sound risk-management program exists that includes the ability of

management to determine and quantify appropriate levels for each component of the program.

10. Evaluate the bank holding company's documented analysis of the capital needed to support its subprime-lending activities. Ascertain whether the capital levels are risk sensitive, that is, does allocated capital reflect the level and variability of loss estimates within reasonably conservative parameters? Determine if there is a direct link between the expected loss rates used to determine the required ALLL and the unexpected loss estimates used to determine capital. Document and reference the bank holding company's overall subprime capital evaluation in the inspection comments and conclusions regarding capital adequacy.
11. Analyze the performance of the subprime-lending program, including its profitability, delinquency, and loss experience.
12. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
13. Determine if the bank holding company's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.
14. Classify loans of the parent bank holding company and its nonbank subsidiaries according to the following criteria:
    a. Classify as substandard loans to borrowers that do not have the capacity to service their loans.
    b. Classify as at least substandard subprime loans that are 90 days or more past due based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay.
    c. Consider classifying or criticizing the entire portfolio or segments of the portfolio when the portfolio review or loan sample indicates serious concerns with credit-risk-selection practices, underwriting standards, or loan quality.
    d. Classify as substandard high-risk unsecured loan portfolios or secured high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame.
15. Report as unsafe and unsound imprudent loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the pledged collateral.
16. Carefully assess the ability of the parent bank holding company's board of directors and management to oversee and administer the higher risk in subprime portfolios, including those of its nonbank subsidiaries. If risk-management practices are deficient, criticize management and reach specific agreements with the board of directors and senior management to initiate corrective action.

When a financial institution participates in a complex structured finance transaction (CSFT), it bears the usual market, credit, and operational risks associated with the transaction.[1] In some circumstances, a financial institution may also face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution may face heightened legal or reputational risks if a customer's regulatory, tax, or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations, or accounting principles.

The agencies have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate, and address the risks associated with their business activities.[2] Financial institutions must also conduct their activities in accordance with applicable statutes and regulations. Therefore, financial institutions engaged in CSFTs are expected to have policies and procedures that are designed to allow the institution to effectively manage and address the full range of risks associated with its CSFT activities, including the elevated legal or reputational risks that may arise in connection with certain CSFTs. The agencies continue to believe that this is important.

This section sets forth the Interagency Statement on Sound Practices Concerning Elevated-Risk Complex Structured Finance Activities, issued January 11, 2007. The supervisory guidance addresses risk-management principles that should assist institutions to identify, evaluate, and manage the heightened legal and reputational risks that may arise from their involvement in CSFTs. The guidance is focused on those CSFTs that may present heightened levels of legal or reputational risk to the institution and are defined as "elevated-risk CSFTs." Such transactions are typically conducted by a limited number of large financial institutions.[3] (See SR-07-05 and 72 *Fed. Reg.* 1,372, January 11, 2007.)

2128.09.1 INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED-RISK COMPLEX STRUCTURED FINANCE ACTIVITIES

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways.

Financial derivatives for market and credit risk, asset-backed securities with customized cash-flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions have become an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution participates in a complex structured finance transaction (CSFT), it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution may also face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax, or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations, or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities, and others. In these situations, investors have been harmed and financial institutions

1. The term *financial institutions* is not limited to federally insured depository institutions. It refers broadly to bank holding companies (other than foreign banks), national banks, state banks, federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisors.

2. The agencies are the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Securities and Exchange Commission (SEC).

3. The statement will not affect or apply to the vast majority of financial institutions, including most small institutions.

have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors, and the general marketplace.

The agencies have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate, and address the risks associated with their business activities. Financial institutions must also conduct their activities in accordance with applicable statutes and regulations.

2128.09.2 SCOPE AND PURPOSE OF STATEMENT

This statement was issued to describe the types of risk-management principles that the agencies believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution and to evaluate, manage, and address these risks within the institution's internal control framework.[4]

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving "plain vanilla" derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this statement.

Because this statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks—transactions that typically are conducted by a limited number of large financial institutions—it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity, and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this statement are not all inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this statement draws heavily on controls and procedures that the agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated-risk CSFTs. Although this statement highlights some of the most significant risks associated with elevated-risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the agencies for further information concerning market, credit, operational, legal, and reputational risks, as well as internal audit and other appropriate internal controls.

This statement does not create any private rights of action and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders, or other third parties under applicable law. At the same time, adherence to the principles discussed in this statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

2128.09.3 IDENTIFICATION AND REVIEW OF ELEVATED-RISK COMPLEX STRUCTURED FINANCE TRANSACTIONS

A financial institution that engages in CSFTs should maintain a set of formal, written, firmwide policies and procedures that are designed to allow the institution to identify, evaluate,

4. As used in this statement, the term *financial institution* or *institution* refers to state member banks and bank holding companies (other than foreign banking organizations) in the case of the FRB, national banks in the case of the OCC, federal and state savings associations and savings and loan holding companies in the case of the OTS, state nonmember banks in the case of the FDIC, and registered broker-dealers and investment advisors in the case of the SEC. The U.S. branches and agencies of foreign banks supervised by the FRB, the OCC, and the FDIC also are considered to be financial institutions for purposes of this statement.

assess, document, and control the full range of credit, market, operational, legal, and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations, and standards of those jurisdictions.[5]

Financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products; whether the product is targeted at a new class of customers; whether it is designed to address a new need of customers; whether it raises significant new legal, compliance, or regulatory issues; and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

2128.09.3.1 Identifying Elevated-Risk CSFTs

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures, and systems to identify elevated-risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated-risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new product approval process to—

1. lack economic substance or business purpose;
2. be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
3. raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
4. involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
5. involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;[6]
6. have material economic terms that are inconsistent with market norms (for example, deep "in the money" options or historic rate rollovers); or
7. provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institu-

5. In the case of U.S. branches and agencies of foreign banks, these policies, including management, review, and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

6. This item is not intended to include traditional, nonbinding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (that is, the parent's subsidiary) is an integral and important part of the parent's operations.

tions may differ in how they seek to identify elevated-risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same: to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax, or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated-risk CSFT may differ depending on its role.

2128.09.3.2 Due-Diligence, Approval, and Documentation Process for Elevated-Risk CSFTs

Having developed a process to identify elevated-risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

2128.09.3.2.1 Due Diligence

If a CSFT is identified as an elevated-risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated-risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated-risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated-risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws or other laws or regulations and, thus, may have greater legal and reputational risk exposure with respect to an elevated-risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated-risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated-risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.[7]

In conducting its due diligence for an elevated-risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated-risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax, or legal issues associated with an elevated-risk CSFT.

2128.09.3.2.2 Approval Process

A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are indepen-

7. Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

dent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated-risk CSFT on behalf of a financial institution should have sufficient experience, training, and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market, and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated-risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market, and operational risks presented by the transaction.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated-risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in consistently managing the review and approval of elevated-risk CSFTs on a firmwide basis.[8]

If, after evaluating an elevated-risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated-risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.

8. The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading, or other concerns.

2128.09.3.2.3 Documentation

The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection, and retention of documents associated with elevated-risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to—

1. Document the material terms of the transaction,
2. Enforce the material obligations of the counterparties,
3. Confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide, and
4. Verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated-risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated-risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

2128.09.3.3 Other Risk-Management Principles for Elevated-Risk CSFTs

2128.09.3.3.1 General Business Ethics

The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification, and encourage personnel to move ethical or legal concerns regarding elevated-risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.[9] As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated-risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical, and reputational risk interests of the institution.

2128.09.3.3.2 Reporting

A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated-risk CSFTs to perform their oversight functions.

9. The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. (See 15 U.S.C. 78j-1(m).)

2128.09.3.3.3 Monitoring Compliance with Internal Policies and Procedures

The events of recent years evidence the need for an effective oversight and review program for elevated-risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated-risk CSFTs are being implemented effectively and that elevated-risk CSFTs are accurately identified and received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance, or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more frequent assessments of the risk arising from elevated-risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

2128.09.3.3.4 Audit

The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking, and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated-risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated-risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated-risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated-risk CSFTs.

2128.09.3.3.5 Training

An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated-risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated-risk CSFTs, including the processes established by the institution for identification and approval of elevated-risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated-risk CSFTs that may result in a violation of law.

2128.09.4 CONCLUSION

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk-management and internal control systems that are designed to allow the institution to identify elevated-risk CSFTs; to evaluate, manage, and address the risks arising from such transactions; and to conduct those activities in compliance with applicable law.

Banking organizations must establish and maintain sound risk-management policies and procedures and effective internal controls over their use of credit derivatives. Credit derivatives are off-balance-sheet financial instruments that are used to assume or lay off credit risk on loans and other assets, some only to a limited extent. They allow one party (the beneficiary) to transfer the credit risk of a "reference asset," which it often actually owns, to another party (the guarantor).[1] This arrangement allows the guarantor party to assume the credit risk associated with the reference asset without directly purchasing it. Unlike traditional guarantee arrangements, credit-derivative transactions often are documented using master agreements developed by the International Swaps and Derivatives Association (ISDA) that are similar to those governing swaps or options. Since credit derivatives are privately negotiated financial contracts, they expose the user to credit risk as well as liquidity risk (thin secondary market for credit derivatives), operational risk (instruments used for speculation rather than hedging), counterparty risk (default), and legal risk (the contracts may be deemed illegal).

Banking organizations use credit-derivative instruments either as end-users, purchasing credit protection from or providing credit protection to third parties, or as dealers intermediating such protection. Credit derivatives are used to manage overall credit-risk exposure. A banking organization may use credit derivatives to mitigate its concentration to a particular borrower or industry without severing the customer relationship. In addition, organizations that are approaching established in-house limits on counterparty credit exposure could continue to originate loans to a particular industry, using credit derivatives to transfer the credit risk to a third party.

Banking organizations may also use credit derivatives to diversify their portfolios by assuming the associated credit exposures and revenue returns to different borrowers or industries without actually purchasing the underlying assets. Nonbank companies may serve as counterparties to credit-derivative transactions with banks to gain access to the commercial bank loan market. Such entities may not lend or may not have the facilities or staff to adequately administer a loan portfolio.

Under some credit-derivative arrangements, a beneficiary may pay a fee to the guarantor in exchange for a guarantee against any loss that may occur, usually in excess of a prespecified amount, if the reference asset defaults (a "credit-default swap"). Alternatively, the beneficiary may pay the total return on a reference asset, including any appreciation in the asset's price, to a guarantor in exchange for a spread over funding costs plus any depreciation in the value of the reference asset (a "total-rate-of-return swap").

Credit derivatives and their market are likely to take on various forms, such as the market for put options on specific corporate bonds or loans. While the payoffs of these puts are expressed in terms of a strike price, rather than a default event, if the strike price is sufficiently high, credit risk effectively could be transferred from the buyer of the put to the writer of the put. See SR-96-17.

2129.0.1 SUPERVISORY AND EXAMINER GUIDANCE

In reviewing credit derivatives, examiners should consider the credit risk associated with the reference asset as the primary risk, as they do for loan participations or guarantees. A banking organization providing credit protection through a credit derivative may be as exposed to the credit risk of the reference asset as it would be if the asset were on its own balance sheet. Thus, for supervisory purposes, the exposure generally should be treated as if it were a letter of credit or other off-balance-sheet guarantee.[2] This treatment would apply, for example, in determining a banking organization's overall credit exposure to a borrower for purposes of evaluating concentrations of credit. The overall exposure should include exposure it assumes

1. For purposes of this supervisory guidance, when the beneficiary owns the reference asset, it will be referred to as the "underlying" asset. However, in some cases, the reference asset and the underlying asset are not the same. For example, the credit-derivative contract may reference the performance of an ABC Company bond, while the beneficiary banking organization may actually own an ABC Company loan. The use of the term "guarantor" does not necessarily refer to a guarantor involving a suretyship contract. The transferred risk can be in a primary liability of the acquiring party that assumes the credit risk.

2. Credit derivatives that are based on a broad-based index, such as the Lehman Brothers Bond Index or the S&P 500 stock index, could be treated for capital and other supervisory purposes as a derivative contract. This determination should be made on a case-by-case basis.

by acting as a guarantor in a credit-derivative transaction where the borrower is the obligor of the reference asset.

Banking organizations providing credit protection through a credit derivative should hold capital and reserves against their exposure to the reference asset.[3] This broad principle holds for all credit derivatives, except for credit-derivative contracts that incorporate periodic payments for depreciation or appreciation, including most total-rate-of-return swaps. For these transactions, the guarantor can deduct the amount of depreciation paid to the beneficiary from the notional amount of the contract in determining the amount of reference exposure subject to a capital charge.

In some cases (for example, total-rate-of-return swaps), the guarantor also is exposed to the credit risk of the counterparty, which for derivative contracts generally is measured as the replacement cost of the credit-derivative transaction plus an add-on for the potential future exposure of the derivative to market price changes. For banking organizations acting as dealers that have matching offsetting positions, the counterparty risk stemming from credit-derivative transactions could be the principal risk to which the dealer banks are exposed.

In reviewing a credit derivative entered into by a beneficiary banking organization, the examiner should review the organization's credit exposure to the guarantor, as well as to the reference asset—if the asset is actually owned by the beneficiary. The degree to which a credit derivative, unlike most other credit-guarantee arrangements, transfers the credit risk of an underlying asset from the beneficiary to the guarantor may be uncertain or limited. The degree of risk transference depends on the terms of the transaction. For example, some credit derivatives are structured so that a payout only occurs when a predefined event of default or a downgrade below a prespecified credit rating occurs.[4] Others may require a payment only when a defined default event occurs *and* a predetermined materiality (or loss) threshold is exceeded. Default payments themselves may be based on an average of dealer prices for the reference asset during some period of time after default using a prespecified sampling procedure or may be specified in advance as a set percentage of the notional amount of the reference asset. Finally, the term of many credit-derivative transactions is shorter than the maturity of the underlying asset and, thus, provides only temporary credit protection to the beneficiary.

Examiners must ascertain whether the amount of credit protection a beneficiary receives by entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes. Those arrangements that provide virtually complete credit protection to the underlying asset will be considered effective guarantees for purposes of asset classification and risk-based capital calculations. On the other hand, if the amount of credit risk transferred by the beneficiary is severely limited or uncertain, then the limited credit protection provided by the derivative should not be taken into account for these purposes.

In this regard, examiners should carefully review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization. For the derivative contract to be considered as providing effective credit protection, the examiner must review the arrangement and be satisfied that the reference asset is an appropriate proxy for the loan or other asset, whose credit exposure the banking organization intends to offset. To determine this, examiners should consider, among other factors, whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.

A banking organization's management should not enter into credit-derivative transactions unless it has the ability to understand and manage the credit and other risks associated with these instruments in a safe and sound manner. Accordingly, examiners should determine the appropriateness of these instruments on an entity-by-entity basis, taking into account management's expertise in evaluating the instruments used; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant information systems and internal controls.[5]

3. For guidance on risk-based capital treatment of credit derivatives, see section 4060.3.5.3.9.

4. It may also be necessary to review the credit documentation of the primary obligor to determine the degree of transferred risk.

5. For further guidance on examining the risk-management practices of banking organizations, including guidance on derivatives, that examiners may find helpful in reviewing an organization's management of its credit-derivative activity, see sections 2125.0, 2126.0, 2128.0, and 4070.1. See also the *Commercial Bank Examination Manual* and the *Trading and Capital-Markets Activities Manual*.

2129.0.2 TYPES OF CREDIT DERIVATIVES

The most widely used types of credit derivatives are credit-default swaps and total-rate-of-return (TROR) swaps.[6] While the timing and structure of the cash flows associated with credit default and TROR swaps differ, the economic substance of both arrangements is that they seek to transfer the credit risk on the asset(s) referenced in the transaction.

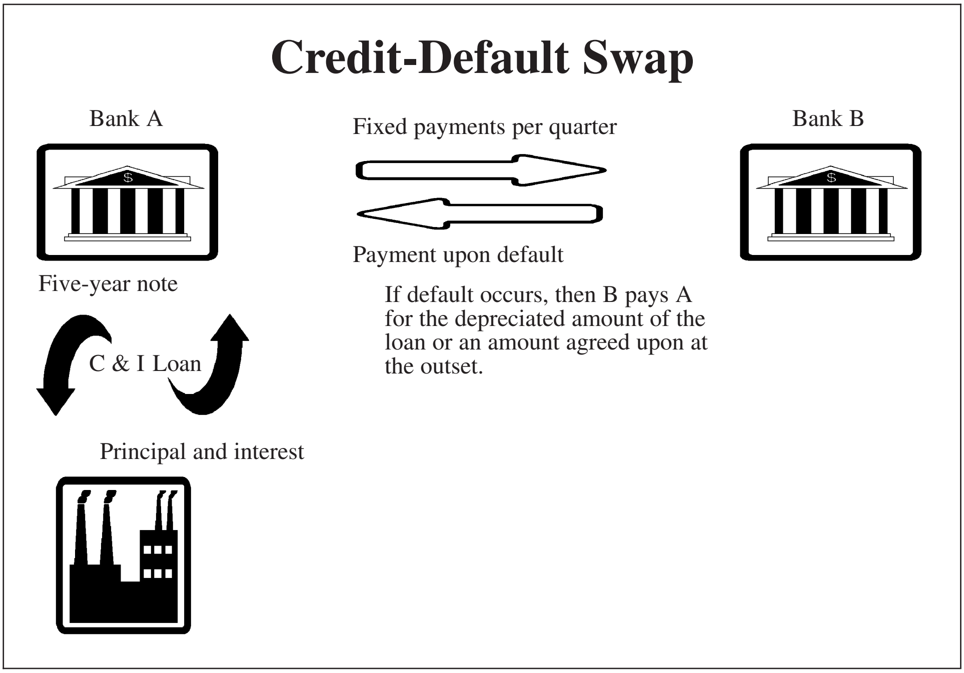
6. Another less common form of credit derivative is the *credit-linked note*, which is an obligation that is based on a reference asset. Credit-linked notes are similar to structured notes with embedded credit derivatives. If there is a credit event, the repayment of the bond's principal is based on the price of the reference asset. A credit-linked note may be a combination of a regular bond and a credit option. The note can promise to make periodic interest payments and a large lump-sum payment when the bond matures. The credit option on the note may allow the issuer to reduce the note's payments if a primary financial indicator or variable deteriorates. When reviewing these transactions, examiners should consider the purchasing banking organization's exposure to the underlying reference asset as well as the exposure to the issuing entity.

2129.0.2.1 Credit-Default Swaps

The purpose of a credit-default swap is to provide protection against credit losses associated with a default on a specified reference asset. The swap purchaser (the beneficiary) "swaps" the credit risk with the provider of the swap (the guarantor). The transaction is very similar to a guarantee or financial standby letter of credit.

In a credit-default swap, illustrated in figure 1, the beneficiary (Bank A) agrees to pay to the guarantor (Bank B) a quarterly or annual fee, typically amounting to a certain number of basis points on the par value of the reference asset. In return, the guarantor agrees to pay the beneficiary an agreed-upon, market-based, post-default amount or a predetermined fixed percentage of the value of the reference asset if there is a default. The guarantor makes no payment until there is a default. A default is strictly defined in the contract to include, for example, bankruptcy, insolvency, or payment default, and the event of default itself must be publicly verifiable. The guarantor may not be obliged to

Figure 1
Credit-Default Swap Cash-Flow Diagram



make any payments to the beneficiary until a preestablished amount of loss has been exceeded in conjunction with a default event (called a materiality threshold).

The swap is terminated if the reference asset defaults before the maturity of the swap. The amount owed by the guarantor is the difference between the reference asset's initial principal (or notional) amount and the actual market value of the defaulted, reference asset. The methodology for establishing the post-default market value of the reference asset should be set out in the contract. Often, the market value of the defaulted reference asset may be determined by sampling dealer quotes. The guarantor may have the option to purchase the defaulted, underlying asset and pursue a workout with the borrower directly, an action it may take if it believes that the "true" value of the reference asset is higher than that determined by the swap-pricing mechanism. Alternatively, the swap may call for a fixed payment in the event of default, such as a percentage of the notional value of the reference asset.

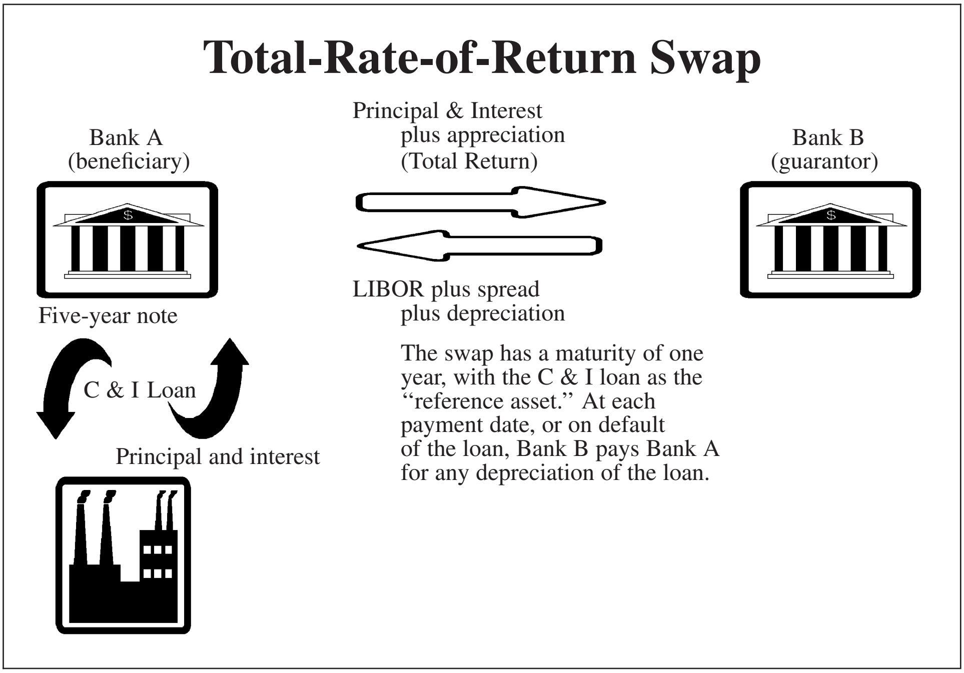
2129.0.2.2 Total-Rate-of-Return Swaps

In a total-rate-of-return (TROR) swap, illustrated in figure 2, the beneficiary (Bank A) agrees to pay the guarantor (Bank B) the "total return" on the reference asset, which consists of all contractual payments, as well as any appreciation in the market value of the reference asset. To complete the swap arrangement, the guarantor agrees to pay LIBOR plus a spread and any depreciation to the beneficiary.[7] Since it bears the risks and rewards of ownership over the term of the swap, the guarantor in a TROR swap could be viewed as having synthetic ownership of the reference asset.

At each payment-exchange date (including when the swap matures) or on default, at which point the swap may terminate, any depreciation

7. The reference asset is often a floating-rate instrument, for example, a prime-based loan. Thus, if both sides of a TROR swap are based on floating rates, interest-rate risk is effectively eliminated with the exception of some basis risk.

Figure 2
Total-Rate-of-Return Swap Cash-Flow Diagram



or appreciation in the amortized value of the reference asset is calculated as the difference between the notional principal balance of the reference asset and the "dealer price."[8] The dealer price is generally determined either by referring to a market quotation source or by polling a group of dealers, and the price reflects changes in the credit profile of the reference obligor and reference asset.

If the dealer price is less than the notional amount of the contract (the hypothetical original price of the reference asset), then the guarantor must pay the difference to the beneficiary, absorbing any loss caused by a decline in the credit quality of the reference asset.[9] Thus, a TROR swap differs from a standard direct credit substitute in that the guarantor is guaranteeing not only against default of the reference obligor, but also against a deterioration in that obligor's credit quality, which can occur even if there is no default.

TROR swaps allow banking organizations to diversify credit risk and at the same time maintain confidentiality of their client's financial records since the borrowing entity's financial records are held by the originating lender. When the loans are sold, the records are transferred to the new acquiring lender. TROR swaps generally involve fewer administrative costs than those involved in a loan-sales transaction. Risk diversification can thus be achieved at a reduced cost.

2129.0.3 OTHER SUPERVISORY ISSUES

The decision to treat credit derivatives as guarantees could have significant supervisory implications for the way examiners treat concentration risk, classified assets, the adequacy of the allowance for loan and lease losses (ALLL),[10] and transactions involving affiliates. Examples of how credit derivatives that effectively transfer credit risk could affect supervisory procedures are discussed below.

2129.0.3.1 Credit Exposure

For internal purposes of managing credit risk, banking organizations are encouraged to develop policies to determine how credit-derivative activity will be used to manage credit exposures. For example, a banking organization's internal credit policies may set forth situations in which it is appropriate to reduce credit exposure to an underlying obligor through credit-derivative transactions. Such policies need to address when credit exposure is effectively reduced and how all credit exposures will be monitored, including those resulting from credit-derivative activities.

2129.0.3.2 Concentrations of Credit

Concentrations of credit may be defined as—

- loans collateralized by a common security;
- loans to one borrower or related group of borrowers;
- loans that depend on a particular agricultural commodity;
- aggregate loans to major employers, their employees, and their major suppliers;
- loans within industry groups;
- out-of-territory loans;
- the aggregate amount of paper purchased from any one source; or
- those loans that often have been included in other homogeneous risk groupings.

Credit concentrations, by their nature, depend on common key factors, and when weaknesses develop, they have an adverse impact on each individual loan making up the concentration.[11] Generally, examiners should not consider a banking organization's asset concentration to a particular borrower reduced because of the existence of a nongovernment guarantee on one of the borrower's loans since the underlying concentration to the borrower still exists. However, examiners should consider how the banking organization manages the concentration, which could include the use of nongovernmental guarantees. Asset concentrations are to be listed in the confidential "Administrative and Other Matters" page D of the inspection report to highlight that the ultimate risk to the banking organization stems from these concentrations,

8. Depending on contract terms, a TROR swap may not terminate on default of the reference asset. Instead, payments would continue to be made on subsequent payment dates based on the reference asset's post-default prices until the swap's contractual maturity.

9. As in a credit-default swap, the guarantor may have the option of purchasing the underlying asset from the beneficiary at the dealer price and trying to collect from the borrower directly.

10. See sections 2010.7 and 2065.2.

11. See sections 2010.2, 2010.7, and 2065.2.

although the associated credit risk may be mitigated by the existence of nongovernmental guarantees.

Any nongovernment guarantee will be included with other exposures to the guarantor to determine if there is an asset concentration with respect to the guarantor. Thus, the use of credit derivatives will increase the beneficiary's concentration exposure to the guarantor without reducing the concentration risk of the underlying borrower. Similarly, a guarantor banking organization's exposure to all reference assets will be included in its overall credit exposure to the reference obligor.

2129.0.3.3 Classification of Assets

The criteria used to classify assets are primarily based on their degree of risk and the likelihood of repayment, as well as on the potential effect of the assets on the bank's safety and soundness.[12] When evaluating the quality of a loan, examiners should review the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as guarantees; and other factors. The primary focus in the review of a loan's quality is the original source of payment. The assessment of the credit quality of a troubled loan, however, should take into account support provided by a "financially responsible guarantor."[13]

The protection that a credit derivative from a financially responsible guarantor provides on an underlying asset may be sufficient to preclude classification of the underlying asset or reduce the severity of classification. Sufficiency *depends on the extent of credit protection that is provided*. To be considered a guarantee for purposes of determining the classification of assets, a credit derivative must transfer the credit risk from the beneficiary to the financially responsible guarantor; the financially responsible guarantor must have *both* the financial capacity and willingness to provide support for the credit; the guarantee (the credit-derivative contract) must be legally enforceable; and the guarantee must provide support for repayment of the indebtedness, in whole or in part, during the remaining term of the underlying asset.

However, credit derivatives tend to have a shorter maturity than the underlying asset being protected. Furthermore, it is uncertain whether the credit derivative will be renewed once it matures. Thus, when determining whether to classify an underlying asset protected by a credit derivative, examiners need to consider the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred. In general, the beneficiary banking organization continues to be exposed to the credit risk of the classified underlying asset when the maturity of the credit derivative is shorter than the underlying asset. Thus, in these situations of maturity mismatch, the examiner's presumption may be against a diminution of the severity of the underlying asset's classification.

For guarantor banking organizations, examiners should review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit. Thus, examiners should evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral. As a rule, exposure from providing credit protection through a credit derivative should be classified if the reference asset is classified.[14]

2129.0.3.4 Transactions Involving Affiliates

Credit-derivative transactions can involve two or more legal entities (affiliates) within the same banking organization. Thus, transactions between or involving affiliates raise important supervisory issues, especially whether such arrangements are effective guarantees of affiliate obligations or transfers of assets and their related credit exposure between affiliates. Banking organizations should carefully consider existing supervisory guidance on interaffiliate

12. Loans that exhibit potential weaknesses are categorized as "substandard," while those with well-defined weaknesses and a distinct possibility of loss are either "doubtful" or "loss."

13. See section 5010.10 of this manual and section 2060.1 of the *Commercial Bank Examination Manual*.

14. A guarantor banking organization providing credit protection through the use of a credit derivative on a classified asset of a beneficiary bank may preclude classification of *its derivative contract* by laying off the risk exposure to another financially responsible guarantor. This could be accomplished through the use of a second offsetting credit-derivative transaction.

transactions before entering into credit-derivative arrangements involving affiliates, particularly when substantially the same objectives could be met using traditional guarantee instruments.

2129.0.4 INSPECTION OBJECTIVES

1. To determine if the banking organization is providing credit protection through a credit derivative.
2. To ascertain whether the banking organization has and maintains sound risk-management policies and procedures and effective internal controls over the use of credit derivatives.
3. To review and evaluate existing risk involving credit-derivative arrangements.
4. To ascertain whether adequate capital and reserves are held against exposures to reference assets, including whether risk-based capital computations have accounted for any additional risk resulting from derivative arrangements.

2129.0.5 INSPECTION PROCEDURES

1. Consider credit risk associated with reference assets as primary risks. Determine whether the credit-risk exposure is treated as if it was a letter of credit or other off-balance-sheet guarantee.
2. Review the organization's credit exposure to the guarantor, as well as to the reference asset. Determine if the asset is actually owned by the beneficiary.
3. Ascertain whether the amount of credit protection a beneficiary receives when entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes.
4. Review credit-derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization.
    a. Ascertain if the reference asset is an appropriate proxy for loans or other assets whose credit exposure the banking organization intends to offset.
    b. Consider whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.
5. Determine whether management has the ability to understand and manage the credit and other risks associated with credit derivatives in a safe and sound manner. Consider management's expertise in evaluating the instruments; the adequacy of relevant policies, including position limits; and the quality of the banking organization's relevant management information systems and internal controls.
6. Evaluate the management of a banking organization's asset concentration to a particular borrower, which could include the use of non-governmental guarantees on one or more of the borrower's loans. List the asset concentrations in the confidential ''Administrative and Other Matters'' page D of the inspection report.
7. Review the quality of loans and the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as financially responsible guarantors; and other factors.
8. When determining whether to classify an underlying asset protected by a credit derivative, compare the *term* of the credit derivative in relation to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, and whether the credit risk has actually been transferred.
9. For guarantor banking organizations, review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit.
    a. Evaluate a credit derivative in which a banking organization provides credit protection based on the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral.
    b. If the reference asset is classified, classify the exposure from providing credit protection through a credit derivative.

2129.05.05 RISK IDENTIFICATION AND RISK MANAGEMENT OF SECONDARY MARKET CREDIT ACTIVITIES

A firm engages secondary-market credit activities, such as loan syndications, loan sales and participations, credit derivatives, and asset securitizations. These activities can enhance both credit availability and a firm's profitability, but managing the risks of these activities poses increasing challenges. The risks involved, while not new to banking, may be less obvious and more complex than the risks of traditional lending activities. Concentrations in certain secondary-market credit activities involve credit, liquidity, operational, legal, and reputational risks that may not be fully recognized by management or adequately incorporated in a firm's risk-management systems. In reviewing these activities, examiners should assess whether a firm fully understands and adequately manages the full range of the risks involved in secondary-market credit activities.

Improvements in technology, greater standardization of lending products, and the use of credit enhancements have helped to increase dramatically the volume of loan syndications, loan sales, loan participations, asset securitizations, and credit guarantees undertaken by commercial banks, affiliates of holding companies, and some U.S. branches and agencies of foreign banks. In addition, credit derivatives permit firms to trade credit risk, manage it in isolation from other types of risk, and maintain credit relationships while transferring the associated credit risk. If appropriately managed, such relationships can improve the availability of credit to businesses and consumers, allow management to better tailor the mix of credit risk within loan and securities portfolios, and improve overall bank profitability.

This section identifies some of the important risks involved in several of the more common types of secondary-market credit activities. Guidance is provided on sound risk-management practices, along with special considerations that examiners should consider in assessing the risk-management systems for these activities. A firm's failure to adequately understand the risks inherent in secondary market credit activities and the failure to incorporate such risk within its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice.

A firm should incorporate the full range of risks of their secondary-market credit activities into their overall risk-management systems. In particular, examiners should determine whether firms are recognizing the risks of secondary-market credit activities by

(1) adequately identifying, quantifying, and monitoring these risks;
(2) providing sufficient information on the extent and depth of these risks to senior management and the firm's board of directors;
(3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and
(4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding.

Incorporating secondary-market credit activities into a firm's risk-management systems and internal capital adequacy allocations is particularly important.[1]

Certain credit and liquidity enhancements that a firm requires for its secondary-market credit activities can make the evaluation of risks less straightforward than evaluating the risks involved in traditional on-balance-sheet lending activities. These enhancements, or guarantees, generally include recourse provisions; securitization structures that entail credit-linked early amortization and collateral-replacement events; and direct-credit substitutes, such as letters of credit and subordinated interests that, in effect, provide credit support to secondary-market instruments and transactions.[2]

The transactions involving credit and liquidity enhancements tend to be complex and may expose a firm to additional obligations that may not become evident until a transaction has dete-

1. For a more general discussion of risk management, see SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies" and SR-98-12, "Investment Securities and End-User Derivatives Activities."

2. Examiners should also refer to the Board's regulatory capital rules at 12 CFR part 217 (Regulation Q). In addition, firms have retained the risk of loss, that is, recourse, on sales and securitizations of assets when, in accordance with generally accepted accounting principles, they record on their balance sheets interest-only strips receivables or other assets that serve as credit enhancements. For more information, see the instructions to the Reports of Condition and Income and the FR-Y9 series reports.

riorated. In substance, such activities move the credit risk off the balance sheet by shifting risks associated with traditional on-balance-sheet assets into off-balance-sheet contingent liabilities. Given the potential complexity and, in some cases, the indirect nature of these enhancements, the actual credit-risk exposure can be difficult to assess, especially in the context of traditional credit-risk limit, measurement, and reporting systems.

Moreover, many secondary-market credit activities involve reputational, liquidity, operational, and legal risks that are not readily identifiable and may be difficult to control. For example, recourse provisions and certain asset-backed security structures can give rise to significant reputational- and liquidity-risk exposures, and ongoing management of underlying collateral in securitization transactions can expose a firm to unique operating and legal risks.

For a firm providing credit enhancements in connection with loan sales and securitizations, and a firm involved in credit derivatives and loan syndications, examiners should assess whether the firm's systems and processes adequately identify, measure, monitor, and control the risks involved in the secondary-market credit activities. In particular, the risk-management systems employed should include the identification, measurement, and monitoring of these risks, as well as an appropriate methodology for the internal allocation of capital and reserves. The stress testing conducted within the risk-measurement element of the management system should fully incorporate the risk exposures of these activities under various scenarios in order to identify their potential effect on a firm's liquidity, earnings, and capital adequacy. Moreover, senior management should have sufficient information to assess the risks associated with these activities, as well as whether contingency plans are adequate to deal with possible adverse conditions.

2129.05.1 CREDIT RISKS IN SECONDARY-MARKET CREDIT ACTIVITIES

A firm should be aware that the credit risk involved in many secondary-market credit activities may not always be obvious. For certain types of loan sales and securitization transactions, a firm may actually be exposed to essentially the same credit risk that arises from traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the firm from credit risk. For instance, an off-balance-sheet transaction may not result in a commensurate reduction in credit risk. Such transactions include loan sales with recourse; credit derivatives; direct-credit substitutes, such as letters of credit; liquidity facilities extended to securitization programs; and certain asset-securitization structures (for example, securitized credit card receivables).

2129.05.1.1 Loan Syndications

A firm should periodically review syndication underwriting standards and pricing practices to verify that they remain consistent over time with (1) the degree of risk associated with the activity and (2) the potential for unexpected economic developments to adversely affect borrower creditworthiness.

A firm may be asked to make a commitment to participate in a loan syndication within a shorter period of time that may limit the time for the firm to conduct its risk assessment. Therefore, examiners will periodically review underwriting standards and consider whether a firm performs an independent credit analysis of the syndicated credit instead of placing undue reliance on the analysis of the lead underwriter or on commercial-loan credit ratings. A firm should avoid making an irrevocable commitment to participate in a syndication until the firm completes its own risk assessment.

2129.05.1.2 Credit Derivatives

Credit derivatives are generally off-balance-sheet financial instruments that are used by a firm to assume or mitigate the credit risk of loans and other assets.[3] A firm employs these instruments, either as end-users, purchasing credit protection from—or providing credit protection to—third parties, or as dealers intermediating such protection. In reviewing credit derivatives, supervisors should consider the credit risk associated with the referenced asset, as well as general market risk and the risk of the counterparty to the contract.

With respect to credit-derivative transactions in which a firm is mitigating the credit risk of its assets, examiners will review those situations in which the referenced assets are not identical to

3. Credit-linked notes are on-balance-sheet instruments.

the assets actually owned by the firm. Examiners should consider whether the referenced asset is an appropriate proxy for the risks posed by the underlying loan or other assets of the derivative transaction.

2129.05.1.3 Recourse Obligations, Direct-Credit Substitutes, and Liquidity Facilities

2129.05.1.3.1 Recourse Obligations

Partial, first-loss recourse obligations retained when selling assets, as well as the extension of partial credit enhancements (for example, 10 percent letters of credit), can be a source of concentration credit risk by exposing a firm to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or a pool of loans that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by the firm selling and securitizing the assets. In these situations, even though a firm may have reduced its exposure to catastrophic loss on the assets sold, the firm generally retains the same credit-risk exposure as if the firm continued to hold the loans or assets on its balance sheet.

2129.05.1.3.2 Direct-Credit Substitutes

A firm should consider the level of credit concentration risk that arise from the extension of partial direct-credit substitutes, such as the purchase of subordinated interests and the extension of letters of credit. For example, a firm that sponsors certain asset-backed commercial paper programs, or so-called remote-origination conduits, can be exposed to a high degree of credit risk even though its notional exposure is minimal. In these situations, the sponsoring firm refers an existing corporate customer to the conduit, which becomes the new lender to that customer. The conduit funds this lending activity by issuing commercial paper that, in turn, is guaranteed by the sponsoring firm. The net result is that the sponsoring firm has much the same credit-risk exposure through its guarantee as it would have on a direct loan to that corporate borrower and held on-balance-sheet. However, this credit extension is an off-balance-sheet transaction, and the associated risks may not be fully addressed in the firm's risk-management system.

2129.05.1.3.3 Liquidity Facilities

A firm that extends liquidity facilities to securitized transactions, particularly asset-backed commercial paper programs, may be exposed to a high degree of credit risk that may be embedded within a facility's provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow of an asset-backed commercial paper. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject a firm to the credit risk of the underlying asset pool, often trade receivables, or to the credit risk of a specific company using the program for funding. Often the stated purpose of such liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[4] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit-enhancement levels.

2129.05.1.4 Asset-Securitization Structures

The structure of various securitization transactions can result in a firm retaining the underlying credit risk for a pool of assets that the firm securitized. An example of this contingent credit-risk retention is credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust but, in practice, retains the majority of the economic risk of loss associated with the assets—because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization.

4. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[5] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

The structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early-amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (paydown) on the security, the credit card accounts that were assigned to the master credit card trust return to the securitizing institution more quickly than had originally been anticipated, thus exposing the firm to liquidity pressures and to further credit losses on the returned accounts.

2129.05.2 REPUTATIONAL RISKS

A firm's secondary-market credit activities give rise to reputational risks. Loan-syndication underwriting may present significant reputational-risk exposure to lead underwriters because syndicate participants may seek to hold the lead underwriter responsible for actual or perceived inadequacies in the loan's underwriting practices, even though participants are responsible for conducting an independent due-diligence in evaluating the credit.

There is the possibility that pressure may be brought to bear on the lead participant to repurchase portions of the syndication if the credit deteriorates in order to protect its reputation in the market, even though the syndication was sold without recourse. In addition, when there is deterioration in the syndicated credit, a participant may pursue legal action against the lead organization. One way to mitigate reputational risk in a syndication is for a firm to determine whether a possible participant in the syndication is able to conduct its own evaluation of the credit risks involved in the transaction.

A firm that sponsors an asset-backed security may also be acting as the servicer, administrator, or liquidity provider in the securitization transaction. Therefore, a firm should assess the potential losses and risk exposure associated with reputational risk arising from these activities. An asset securitization with deterioration of performance may result in a negative market reaction that could increase the spreads on a firm's future issuances. In order to avoid potentially adverse implications on future issuances, a firm may provide support to its securitization transactions by improving the performance of the securitized asset pool. For example, a firm may sell discounted receivables or add higher-quality assets to the securitized asset pool. Thus, a firm's voluntary support of its securitization in order to protect the firm's reputation can adversely affect the sponsoring or issuing organization's earnings and capital. A firm may take these actions to avoid either a rating downgrade or an early amortization of the outstanding asset-backed securities.

2129.05.3 LIQUIDITY RISKS

The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and the early-amortization triggers of certain asset-securitization transactions can involve significant liquidity risk to institutions engaged in these secondary-market credit activities. A firm should consider whether its liquidity contingency plans fully incorporate the potential risk posed by its secondary-market credit activities. With the issuance of new asset-backed securities, the issuing firm should determine the potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

A firm's contingency plans should consider the need to obtain replacement funding and specify the possible alternative funding sources, addressing the amortization of outstanding asset-backed securities. This is particularly important for securitizations with revolving receivables, such as credit cards, when an early amortization of the asset-backed securities could

5. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield the (1) coupon paid to investors; (2) charge-offs for that month; and (3) servicing fee, usually 200 basis points paid to the firm sponsoring the securitization.

unexpectedly return the outstanding balances of the securitized accounts to the issuing firm's balance sheet. An early amortization of a firm's asset-backed securities could impede its ability to fund itself—either through reissuance or other borrowings—since the firm's reputation with investors and lenders may be adversely affected.

2129.05.4 INCORPORATING THE RISKS OF SECONDARY-MARKET CREDIT ACTIVITIES INTO RISK MANAGEMENT

Supervisors should verify that a firm incorporates the risks involved in its secondary-market credit activities in its overall risk-management system. The system should entail

(1) information on risk exposures for the firm's senior management;
(2) review, approval, and adoption of appropriate policies, procedures, and guidelines to manage the risks involved;
(3) appropriate processes to measure and monitor risks; and
(4) appropriate internal controls to verify the integrity of the management process with respect to these activities.

The formality and sophistication with which the risks of these activities are incorporated into a firm's risk-management system should be commensurate with the nature and volume of its secondary-market credit activities. A firm with significant secondary-market activity should have a more robust risk-management process to monitor and control the risks of this activity.

2129.05.4.1 Role of the Board of Directors

The board of directors should consider the capacity of the firm's risk management framework when overseeing aspects of the firm's strategy arising from the firm's secondary-market credit activities. The board should also review any corresponding risk management or controls enhancements that are necessary to align with the risk appetite. The board should review and approve all significant policies relating to the management of risk arising from secondary-market credit activities based on the firm's strategy, risk appetite, risk-management capacity, and structure.

A firm involved in securitization activities should have appropriate policies, procedures, and controls with respect to underwriting asset-backed securities; funding the possible return of revolving receivables (for example, credit card receivables and home equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations. A lead firm in a loan syndication should have policies and procedures in place describing the instances when portions of syndications may be repurchased. Furthermore, a firm participating in a loan syndication should not place undue reliance on the credit analysis performed by the lead organization. Rather, the participant should have clearly defined policies and procedures addressing its own due diligence in analyzing the risks inherent in the transaction.

2129.05.4.2 Role of Senior Management

Senior management is responsible for understanding the credit, market, liquidity, operational, legal, and reputational risks arising from the firm's secondary-market credit activities. Senior management is also responsible for implementing a risk-management structure that is commensurate with the level of the organization's activities. Senior management should confirm that the risk exposures are fully incorporated into information provided to the firm's board of directors. Senior management is responsible for ensuring that the risks arising from secondary-market credit activities are adequately managed on both a short-term and long-term basis. Senior management should establish adequate policies and procedures for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should clarify that the economic substance of the risk exposures generated by these activities is identified, monitored, and controlled. Senior management should provide the institution's board of directors with sufficient, timely, and well-organized information about secondary-market activities so that the board can understand the risks posed by secondary-market credit activities.

2129.05.4.3 Management Information and Risk-Measurement Systems

A firm's management information and risk-measurement systems should fully incorporate the risks involved in its secondary-market credit activities. A firm should be able to identify credit exposures from all secondary-market credit activities and be able to measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of secondary-market credit activities should be fully incorporated into the firm's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss-probability distributions. Secondary-market credit activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

It is particularly important that a firm's information systems can identify and segregate those credit exposures arising from the firm's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit-enhancement and liquidity facilities, the effects of an early-amortization event, and the investment in asset-backed securities. The information that senior management provides to the board of directors should be appropriately tailored in order to enable the board to make sound, well-informed decisions, and consider potential risk.

2129.05.4.4 System of Internal Controls

The board oversees and holds senior management accountable for establishing and maintaining an effective system of internal controls that, among other things, enforces the official lines of authority and the appropriate separation of duties in managing the firm's risks. These internal controls should be commensurate with the firm's activities and associated risks. Moreover, these internal controls should provide reasonable assurance of reliable financial reporting (in published financial reports and regulatory reports), including adequate allowances or liabilities for expected losses.

2129.05.5 STRESS TESTING

The use of stress testing, including consideration of multiple market events that could affect a firm's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the firm and assessing its ability to withstand them. Stress testing should consider the probability of adverse events, as well as likely worst-case scenarios. Such an analysis should be done on a consolidated basis and consider, for instance, the effect of higher-than-expected levels of delinquencies and defaults, as well as the consequences of early-amortization events with respect to credit card securities that could raise concerns regarding the firm's capital adequacy and its liquidity and funding capabilities. Stress-test analyses should also include contingency plans regarding the actions management might take, given certain situations.

2129.05.6 CAPITAL ADEQUACY

A firm should fully support the risk exposures of its secondary-market credit activities with adequate capital. A firm should validate that its capital position is sufficiently strong to support the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in affiliated entities engaged in these activities. The Federal Reserve's Regulation Q (12 CFR part 217) establishes minimum capital ratios, and a firm exposed to high or above-average degrees of risk is therefore expected to operate above the minimum capital standards.

Examiners should review the substance of secondary-market transactions when assessing underlying risk exposures. For example, partial, first-loss direct-credit substitutes providing credit protection to a securitization transaction can, in substance, involve much the same credit risk as that involved in holding the entire asset pool on the firm's balance sheet. Examiners should assess whether banking organizations have appropriately allocated capital against the economic substance of credit exposures arising from early-amortization events and liquidity facilities associated with securitized transactions.[6]

If, in the examiner's judgment, a firm's capital level is not sufficient to absorb potential losses from such credit exposures, examiners should reflect this deficiency in the firm's report of examination and supervisory ratings, as appropriate. Furthermore, examiners should discuss the capital deficiency with the firm's management and, if necessary, its board of directors.

6. For further information, refer to the Board's regulatory capital rule at 12 CFR part 217 (Regulation Q).

In these situations, a firm will be expected to develop and implement a plan for strengthening its overall capital adequacy to levels deemed appropriate given the firm's risk exposure.

2129.05.7 INSPECTION OBJECTIVES

1. To determine whether a firm's risk-management systems accurately identify the risk exposures stemming from secondary-market activities.
2. To determine whether there has been a lowering of credit standards as a result of the firm's secondary-market credit activities.
3. To determine whether the firm's management system performs stress testing to evaluate the risk exposures of secondary-market credit activities under various scenarios and to evaluate the potential effect of the activities on the firm's liquidity, earnings, and capital adequacy.
4. To assess the effectiveness of any liquidity contingency plans as the plans relate to secondary-market credit activities, including the need to obtain replacement funding.
5. To determine whether the board of directors is fully informed of the risks involved in secondary-market activities and whether it approves policies, to mitigate credit, liquidity, operational, legal, reputational, and other risks.
6. To determine whether the firm's capital planning and positions support the risks associated with secondary-market credit activities.
7. To ascertain whether there is an effective system of internal controls to monitor and contain the risks associated with secondary-market activities.

2129.05.8 INSPECTION PROCEDURES

1. Determine whether the firm's senior management
   a. adequately identifies, quantifies, and monitors risks involved in secondary-market credit activities;
   b. clearly communicates the extent and depth of those risks in discussions, presentations, and inspection reports that are delivered to the board of directors and senior officials of the institution;
   c. presents to the board of directors, for its approval, all significant policies relating to the risk management of secondary-market activities;
   d. conducts periodic stress testing to identify potential losses and liquidity needs under adverse and worst-case scenarios; and
   e. has set adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding.
2. Assess whether the firm's risk-management systems and processes adequately identify, measure, monitor, and control all of the risks involved in the firm's secondary-market credit activities.
3. Determine whether the various risks associated with secondary-market activities are incorporated into contingency plans, including replacement funding plans and identified alternative funding sources, to lessen the impact of those risks.
4. Assess the appropriateness of loan-syndication contract agreements, underwriting documentation, and relevant correspondence with loan-syndication contractual parties to establish whether
   a. the firm's management has performed adequate credit investigations and evaluations of the syndicate loans, the syndicate participants, and the extent of the firm's credit-risk exposures;
   b. the syndication customers are in a position to evaluate the credit risks involved in the transaction; and
   c. undue reliance is placed on the lead underwriter, the participants, or on commercial-loan credit ratings of the participants.
5. For credit derivatives—
   a. analyze the credit risk associated with the reference asset, the general market risk, and the counterparty risk; and
   b. determine, for those reference assets that are not identical assets actually owned, whether the reference asset is an appropriate proxy for the loan or other assets whose credit exposure is to be offset.
6. Review the substance of secondary-market transactions, when evaluating and analyzing underlying risk exposures.
7. Assess the appropriateness of the firm's methods for internally allocating capital against the economic substance of credit exposures that arise from amortization events and liquidity facilities associated with securitized transactions.

8. Incorporate the evaluation of potential risks and losses from credit exposures, including management deficiencies, into the report of examination and the firm's supervisory ratings, as appropriate.

2130.0.1 INTRODUCTION

Effective March 1, 1983, the Board issued an amended bank holding company policy statement entitled "Futures, Forward and Options on U.S. Government and Agency Securities and Money Market Instruments." Bank holding companies are now required to furnish written notification to their District Federal Reserve Banks within 10 days after financial contract activities are begun by the parent or a nonbank subsidiary. The policy is consistent with the joint policy statement previously issued by the three federal bank regulators with regard to banks participating in financial contracts, and reflects the Board's judgment that bank holding companies, as sources of strength for their subsidiary banks, should not take speculative positions in such activities.

If a bank holding company or nonbank subsidiary is taking or intends to take positions in financial contracts, that company's board of directors should approve written policies and establish appropriate limitations to ensure that the activity is conducted in a safe and sound manner. Also, appropriate internal control and audit procedures should be in place to monitor the activity. The following discussion and inspection procedures apply to futures contract activity generally, but are intended to focus specifically on financial futures contracts. For a discussion of currency futures and options and the examination procedures for those instruments, see sections F and G in the Merchant and Investment Bank Examination Manual.

Information, instructions, and inspection procedures have been provided for verifying compliance with the Board's policy statement. It is intended that the policy statement will ensure that contract activities are conducted in accordance with safe and sound banking practices. The task of evaluating BHC contract activities is the responsibility of System examiners. The following information and inspection procedures are intended to serve as a guide for Federal Reserve Bank staff in that effort.

2130.0.2 DEFINITIONS

Basis—Basis is defined as the difference between the futures contract price and the cash market price of the same underlying security, money market instrument, or commodity.

Call Option—A contract that gives the buyer (holder) the right, but not the obligation to buy (call), a specified quantity of an underlying security, money market instrument or commodity at or before the stated expiration of the contract. At expiration, if the value of the option increases, the holder will exercise the option or close it at a profit. If the value of the option does not increase, the holder would probably let the option expire (or close it out at a profit) and, consequently, will lose the cost (premium paid) of (for) the option. Alternatively, the option may be sold prior to expiration.

Clearing Corporation—A corporation organized to function as the clearing house for an exchange. The clearing house registers, monitors, matches and guarantees trades on a futures market, and carries out financial settlement of futures transactions. The clearing house acts as the central counterparty to all trades executed on the exchange. It substitutes as a seller to all buyers and as a buyer to all sellers. In addition, the clearing corporation serves to insure that all contracts will be honored in the event of a counterparty default.

Clearing Member—A member firm of the clearing house or corporation. Membership in clearing associations or corporations is restricted to members of the respective commodity exchanges, but not all exchange members are clearing house members. All trades of a nonclearing member must be registered with, and eventually settled through, a clearing member.

Commodities Futures Trading Commission—The CFTC is a federal regulatory agency charged with regulation of futures trading in all commodities. It has broad regulatory authority over futures trading. It must approve all future contracts traded on U.S. commodity exchanges, ensure that the exchanges enforce their own rules (which it must review and approve), and direct an exchange to take any action needed to maintain orderly markets whenever it believes that an "emergency" exists.

Contract Activities—This term is used in this manual to refer to banking organization participation in the futures, forward, standby contract, or options markets to purchase and sell U.S. government and agency securities or money market instruments, foreign currencies and other financial instruments.

Convergence—The process by which the futures market price and the cash market price of a financial instrument or commodity converge as the futures contract approaches expiration.

Covered Call Options—This term refers to the issuance or sale of a call option where the option seller owns the underlying deliverable security or financial instrument.

Cross Hedging—The process of hedging a ‘‘cash’’ or derivative instrument position with another cash or derivative instrument that has significantly different characteristics. For example, an investor who wants to hedge the sales price of long-term corporate bonds might hedge by establishing a short position in a treasury bond or treasury bond futures contract, but since the corporate bonds cannot be delivered to satisfy the contract, the hedge would be a cross hedge. To be successful, the price movements of the hedged instrument must be highly correlated to that of the position being hedged.

Difference Check—A difference check is sent by the party which recognizes a loss when a forward contract is closed out by the execution of an offsetting forward contract pursuant to a pair-off clause. In essence, the difference check represents a net cash settlement on offsetting transactions between the same two parties and replaces a physical delivery and redelivery of the underlying securities pursuant to offsetting contracts.

Financial Contract—This term is used in the manual to refer to financial futures, forward, standby contracts, and options to purchase and sell U.S. government and agency securities, money market instruments, foreign currency futures and other financial instruments.

Firm Forward Contract—This term is used to describe a forward contract under which delivery of a security is mandatory. See ‘‘Standby Contract’’ for a discussion of optional delivery forward contracts.

Forward Contracts—Over-the-counter contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following trade date shall be deemed to be forward contracts. Forward contracts are usually nonstandardized and are not traded on organized exchanges, generally have no required margin payments, and can only be terminated by agreement of both parties to the transaction. The term also applies to derivative contracts such as swaps, caps, and collars.

Futures Contracts—Standardized contracts traded on organized commodity exchanges to purchase or sell a specified financial instrument or commodity on a future date at a specified price. While futures contracts traditionally specified a deliverable instrument, newer contracts have been developed that are based on various indexes. Futures contracts based on indexes settle in cash and never result in delivery of an underlying instrument; some traditional contracts that formerly specified delivery of an underlying instrument have been redesigned to specify cash settlement. New financial futures contracts are continually being proposed and adopted for trading on various exchanges.

Futures Commission Merchant (FCM)—An FCM functions like a broker in securities. An FCM must register with the Commodities Futures Trading Commission (CFTC) in order to be eligible to solicit or accept orders to buy or sell futures contracts. The services provided by an FCM include a communications system for transmittal of orders, and may include research services, trading strategy suggestions, trade execution, and recordkeeping services.

Financial Futures Contracts—Standardized contracts traded on organized exchanges to purchase or sell a specified security, money market instrument, or foreign currency on a future date at a specified price on a specified date. Futures contracts on GNMA mortgage-backed securities and Treasury bills were the first interest rate futures contracts. Other financial futures contracts have been developed, including contracts on Eurodollars, currencies, and Euro-Rate differentials. It is anticipated that new and similar financial futures contracts will continue to be proposed and adopted for trading on various exchanges.

Futures Exchange—Under the Commodities Exchange Act (CEA), a ‘‘board of trade’’ designated by the Commodity Futures Trading Commission as a contract market. Trading occurs on the floor of the exchange and is conducted by open auction in designated trading areas.

GNMA or GINNIE MAE—Either term is used to refer to the Government National Mortgage Association. Ginnie Mae is a government corporation within the U.S. Department of Housing and Urban Development. In creating GNMA, Congress authorized it to grant a full faith and credit guaranty of the U.S. government to mortgage-backed securities issued by private sector organizations.

Hedge—The process of entering transactions that will protect against loss through compensatory price movement. A hedge transaction is one which reduces the organization's overall level of risk.

Initial Futures Margin—In the futures market, a deposit held by an FCM on behalf of a client against which daily gains and losses on futures positions are added or subtracted. A futures margin represents a good-faith deposit or performance bond to guarantee a participant's performance of contractual obligations.

Interest Rate Cap—A multi-period interest rate option for which the buyer pays the seller a fee to receive, at predetermined future times, the excess, if any, of a specified floating interest rate index above a specified fixed per annum rate (cap or strike rate). Caps can be sold separately or may be packaged with an interest rate swap.

Interest Rate Collar—the combination, in single contract, of a simultaneous sale of a cap and the purchase of a floor, or, a purchase of a cap and sale of a floor. The buyer of the collar is a buyer of a cap and the seller of a floor. By selling the floor, the collar buyer gives up the possibility of benefiting from a decline in interest rates below the strike rate in the floor component. On the other hand, the fee earned in selling the floor lowers the cost of protection against interest rate reversal.

Interest Rate Floor—is the reverse of an interest rate cap. The buyer pays a premium to obtain protection against a decline in interest rates below a specified level.

Long Contract—A financial contract to buy securities or money market instruments at a specified price on a specific future date.

Long Hedge—The long hedge, also called the *anticipatory hedge* is the process by which a market participant protects a cash or risk position by buying a futures or forward contract, i.e. taking a long financial contract position.

Maintenance Margin—Maintenance margin is the minimum level to which an equity position can decline as a result of a price decline before additional margin is required. In other words, it is the minimum margin which a customer must keep on deposit with a member at all times. Each futures contract has specified maintenance margin levels. A margin call is issued when a customer's initial margin balance falls below the maintenance margin level specified by the exchange. Maintenance margin must be satisfied by the deposit of cash or agreed upon cash equivalents. The amount of cash required is that amount which is sufficient to restore the account balance to the initial margin level.

Mandatory Delivery—See "Firm Forward Contract."

Mark-to-market—The process by which the carrying value (market value or fair value) of a financial instrument is revalued, and which is recognized as the generally accepted accounting principle for determining profit or loss on securities positions in proprietary trading and investment accounts. Futures positions are typically marked-to-market at the end of each trading session.

Naked Call Option—Refers to the issuance or sale of a call option where the option seller does not own the underlying deliverable security or instrument.

Open Interest—Refers to the number of futures contracts outstanding for a given delivery month in an individual futures contracts. The mechanics of futures trading require that for every open long futures contract there is an open short futures contract. For example, an open interest of 10,000 futures contracts means that there are 10,000 long contract holders and 10,000 short contract holders.

Options Contracts—Option contracts require that the buyer of the option pay the seller (or writer) of the option a premium for the right, but not the obligation, to exercise an option to buy (call option) or sell (put option) the instrument underlying the option at a stated price (strike or exercise price) on a stated date (European style option) or at any time before or on the stated expiration date (American style option). There are also exchange traded options contracts: (1) put and call options on futures contracts that are traded on commodities exchanges; and (2) put and call options that specify delivery of securities or money market instruments (or that are cash settled) that are traded on securities exchanges. The key economic distinction between options on futures and options on securities, is that the party who exercises an option on a futures contract receives a long or short futures position rather than accepting or making delivery of the underlying security or financial instrument.

Pair-Off Clause—A pair-off clause specifies that if the same two parties to a forward contract trade should subsequently execute an offsetting trade (e.g. a long contract against an outstanding short contract), settlement can be effected by one party sending the other party a difference check rather than having physical delivery and redelivery of securities.

Par Cap—This term refers to a provision in the contract of sale for Ginnie Mae mortgage-backed securities which restricts delivery only to pools which bear an interest rate sufficiently high so that the securities would trade at or below par when computed based on the agreed to yield.

Put Option—An option contract which gives the holder the right, but not the obligation, to sell (put) a specified quantity of a financial instrument (money market) or commodity at a specified price on or before the stated expiration date of the contract. If price of the underlying instrument occurs, the purchaser will exercise or sell the option. If a decline in price of the underlying instrument does not occur, the option purchaser will let it expire and will lose only the cost (premium paid) of (for) the option.

Round Turn—Commissions for executing futures transactions are charged on a round turn basis. A round turn constitutes opening a futures position and closing it out with an offsetting contract, i.e. executing a short contract and closing out the position with a long contract or vice-versa.

Short Contract—A financial contract to sell securities or money market instruments at a specified price on a specified future date.

Short Hedge—The process by which a customer protects a cash or risk position by selling a futures or forward contract, i.e. taking a short financial contract position. The purpose of the short hedge is to lock in a selling price.

Standby Contract—Optional delivery forward contracts on U.S. government and agency securities arranged between securities dealers and customers that do not involve trading on organized exchanges. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of a standby (the issuer) receives the fee, and must stand ready to buy the securities at the other party's option. See the fuller discussion of Standby Contracts under 2130.0.3.1.2)

TBA (To Be Announced) Trading—TBA is the abbreviation used in trading Ginnie Mae securities for forward delivery when the pool number of securities bought or sold is "to be announced" at a later date.

Variation Margin—is when, in very volatile markets, additional funds are required to be deposited to bring the account back to its initial margin level, while trading is in progress. Variation margin requires that the needed funds be deposited within the hour, or when reasonably possible. If the customer does not satisfy the variation or maintenance margin call(s), the futures position is closed. Unlike initial margin, variation margin must be in cash. Also refer to "Maintenance Margin".

Weighted Hedge—a hedge that is used to compensate for a greater decline in the dollar value of a cash bond as compared to a price decline of an accessible T-bond futures contract.

Yield Maintenance Contract—This is a forward contract written with terms which maintain the yield at a fixed rate until the delivery date. Such a contract permits the holder of a short forward contract to deliver a different coupon security at a comparable yield.

2130.0.3 FINANCIAL CONTRACT TRANSACTIONS

Futures, forward and options contracts are merely other tools for use in asset–liability management. These contracts are neither inherently a panacea nor a speculative vehicle for use by banks and bank holding companies. Rather, the benefit or harm resulting from engaging in financial contract activities results from the manner in which contracts are used. Proper utilization of financial contracts can reduce the risks of interest or exchange rate fluctuations. On the other hand, financial contracts can serve as leverage vehicles for speculation on rate movements.

2130.0.3.1 Markets and Contract Trading

Forward contract (OTC) trading of Government National Mortgage Association ("GNMA") or "Ginnie Mae" Mortgage-Backed Securities preceded exchange trading of GNMA futures contracts in 1975.

2130.0.3.1.1 Forward Contracts

Forward contracts are executed solely in an over-the-counter market. The party executing a contract to acquire securities on a specified future date is deemed to have a "long" forward contract; and the party agreeing to deliver securities on a future date is described as a party holding a "short" forward contract. Each contract is unique in that its terms are arrived at after negotiation between the parties.

For purposes of illustrating a forward contract, assume that SMC Corporation is an originator of government guaranteed mortgages and issuer of GNMA securities. SMC Corporation has a proven ability to manage and predict the volume of its loan originations over a time horizon of three to four months. To assure a profit or prevent a loss on current loan originations, SMC Corporation may enter binding over-the-counter commitments to deliver 75% of its mortgage production which will be converted into GNMA securities three months in the future. If SMC agrees to sell $3 million of GNMA securities (11% coupon) to the WP Securities Firm at par in three months, SMC Corporation is considered to have entered a "short" (commitment to sell) forward contract. Conversely, WP has entered a "long" (commitment to buy) forward contract. The two parties to the transaction are both now obligated to honor the terms of the contract in three months, unless the contract is terminated by mutual agreement.

It should be noted that executing a "short" forward contract is not the same as executing the short sale of a security. Generally, a short sale of a security is understood to represent the speculative sale of a security which is not owned by the seller. The short seller either purchases the security prior to settlement date or borrows the security to make delivery; however, a "short" forward contract merely connotes the side of the contract required to make delivery on a future date. Short forward contracts should not be considered inherently speculative, but must be considered in light of the facts surrounding the contract.

Forward trading can be done on a mandatory delivery (sometimes referred to as "firm forward" contracts) basis or on an optional delivery basis ("standby" contract). With respect to a "mandatory" trade, the contract can also be written with a "pair-off" clause. A pair-off clause specifies that if the same two parties to a trade should subsequently execute an off-setting trade (e.g., the banking organization executes a long contract against an outstanding short contract), settlement can be effected by one party sending the other party a "difference check" rather than having a physical delivery and redelivery of securities.

When a forward contract is executed by a dealer, a confirmation letter or contract is sent to the other party to the transaction. The contract will disclose pertinent data about the trade, such as the size of the trade, coupon rate, the date upon which final delivery instructions will be issued, and the yield at which the trade was effected. In addition, the contract letter will specify whether it is permissible for the "short" side of the trade to deliver a different coupon security at a comparable yield ("yield maintenance contract") if the coupon specified in the contract is not available for delivery. Contracts which prohibit the delivery of securities requiring a premium over par are considered to have a "par cap." The initial contract letter generally does not specify which specific securities (e.g., GNMA mortgage-backed securities identified by a pool number) will be delivered. Instead, such contracts generally identify the deliverable securities as having been traded on a "TBA" basis ("to be announced"). Prior to settlement, the dealer holding the short contract will send a final confirmation to the other party specifying the actual securities to be delivered, accrued interest, dollar price, settlement date, coupon rate, and the method of payment.

Forward contracts are not typically marked-to-market. Both parties in a forward contract are exposed to credit risk, since either party can default on its obligation.

2130.0.3.1.2 Standby Contracts

Standby contracts are "put options" that trade over-the-counter, with initial and final confirmation procedures that are quite similar to those on forward transactions. Standby contracts were developed to allow GNMA issuers to hedge their production of securities, especially in instances where mortgage bankers have extended loan commitments in connection with the construction of new subdivisions. When a mortgage banker agrees to finance a subdivision with conventional and government guaranteed mortgages it is difficult to predict the actual number of FHA and VA guaranteed loans which will be originated. Hence, it is risky for a GNMA issuer to enter mandatory forward contracts to deliver the entire estimated amount of loans eligible to be pooled as GNMA securities. By entering an option contract and paying a fee for the option to "put" securities to another party, a GNMA issuer or securities dealer obtains downside market protection, but remains free to obtain the benefits of market appreciation since it can "walk away" from the option contract. In addition to the flexibility of walking away and selling securities at the prevailing market price when GNMA prices are rising, a GNMA issuer avoids the potential risk of purchasing mortgages or GNMA securities to cover short forward contracts in the event that production of GNMA securities falls below anticipated levels.

When a securities dealer sells a standby contract granting a GNMA issuer the right "to put" securities to it, the dealer, in turn, will attempt to purchase a matching standby contract from an investor because the dealer does not want to shoulder all of the downside market risk. There is also potential for securities firms to deal in standby contracts having no relationship to the issuance of GNMA securities.

Some illustrations of standby contracts follow. They are intended to illustrate the mechanics of a standby contract when a banking organization has sold or issued a standby contract granting the contra party the option to "put" GNMA securities to the banking organization.

Assumptions

1. Fee paid to banking organization = 1% of contract value
2. Contract delivery price = 98
3. Coupon = 12%

Situation 1

On contract exercise date: Market Price = 100. Therefore, the dealer would sell securities at market rather than put them to the bank.

Dealer		*Banking organization*	
Sale price	100	Purchase price	N/A
Fee paid	(1)	Fee Received	1
	99		1

Result: Dealer sacrificed 1% to insure sale price.

Result: Banking organization earned 1% fee for "standing by."

Situation 2

On contract exercise date: Market price = 95. Therefore, dealer would deliver securities pursuant to the standby contract.

Dealer		*Banking organization*	
Sale price	98	Purchase price	98
Market price	95	Market price	95
Contract gain	3	Contract loss	(3)
Fee paid	(1)	Fee received	1
Actual gain	2	Actual loss	(2)

Result: Dealer paid 1% fee to avoid 3 point market loss.

Result: Banking organization received 1% fee to compensate for purchasing securities 3 points above market.

2130.0.3.1.3 Futures Contracts

Futures Contract transactions involve three types of participants: customers—the buyers or sellers of contracts, brokers, and a futures exchange. As in the forward markets, a buyer (party committed to take delivery of securities specified in the futures contract) of a futures contract has a "long" contract and the seller (party committed to deliver the underlying securities) has a "short" contract. If a customer desires to purchase (sell) a futures contract, the broker—possibly a member of a clearing house of an exchange—will take the order to the exchange floor and purchase (sell) a contract sold (bought) by another customer (through another broker).[1] All futures transactions are made through and carried on the books of clearing house member brokers, who are treated by the exchange as their own customers. Hence, there are always an equal number of long and short contracts outstanding, referred to as the "open interest," since the auction process requires a buyer and seller for every contract.

All futures contracts are obligations of an exchange's clearing association or corporation, i.e. the clearing association is on the opposite side of each long and short contract; and all transactions are guaranteed within the resources of the exchange's clearing association (on most futures exchanges a small fee is collected on each transaction and placed into an insurance fund). Should an FCM default on a futures contract, the association pays the costs of completing the contract.

2130.0.4 MARGIN REQUIREMENTS

In order to insure the integrity of futures markets, the clearing house requires that member brokers (clearing house members) deposit initial margin in connection with new futures positions carried for the firm, other brokers or FCMs for whom the clearing house member clears transactions, and public customers. The clearing house members in turn require their customers—whether they are other FCMs or public customers—to deposit margin.[2] The FCMs generally require that public customers meet initial margin requirements by depositing cash, pledging government securities, or obtaining irrevocable standby letters of credit from substantial commercial banking organizations. Daily maintenance margin or variation margin calls (deposits of cash required to keep a certain minimum balance in the margin account) based upon each day's closing futures prices are calculated pursuant to rules of the various futures exchanges, and clearing house members are required to meet daily variation margin calls on positions carried for customers and the firm. In turn, the

1. Brokers in commodities are required to register as futures commission merchants ("FCMs") with the Commodities Futures Trading Commission ("CFTC") in order to be eligible to solicit or accept orders to buy or sell futures contracts.

2. In general, the futures exchanges set different initial margin requirements based upon the types of activity engaged in by the customer. Margin requirements are higher for customer contracts characterized as "speculative" than for those contracts deemed to be "hedge" positions. The commodities industry traditionally defines someone with a business need for using the futures market as a hedger; others are defined as speculators. Therefore, in instances where there are different initial hedge and speculative margin requirements, it is assumed that banking organizations will only be required to meet margin required for hedgers.

FCMs require customers to reimburse them for posting additional margin.

Once a customer has executed a futures contract to make or accept delivery of securities in the future it is obligated to fulfill the terms of the contract. A futures contract cannot be resold over-the-counter because futures contracts are not transferable. However, a customer may terminate its obligation under a futures contract either by making or accepting delivery of the securities as specified by the contract, or by executing an offsetting futures contract (long contract to cancel a short contract or vice-versa) with the same broker to cancel the original contract on the same exchange. The overwhelming majority of futures contracts are closed out by the execution of an offsetting contract prior to expiration.

The key to understanding futures transactions is the fact that futures contract prices on U.S. government and agency securities move in the same manner as bond prices; e.g. rising interest rates result in falling futures prices and falling interest rates result in rising futures prices. Hence, the purchase of a futures contract ("long" futures contract) at a price of 98 will result in a loss if future market participants perceive rising interest rates in the month of contract expiration and act accordingly; then the offsetting of a futures contract (executing a "short" futures contract) would have to be at a lower price; e.g. 96. As in the case of any commercial transaction, the participant has a loss if the sale price is lower than the purchase price, or a gain if the sale price is higher than the purchase price.

2130.0.4.1 Variation Margin Calls

Variation margin calls for each contract and expiration month are based upon the closing futures exchange price. If there is a change from the previous day's closing prices, the long contract holders will be required to post additional margin which will be passed through via the clearing house process to short contract holders or vice-versa. Subsequent to the computation of variation margin calls, the clearing house member brokers are required to post variation margin on behalf of the clearing firm and its customer accounts prior to commencement of the next day's trading. Then, the clearing brokers call their FCM and public customers requesting more margin to bring the accounts up to the required maintenance margin level.[3] Of course, if a futures position has a gain at the end of the day, the clearing firm receives a deposit in its margin account. The firm, in turn, increases the margin account balances of customers holding contracts with gains.

For illustrative purposes, we will again assume that a customer purchased a futures contract (long contract, face value $100,000) at a price of 98. If the next closing futures price is 97, the customer will have suffered a one point margin loss (if the customer chose to offset the long contract with a short contract, the transaction would be closed out at a one point loss). Conversely, the party with a short contract executed at 98 would receive a one point margin payment to his account.

Assuming that the initial margin requirement is $1,500 and the variation margin requirement is $1,000, the following summarizes the steps followed in administering a customer's (long position) margin account in connection with the previously described transaction.

Transaction	*Margin Account Balance*
1. Deposit initial margin	$1,500
2. Purchase $100,000 contract @ 98	500
3. Day 1—Closing futures price 97 (Reduction of $1,000 in margin account to reimburse broker for posting margin with clearing corporation).	
4. FCM calls customer to request $1,000 to bring account up to required initial margin level.	
5. Reimbursement to FCM of $1,000	1,500

It is important to note that once the margin account balance falls below the variation margin level, the customer is required to deposit additional funds to replenish the account balance to

3. It should be noted that public customers generally have more time to meet maintenance margin calls than do FCMs. However, if a customer fails to meet a variation margin call within three days, the FCM must take a charge against its net capital if it fails to close out the customer's contract (17 C.F.R. 1.17(c)5(viii)).

the initial margin level. If there is a drop in the value of the contract which places the margin account balance below the initial margin level but above the variation margin level, the customer is not required to deposit additional margin monies. Alternatively, if there is a positive flow of margin monies the customer is free to withdraw any amount which exceeds the initial margin requirement.

The entire marking-to-the-market process is repeated at the close of the next business day using a comparison of the previous day's closing price (97) to the current closing price. (The preceding example is simplified because it implies that the customer deposits promptly the required margin. In reality, margin is not always deposited so quickly.)

In summary, futures trading is a "zero sum game" because of the equal number of long and short contracts outstanding, and the variation margin payments reflect this fact, i.e. for every long contract holder posting variation margin, there is a short contract holder receiving margin.

2130.0.5 THE DELIVERY PROCESS

Futures contracts are defined as "standardized contracts traded on organized exchanges to purchase or sell a specified financial instrument or physical commodity on a future date at a specified price." Even when a participant keeps a contract open for delivery, the "specified price" (which corresponds to a specified yield) is actually obtained through a combination of past futures market gains or losses (incurred through the daily mark to market process) and the current futures market price. For invoicing purposes, the actual delivery price is based upon a closing futures market "settlement price" on a date designated by the exchange. In addition, the final calculation of a delivery price on a bond contract will typically involve an adjustment reflecting the fact that the coupon issue to be delivered against the contract grade (8 percent) futures contract is not an 8 percent bond. For example, when current U.S. treasury bond coupons are 12 percent it is highly unlikely that a party with a short futures position would deliver a bond with an 8 percent coupon.

2130.0.6 MECHANICS AND OPERATION OF FUTURES EXCHANGES

Certain technical factors should be noted with respect to futures markets. First, futures markets are not totally free markets. Rules of the exchanges put artificial constraints—daily price movement limits—upon the amount of daily market movement allowed in given types of futures contracts. For example, government securities prices in the cash market will move as far as the market participants deem necessary to reflect the "market" for those securities, while the futures market specifying delivery of the underlying security will be constrained from having the same potential unlimited market movement. There have been instances where persons desiring to close out a futures contract by executing an offsetting contract have been unable to do so for one or more days until the exchange's daily trading limits allowed futures prices to "ratchet" up or down to the level that reflected the true "market" price as perceived by hedgers, speculators, and arbitragers.

Although the preceding illustrates the basic nature of futures price movements, do not assume that futures and cash market prices always move in the same direction at the same velocity. Futures prices by definition predict future events, e.g., a market participant can buy a futures contract to take delivery of a three month Treasury bill two years in the future.[4] In such an instance, the holder of a long T-bill futures contract agrees to the future purchase of a government security which has not yet been issued. There is no reason to assume that a contract with a distant maturity will move in the same manner as the cash market for a three month Treasury bill. In addition, there is a relationship between the cash market price of an existing security and the price of that security in the futures market which is called the basis. The basis can vary significantly over the life of a given futures contract. In the contract delivery month, the futures market price will converge towards the cash market price (the basis approaches zero), adjusted for technical factors that reflect the costs of processing and delivering securities. If the futures market price did not converge towards the cash market price in the delivery month, the arbitragers would take offsetting futures and cash market positions to arbitrage away any profitable discrepancies between the two markets.

4. All financial futures contracts have a number of contract expiration months extending into the future. As the near term contract expires, a contract with a more distant expiration date is added.

2130.0.7 COMPARISON OF FUTURES, FORWARD, AND STANDBY CONTRACTS

Excluding the fact that futures contracts are traded on organized exchanges, there are many similarities between contracts. Conceptually, the contracts are interchangeable; each type of contract can be utilized for hedging, speculating, or arbitrage strategies, but none of the contracts are transferable to third parties. While engaging in contract activities allows the participants to either assume or shift the risks of interest rate changes associated with the security deliverable under the contract, such contracts fail to provide the other benefits of owning the underlying security. Specifically, financial contracts do not pay interest, do not have a U.S. government guaranty of payment of principal at maturity, and cannot be pledged to secure public deposits or be used as collateral for repurchase agreements. The forward markets are perceived to be delivery markets wherein there is a high percentage of delivery of the underlying security.

As in the case of other futures markets, the financial futures markets were not designed to be delivery markets. Nevertheless, there have been a number of instances when a relatively high percentage of financial futures contracts have resulted in delivery. Some persons suggest tax reasons and the deliverable supply of securities as two factors that have contributed to the much higher delivery of securities than delivery of physical commodities. It is, of course, also easier and cheaper to make delivery of securities rather than railroad carloads of grain.

Trading units on futures exchanges are standardized. The standardized trading unit in a physical commodity which may be a railroad car of grain; the typical trading unit in a government or agency security futures contract may be $100,000 or $1 million par principal at a coupon rate (on coupon issues) fixed by the exchange. On the other hand, forward and standby contracts are not traded in standardized units with given contract maturity months. Instead, forward and standby contracts are custom made to suit the needs of the two parties to the transaction.

While all contract holders are involved with market risks, the holders of forward and standby contracts are especially prone to credit risk. Unlike futures contracts where the mechanics of exchange trading provide for the futures exchange clearing association to guaranty performance of each contract, forward and standby contracts are only as good as the entity on the other side of the contract. Anyone who reads the financial press should be aware that prior to the passage of the Government Securities Act of 1986, there were a number of defaults involving forward and standby contracts. In an effort to bring increased integrity into the unregulated forward contract markets, there has been a trend by some of the major securities dealers to require the posting of margin in connection with forward contract trading. There are no uniform margin requirements governing all aspects of forward contract trading, nor is there a uniform application of margin requirements by dealers requiring ‘‘house’’ margin (or internal margin requirements established and enforced by individual securities dealers). GNMA has established limited margin requirements (24 C.F.R. 390.52), as described below.

2130.0.8 OPTION CONTRACTS

Subsequent to the Board’s initial adoption of a policy statement governing futures, forward, and standby contracts, trading of interest rate options began on organized futures and securities exchanges. Proponents of exchange traded options argue that such instruments are attractive to users because they permit the user to obtain down side price risk protection, yet benefit from favorable price movement. In contrast, futures and forward contracts allow the user to lock in a specific price, but the user must forgo future participation if the market should experience an upward price movement. Furthermore, the purchaser of an option pays a one time premium for this protection and is spared the contingent liabilities associated with futures margin calls.

An option is a contract that gives the buyer, or holder, the right, but not the obligation, to buy or sell a specified financial instrument at a fixed price, called the exercise or strike price, before or at a certain future date. Some options, however do not provide for the delivery of the underlying financial instrument and, instead, are cash settled. Moreover, in some cases, the underlying financial instrument is an index. Options that can be exercised before or at the expiration date are referred to as American options; if an option can be exercised only on the expiration date, it is termed a European option.

There are two basic types of options: calls and puts. The *call option* is any option which obligates the writer to deliver to the buyer at a set price (exercise or strike price) within a specified time limit the underlying financial instrument. When the market price of the underlying instrument is above the exercise (strike) price of the call, the call option is "in-the-money." Conversely, when the market price of the underlying financial instrument is below the exercise (strike) price of the call option, the call is "out-of-the-money." When the market price of the underlying instrument is equal to the strike price, the option is "at-the-money." At expiration, the buyer will exercise the option if it is "in-the-money" or let it expire unexercised if it is out-of-the-money. An out-of-the-money call option has no value at expiration, since buyers will not purchase the underlying instrument at a price above the current market price. Prior to expiration, the value of an "in-the-money" call option is at least equal to the market value of the underlying instrument minus the strike price. The ownership of a call provides significant leverage, but raises the breakeven price relative to ownership of the underlying instrument. Holding the call limits the amount of potential loss and offers unlimited potential for gains.

A *put option* gives the buyer the right, but not the obligation, to *sell* the underlying instrument at a specified price (exercise or strike price), before or at expiration. When the market price of the underlying instrument is below the strike price of the put option, the put is "in-the-money," and a put option is out-of-the-money when the market price of the underlying financial instrument is above the strike price of the put option. Ownership of a put option offers leveraged profitability if the market value of the underlying instrument declines.

Some portfolio managers commonly employ "covered" call writing strategies to gain fee income from options written on securities held in the portfolio. If an option position is covered, the seller owns the underlying financial instrument or commodity or has a futures position. For example, an option position would be "covered" if a seller owns cash market U.S. Treasury bonds or holds a long position on a Treasury bond futures contract. Writing "covered calls" has only limited potential for gain. Writing "covered calls" is not a proper strategy for a market that could rise or fall by substantial amounts. It is generally used in a flat market environment.

Referring to the above example, if a seller holds neither the cash market U.S. Treasury Bonds or was not long on the Treasury bond futures contract, the writer would have an uncovered or "naked" position. In such instances, margin would be required (by the exchange, if an exchange traded option—not the case for an OTC option) since the seller would be obligated to satisfy the terms of the option contract if the option buyer exercises the contract. The risk potential for loss in writing "naked calls" (calls against which there are no securities held in portfolio) is great since the party required to deliver must purchase the required securities at current market prices. Naked "covered call" writing is generally viewed to be speculative since the risks are theoretically unlimited, particularly if it is done solely to generate fee income.

Options are purchased and traded either on organized exchanges or in the over-the-counter (OTC) market. Option contracts follow three-month expiration cycles (example: March/June/September/December). The option contracts expire on the Saturday following the third Friday in the expiration month. Thus, options are considered as "wasting assets" because they have a limited life since they expire on a certain day, even though it may be weeks, months, or years from now. The expiration date is the last day the option can be exercised. After that date the option is worthless.

Option premium valuation. The price (value) of an option premium is determined competitively by open outcry auction on the trading floor of the exchange. The premium value is affected by the inflow of buy and sell orders reaching the exchange floor. The buyer of the option pays the premium in cash to the seller of the option which is credited to the seller's account. Several factors affect the value of an option premium, as discussed below. The option premium consists of two parts, "intrinsic value" and "time value." *The intrinsic value* is the gross profit that would be realized upon immediate exercise of the option. Stated another way, it is the amount by which the option is in-the-money. It is the higher of: the value of an option if it is exercised today; or zero. For "in-the-money" *call* options, it is the difference between the price of the underlying financial instrument, and the exercise (strike) price of the option. For "in-the-money" *put* options, it is the difference of the exercise (strike) price of the put option and the price of the underlying financial instrument. The intrinsic value is zero for "at-the-money" or "out-of-the-money" options. The *time value* derives from the chance that an option will gain intrinsic value in the future or that its intrinsic value will increase before maturity of the contract. Time value is determined by subtracting intrinsic value from the option premium. For example,

Time value = Option premium − Intrinsic values

Time value = 5–10/64 − 4.00

Time value = 1.15384

The option premium is affected by several other factors. One factor involves the comparison of the underlying futures price versus the strike price of the option. An option's price is increased the more that it is in-the-money. A second factor is volatility. Volatile prices of the underlying financial instrument can help stimulate demand for the options, thus increasing the premium. A third factor that affects the premium of an option is the time until expiration. Option premiums are subject to greater price fluctuations because the underlying value of the futures contract changes more with a longer time period. Other factors that affect the option premium are the strike rate(s) and the domestic and foreign (if applicable) interest rates.

An exchange-traded option is often referred to as a ''standardized'' option, reflecting the fact that the terms of the contract are uniform with respect to the underlying instrument, amounts, exercise prices, and expiration dates. OTC options are characterized by terms and conditions which are unique to each transaction. Large financial institutions are often dealers in customized interest rate or foreign exchange options. For example, a banking organization might write a ''cap,'' or series of put option on pounds sterling to protect the dollar value of a sterling denominated receivable due in one year. In this case, an option can be tailored to fit the exact needs of the buyer.

Like futures contracts, contract performance on exchange-traded options is guaranteed by the clearing corporation which interposes itself as a central counterparty to all transactions. It substitutes itself as a seller to all buyers and as a buyer to all sellers. Standardization combined with the clearing corporation's guarantee facilitates trading and helps to insure liquidity in the market. The buyer or seller of an exchange-traded option may always close out an open position by entering into an offsetting transaction, with the same strike price and expiration date, and for the same amount. Indeed, most exchange-traded options are liquidated prior to maturity with an offsetting transaction, rather than by exercising the option in order to buy or sell the underlying instrument.

Buyers of exchange-traded options are not required to post funds to a margin account because their risk is limited to the premium paid for the option. However, writers (sellers) of options are required to maintain margin accounts because they face substantial amounts of risk. The amount of the margin varies depending upon the volatility in the price of the option. As the option moves closer and closer to being in-the-money, the writer is required to deposit more and more into his margin account, in order to guarantee his performance should the option eventually be exercised.

Options on futures contracts provide the holder with the right to purchase (call) or sell (put) a specified futures contract at the option's strike price. The difference between the strike price on the option and the quote on the futures contract represents the intrinsic value of the option. Options on futures contracts differ from traditional options in one key way: the party who exercises an option on a futures contract receives a long or short futures position (depending on whether he is exercising a call or put option) rather than accepting or making delivery of the underlying security or financial instrument. When the holder of a call option on a futures contract exercises the option and the futures contract is delivered, the option writer must pay the option holder the difference between the futures contract's current value and the strike price of the exercised call. The buyer takes on a long position, and the writer a short position in the futures contract. When a futures put option is exercised, the holder takes on a short futures position, and the writer a long position. The writer of the put pays the holder the difference between the current price of the futures contract and the strike price of the put option. The resultant futures position, like any other futures position, is subject to a daily marked-to-market valuation. In order to liquidate the futures position, both the buyer and the seller must undertake offsetting futures transactions.

2130.0.8.1 Other Option Contracts

2130.0.8.1.1 Stock Index Options

A stock index option is a call or a put that is based on a stock market index such as the S & P 500. As opposed to a regular call or put option on equity securities where there must be a sale and delivery of shares of stock, there is no delivery of the underlying instrument when an index option is exercised. Rather, settlement is in cash.

2130.0.8.1.2 Foreign Currency Options

The right to buy (call) or sell (put) a quantity of a foreign currency for a specified amount of the domestic currency is a foreign currency option. The size of the contract is standard for each currency. The contracts are quoted in cents per unit of foreign currency. As an example, one call option for the British pound is 12,500 pounds.

2130.0.8.2 Caps, Floors, and Collars

Caps, floors, and collars provide risk protection against floating interest rates. The market for these products is an outgrowth of the OTC market in fixed income (bond) options.

An interest rate cap contract pays the buyer cash if the short term interest index rises above the strike rate in the contract in exchange for a fee. In combination with a floating rate obligation, it effectively sets a maximum level on interest rate payments. If market rates are below the cap rate, no payments are made under the cap agreement. Thus, the buyer of a cap is able to place a ceiling on his floating rate borrowing costs without having to forego potential gains from any decline in market rates.

Cap agreements typically range in maturity from 6 months to as long as 12 years, with reset dates or frequencies that are usually monthly, quarterly, or semiannual. The London Interbank Offered Rate (LIBOR) is the most widely used reference rate for caps, floors, and collars. Other indexes used as reference rates are commercial paper rates, the prime interest rate, Treasury bill rates, and certain tax-exempt rates. Cap fees depend upon the cap level, the maturity of the agreement, the volatility of the index used as the reference rate, and market conditions. The higher the cap rate, the lower the premium. The fee is usually paid up front, but can be amortized.

An interest rate floor agreement is used to protect the overall desired rate of return associated with a floating-rate asset. In accordance with the agreement, the seller receives a fee for the floor agreement from the holder of the underlying asset. When interest rates fall, the holder of the floor contract is protected by the agreement, which specifies the fixed per annum rate (floor rate) that will be retained on those assets, at specified times during the life of the agreement, even though floating interest rates may decline further.

An interest rate collar is a variation of a cap-only agreement. Under this arrangement the seller of the collar, for a fee, agrees to limit the buyer's floating rate of interest within one agreement by a simultaneous sale of a cap and purchase of a floor, or purchase of a cap and sale of a floor. When the reference rate is above the cap rate the seller makes payments to the buyer sufficient to return the buyer's floating rate interest cost to the cap rate. Conversely, the buyer makes payments to the collar provider to bring its rate back to the floor whenever the reference rate falls below the floor rate. In effect, under a collar agreement the buyer is selling a string of call options (the floor) back to the provider of the cap. The premium received from selling the floor reduces the overall cost of the cap to the buyer of the collar. Thus, the premium for a floor/ceiling, or collar, agreement, is lower than for a cap-only agreement with the cap at the same level. This is because the floor sold to the provider of the collar has a certain value, which is passed along to the buyer in the form of a lower premium.

The disadvantage to collars, of course, is that they limit the buyer's ability to profit from declines in market rates below the specified floor. Clearly, one's interest rate expectations play an important role in determining whether or not to use a collar agreement. It should also be noted that collar agreements involve credit risk on both sides of the agreement, similar to the credit risk considerations found in interest rate swap agreements. The buyer of the collar is exposed to the risk that the provider may default on payments due under the cap agreement; and the provider of the collar is exposed to the risk that the buyer may default on payments due under the floor agreement.

2130.0.9 REGULATORY FRAMEWORK

GNMA has adopted limited margin requirements. Specifically, the GNMA margin requirements (12 C.F.R. 390.52) require marking-to-market and the posting of maintenance margin.[5] However, the GNMA margin requirements exclude the majority of GNMA forward contracts and only pertain to contracts involving GNMA issuers with other parties.[6]

The Commodities Futures Trading Commission (''CFTC'') is the agency authorized by Congress to supervise the trading of ''commodities,'' including financial futures. Exchanges which trade commodities must register with the CFTC. In addition, the various futures exchanges must receive CFTC approval before they can begin trading a new futures instrument. Brokers and dealers who execute futures contracts for customers must register as Futures Commission Merchants (''FCM'') with the CFTC. There are also CFTC registration requirements pertaining to firms engaging in commodities activities similar to an investment advisor or mutual fund in the securities markets. Finally, the surveillance activities of the various futures exchange examiners are subject to oversight by the CFTC.

With the exception of reporting requirements concerning persons or entities with large futures positions, the CFTC's jurisdiction generally does not extend to financial institutions. Rather, the federal and state banking agencies, state insurance commissions, and the Office of Thrift Supervision are responsible for supervising regulated entities' future activities, if permitted, under statute or regulation.

2130.0.10 EXAMPLES OF CONTRACT STRATEGIES

For purposes of reporting large positions to the CFTC a market participant defines its future activities as ''speculative'' or as ''hedging.'' Basically, CFTC rules consider a participant to be a hedger if certain facets of such person's business can be hedged in the futures markets; persons who do not have a business need for participating are deemed to be speculators. It is anticipated that bank holding companies characterize their contract activities as ''hedging'', or possibly as arbitrage between various markets. Examiners must scrutinize contract positions for purposes of evaluating risk.

The Board policy statement concerning bank holding companies[7] states:

> ''. . . the Board believes that any positions that bank holding companies or their nonbank subsidiaries take in financial contracts should reduce risk exposure, that is, not be speculative.'' It should be noted, however, that a more liberal interpretation of the policy statement has been permitted for dealer subsidiaries. For example, in a government securities dealer subsidiary, it is permissible to use related financial contracts as a substitute trading instrument for cash market instruments. Thus, the use of financial contracts is not limited solely to reducing the risk of dealing activities.

Some examples of contract strategies are provided which reduce risk when viewed in isolation. A definition of a financial hedge is:

> ''to enter transactions that will protect against loss through a compensatory price movement.''

In looking at a hedge transaction in isolation, there should be certain elements present to make a hedge workable:

1. The interest rate futures or forward contract utilized should have a high positive correlation (prices that tend to move in the same direction with similar magnitude) with the cash position being hedged. In other words, the futures or forward position taken should be structured so that an upward price movement in the contract offsets a downward price movement in the cash or risk position being hedged, and vice versa.
2. The type (e.g. T-bill, T-bond, etc.) and size of the contract position[8] taken should have a proportionate relationship to the cash or risk position being hedged, so that futures gains (losses) will approximately offset any losses (gains) on the hedged position.

5. Initial margin requirements necessitate the pledging of something of value prior to initiation of a transaction. Depositing maintenance margin refers to pledging something of value in reaction to market movements; e.g. depositing cash representing the difference between a forward contract price and its current market value.

6. See SR-625 dated July 23, 1980.

7. The Board's policy statement on engaging in futures, forwards, and option contracts.

8. Futures market participants engage in a practice, sometimes known as ''factorweighting'' or ''overhedging,'' to determine the appropriate number of futures contracts necessary to have the proper amount of compensatory price movement against a hedged cash or risk position. For example, it would require 10 mortgaged-backed futures contracts (8% coupon, $100,000 face value) to hedge an inventory of $1,000,000 mortgage-backed (8% coupon) securities. Alternatively, 14 mortgage-backed futures contracts would be required to hedge a $1 million inventory of mortgage-backed securities with a 13½% coupon. Overhedging or factor weighting is necessary in hedging securities with higher coupons than those specified in futures contracts (currently 8% on bond futures) because higher coupon securities move more in price for a given change in yield than lower coupons.

3. The contract position taken should have a life which is equal to or greater than the end of the period during which the hedge will be outstanding. For example, if interest rate protection was deemed necessary for a six-month time span, it would not ordinarily be wise to enter a contract expiring in three months.

2130.0.10.1 The Mortgage Banking Price Hedge

Assume that a mortgage banking subsidiary agrees in June to originate mortgages at a fixed yield in the following October. Unless the loan originator has a forward commitment to sell the loans to a permanent investor(s), it is exposed to a decline in the principal value of mortgages due to a rise in interest rates between the commitment date and ultimate sale of the loans. An example of a traditional "short hedge" would be the sale of futures contracts in an attempt to reduce the risk of price fluctuation and insure a profitable sale of the loans. However, in following this strategy the mortgage originator also chooses to forfeit its ability to reap a profit if interest rates should fall.

If interest rates increased, the loss on the sale of mortgages or a pool of mortgage-backed securities will probably be largely offset by a gain on the futures transaction; see example below. If interest rates fall, the mortgage originator would gain on the resale of mortgages but lose on the futures market transaction. Hence, in a true hedge, the hedger's earnings are relatively unaffected by a change in market interest rates in either direction.

Generally accepted accounting principles applicable to mortgage activity require that mortgages held for resale be periodically revalued to the lower of cost or market (Financial Accounting Standards Board Statement No. 65, "Accounting for Certain Mortgage Banking Activities"). Unrealized gains and losses on outstanding futures contracts are matched against related mortgages or mortgage commitments when the inventory is revalued to the lower of cost or market; i.e. the lower of cost or market valuation is based upon a net figure including unrealized related futures gains and losses.

2130.0.10.2 Basis

Basis is the difference between the cash (spot) price of a security (or commodity) and its futures price. In other words:

$$\text{Basis} = \text{Spot price} - \text{Future price}$$

For short-term and intermediate futures contracts, the futures price is the quoted futures price times an appropriate conversion factor. For short-term futures contracts the quoted futures price is 100 less the annualized futures interest rate. The invoice price must be determined using yield-to-price conventions for the financial instrument involved.

Basis may be expressed in terms of prices. Due to the complexities involved in determining the futures price, it is thus better to redefine price basis using actual futures delivery prices rather than quoted futures prices. Thus, the price basis for fixed income securities should be redefined as:

$$\text{Price Basis} = \text{Spot price} - \text{Futures delivery price.}$$

Basis may also be expressed in terms of interest rates. The *rate basis* is defined as:

$$\text{Rate basis} = \text{Spot rate} - \text{Futures rate}$$

The spot rate refers to the current rate on the instrument that can be held and delivered on the contract. The futures rate represents the interest rate that corresponds to the futures delivery price of the deliverable instrument.

The rate basis is useful in analyzing hedges of short-term instruments since it nets out all effects resulting from aging. For example, if a one year T-bill has a rate of 9 percent with a price of 85, and a 3-month T-bill has a rate of 9 percent and a price of 94, the price basis would be −9. If a cash security ages, it does not necessarily mean that a change in the rate basis has taken place.

2130.0.10.3 Trading Account Short Hedge

Another example of a short hedge pertains to securities dealers that maintain bond trading accounts. While bonds are held "long" (actually owned by the dealer) in trading accounts, dealers are subject to two risks. First, there is the risk that the cost can change regardless of whether the funds are generated through repurchase agreement financing or the dealer's other funding sources. When there is an inverted yield curve (short-term interest rates are higher than long-term rates), trading portfolio bonds in inventory yield less than the cost of funds required to carry them. Second, there is the risk that bond market interest rates will rise, thus forcing the dollar price of bonds down.

2130.0.10.3.1 Example 1: A Perfect Short Hedge[1]

Month	*Cash Market*	*Futures Market*
June	Mortgage department makes commitment to a builder to originate $1 million of mortgages (based on current GNMA 8's cash price) at 98-28⁄32 for $988,750	Sells 10 December mortgage-backed futures at 96-8⁄32 for $962,500 to yield 8.59 percent
October	Mortgage department originates then *sells* $1 million of pooled mortgages to investors at a price of 95-20⁄32, for $956,250	Buys 10 December mortgage-backed futures at 93, for $930,000 to yield 8.95 percent
	Loss: $32,500	Gain: $32,500

1. The effects of margin and brokerage costs on the transaction are not considered. It should be noted that "perfect hedges" generally do not occur.

The following example pertains to a bond trading account. Assume that the dealer purchases Treasury bonds on October 4 and simultaneously sells a similar amount of Treasury bond futures contracts. The illustration ignores commission charges and uses futures contracts maturing in March 19x9 because the dealer's technical analysis discovered an advantage in using the March 19x9, rather than the previous December contract as a hedge. (At that time the previous December contract was the next available contract still trading.)

	Cash Market		*Futures Market*	
10/04/1998	Purchase $5MM T-bonds maturing Aug. 2005, 8% coupon at 87-10⁄32:		Sell $5MM T-bonds futures contracts expiring Mar. 1999 at 86-21⁄32:	
	Principal =	$4,365,625	Contract value =	$4,332,813
10/23/1998	Sell $5MM T-bonds at 79.0:		Buy $5MM T-bond futures Mar. 1999 at 79-1⁄32	
	Principal =	3,950,000	Contract value =	3,951,563
	Cash loss =	($415,625)	Futures gain =	$381,250

Although the hedge did not prevent the dealer's trading account from losing money, it limited the loss to $34,375 instead of $415,625.

It is worth noting that the preceding example also illustrates some of the dangers of using interest rate futures contracts. Although the futures market proved useful to the trading department, a futures contract could have serious consequences for a dealer using an alleged "long hedge to lock-in an attractive yield."

2130.0.10.4 Long Hedge

In certain areas of the country, financial institutions desiring to hold public deposits are required to bid competitively for deposits. The case discussed below pertains to a situation where the competitive bids must be tendered one calendar quarter in advance of receiving the deposit. In this example, the asset side of the balance sheet is not discussed since it is assumed that a banking organization paying the prevailing one-year C.D. interest rate can utilize the funds at a profitable spread.

In this type of situation the bidding institutions are generally vulnerable to falling interest rates; one can safely assume that an institution selected to hold public deposits would not be dismayed to learn subsequently that interest rates had risen and it had locked-in a funding source at or below market rates. However, the funds will not be received for another 3 months. Thus, there is the possibility that interest rates could drop in the interim, leaving a reduced or possibly negative net interest margin when the funds are deployed.

There are a number of approaches available to attempt to ensure that future time deposits can be obtained without paying higher than market interest rates. One method is forecasting the appropriate interest rate to be paid on a given time deposit three months in the future. However, forecasting has become increasingly difficult to do with accuracy in the recent periods of fluctuating interest rates. An alternative approach would be to quote the current C.D. rate (adjusted slightly for competitive factors) with an intent to hedge in the futures market if the banking organization's interest rate bid is accepted. Upon receiving notification that its deposit bid has been accepted, the institution can then purchase an appropriate number of futures contracts to insure a profitable investment spread three months hence when it actually receives the deposit.

The following example on June 1, 19x0; the facts are as follows:

Size of public deposits offered	$10 million
Date of deposit	September 2, 19x0
Term	1 year
Current C.D. rate	8¼%

For purposes of this illustration, assume that a bid was submitted to pay 8¼% for one year on $10 million. The bids were due June 1 and notification was given June 2 of the intention to provide the funds on September 2; and the banking organization decided to purchase futures contracts on June 2.

A Treasury bill futures contract, expiring in 3 months, is selected as the hedging vehicle because it reflects price movement of an instrument with a comparable maturity to one-year C.D., and there was no C.D. futures contract trading. For purposes of this illustration, it is assumed that the contract offers sufficient liquidity to enable the banking organization to readily offset its open futures position when necessary. Using the bill contract is an example of "cross hedging" which is defined as the buying or selling of an interest rate futures contract to protect the value of a cash position of a similar, but not identical, instrument. This type of hedging is a measured risk since the outcome of such a transaction is a function of the price correlation of the instruments being hedged. At any given moment it is conceivable that a negative correlation could exist between two unlike instruments; despite the presence of a strong correlation over an extended time period.

Date	*C.D. Rate*	*Transactions*	*T-bill*	*Futures* [1]
June 2, 19x0	8.25%	Purchase 40 Contracts	91.84	8.16%
Sept. 2, 19x0	11.00%	Sell 40 Contracts	90.05	9.95%

1. The size of the trading unit is based upon U.S. T-bills having a face value at maturity of $250,000 (40 × 250M = 10MM). Prices are quoted in terms of an index representing the difference between the actual T-bill yield and 100.00. Every one basis point movement on a contract is equal to $25.00 per contract.

2130.0.10.4.1 Evaluation of the Hedge

Total interest (not compounded) to be paid (8¼%)	$ 825,000
Alternative C.D. interest (not compounded) at current rate (11%)	1,100,000
Difference	275,000
Futures trading loss*	(179,000)
Net difference	$ 96,000

*Computation—Purchase price 91.84
Sale price 90.05
1.79 or 179 basis points
(179 × $25.00 × 40 contracts = $179,000)

In retrospect, it would have been better if the banking organization would not have hedged. By agreeing to an interest rate on June 2, it obtained deposits on September 2 and will pay approximately $275,000 less in interest payments to the municipality than is required on an ordinary C.D.(s) issued on September 2. The $179,000 futures trading loss, of course, reduced the windfall interest income due the banking organization. A net interest income spread of approximately $96,000, instead of a $275,000, demonstrates two principles: 1) cross hedging can cause unexpected results; and 2) it is quite difficult to find perfect hedges in the real world. The hedge was structured so that a cash gain was offset by a futures loss—incorporating the offsetting principles of a hedge transaction. If the general level of interest rates had fallen, a futures gain should have occurred to offset the higher (relative to prevailing market rates) cost of funds obtained on September 2.

2130.0.10.5 Using Options to Create an Interest Rate Floor

Assume that on September 28th it is decided to rollover a $1,000,000 investment in 13-week Treasury bills on November 28, which also happens to be the expiration date for call options on the December Treasury bill futures contract. The banking organization, concerned that interest rates will fall between September 28 and the rollover date, wishes to hedge the rollover of its investment. The portfolio manager can set a minimum yield on the rollover investment by either buying a Treasury bill future call option, or by buying a Treasury bill futures contract. Further assume that the December Treasury bill futures contract can be bought for a price of 93.70 which implies a discount yield of 6.30 percent. Treasury bill futures call options with a strike price of 93.75, implying a discount yield of 6.25 percent, sell for a premium of 20 basis points, or $600 (20 basis points × $25/basis point = $500).

If the banking organization could actually buy a Treasury bill futures contract that expired on exactly November 28, then there would be a perfect hedge since the rate of return on the bills would be explicitly fixed by the futures hedging strategy. However, the closest maturing Treasury bill futures contract expires in December, several weeks after the rollover date for the banking organization's investment. Uncertainty over the actual discount yield of the Treasury bills on the rollover date and the yield produced by the hedge is known as "basis risk," the risk that the yield on the hedge may differ from the expected yield on the hedged item. For purposes of this example, assume that the yield on the futures contract equals the actual discount yield on the 13-week Treasury bills at the rollover date. Thus, the futures hedge in this example will provide an effective discount yield of 6.30 percent on the rollover of the 13-week Treasury bill investment.

Assume that rates fall after September 28 and that the discount yield on Treasury bill futures contracts declines from 6.30 percent to 6.00 percent at the November 28 expiration date of the December Treasury bill futures options contract. The option to buy the Treasury bill futures will be exercised since the strike price of 93.75 is below the market price of 94.00 for the underlying futures contract, yielding a profit of 25 basis points or $625 (25 basis points × $25/basis point). The profit must be offset by the 20 basis point cost of the option, which reduces the net profit to 5 basis points. The effective hedged discount yield is 6.05 percent (6.00 percent on the 13-week Treasury bills—assuming no basis risk—plus the 5 basis point profit from the hedge). The option hedge produces a yield that is 5 basis points higher than the unhedged yield, but 25 basis points lower than the 6.30 percent yield that would have resulted from hedging with futures.

Although the option hedge resulted in a lower effective yield than the futures hedge, it set an absolute floor on the investment. This is because any decline in the discount yield of the Treasury bills below 6.05 percent would be offset dollar for dollar by the additional profits from the hedge. The real advantage of the option hedge is that, although it establishes a floor that is lower than the rate fixed by the futures hedge, it allows the hedger to participate in any increase in interest rates above the cost of the call premium. For example, if interest rates increased such that the price on the December Treasury bill futures contract on November 28 falls to 93.00, implying a discount yield of 7.00 percent, the option would expire unexercised since the strike price is above the price of the underlying futures contract. Again, assuming that the spot price for the 13-week Treasury bills is equal to the futures price, the effective discount yield is 6.80 percent (7.00 percent minus the 20 basis point call option premium), 50 basis points higher than the yield that would have been provided by the futures hedge.

2130.0.10.6 Hedging a Borrowing with an Interest Rate Cap

In order to limit a borrower's interest rate risk, sophisticated banking institutions may offer cap agreements as part of a loan package to their clients. While such an arrangement provides some comfort that the borrower's ability to repay will not be jeopardized by a sharp increase in interest rates, it obviously transfers that interest rate risk back to the lender. Nevertheless, many banking institutions feel they are better able to manage that risk than are some of their clients. Cap agreements have also been utilized to cap the rate on issued liabilities. For example, an institution might be able to issue medium-term floating rate notes at 3-month LIBOR plus an eighth of a percent. Alternatively, that institution could issue a capped floating rate note at 3-month LIBOR plus three-eights of a percent. By subsequently selling the cap separately back into the market the institution could, achieve sub-LIBOR funding, depending on the proceeds from the sale of the cap.

A cap agreement is typically specified by following terms: notional principal amount; maturity; underlying index, frequency of reset, strike level. As an illustration, a cap agreement might have the following terms:

Notional Principal Amount	$10,000,000
Maturity	2 Years
Underlying Index	3-month LIBOR
Rate Fixing	quarterly
Payment	quarterly, in arrears, on an actual/360-day basis
Cap Level	9%
Up Front Fee	1.11% of par ($111,000)

Under the terms of this agreement, if at any of the quarterly rate fixing dates 3-month LIBOR exceeds the cap level then the seller of the cap would pay the buyer an amount equal to the difference between the two rates. For example, if at a reset date LIBOR was set at 10 percent, the payment would be:

10%(90/360 × $10,000,000)

–

9%(90/360 × $10,000,000)

=

$25,000

Thus, the writer of the cap would pay the buyer $25,000. If 3-month LIBOR for the quarter were set at or below the cap level of 9 percent, no payment would be made.

2130.0.11 ASSET-LIABILITY MANAGEMENT

Financial contracts can be used as a tool in an overall asset-liability management strategy. In order to use financial contracts in this context, a BHC or nonbank subsidiary must first identify where interest-rate exposure lies as indicated by mismatches between asset and liability structures. In those instances where the BHC or nonbank subsidiary has variable-rate assets and variable-rate liabilities with comparable maturities, there is, in theory, no need to hedge with financial contracts since that portion of the asset-liability structure is already hedged. The same holds true for fixed-rate assets and liabilities (yielding a positive interest-rate margin) of comparable maturities. Once a BHC or nonbank subsidiary has identified the undesired mismatches in assets and liabilities, financial contracts can be used to hedge against the identifiable mismatch—for example, long positions in contracts can be used as a hedge against funding interest-sensitive assets with fixed-rate sources of funds, and short positions in contracts can be used as a hedge against funding fixed-rate assets with interest-sensitive liabilities.

BHCs or nonbank subsidiaries that choose to employ financial contracts as a tool in their general asset-liability management program and properly use financial contracts are striving towards worthwhile goals. The discipline of identifying mismatches between assets and liabilities tends to focus the practitioner's attention on the entire balance sheet. Examiners should be aware that marketing efforts on behalf of the futures exchanges have attempted to focus upon just one side of the balance sheet by "pairing" a futures contract with an asset or a liability. In considering financial-contract activities, examiners need to remember that financial-contract activities must be evaluated in light of both sides of a balance sheet.

One final point should be made with respect to “hedging” based upon pairing a futures contract against a portfolio security. Since this type of “hedging” can be done while considering only the asset side of the balance sheet, it is possible that such a strategy could increase interest-rate risk rather than reduce it. For example, assume (unrealistically) that there is a perfect balance between variable-rate assets and liabilities, and the firm is evaluating fixed-rate assets and liabilities. Management determines that there is a perfect balance between fixed-rate assets and liabilities and then isolates the last fixed-rate asset and liability. Make the further assumption that the organization holds a six-month note yielding 12 percent which is financed by funds maturing in six months which costs the organization 10.5 percent. By executing a short futures contract “paired” against the six-month note, the organization would move from an overall “hedged” position to an “unhedged” position. In other words, the futures contract would move the organization from an overall neutral position and expose the organization to interest-rate risk.

It should be evident why it is more productive to consider the “big picture” in inspections rather than focusing upon individual or “paired” (futures against each position) transactions. The most meaningful approach is to evaluate hedging strategies and open financial contract positions in light of its business needs, operations, and asset-liability mix.

2130.0.12 INSPECTION OBJECTIVES

1. To determine the purpose of financial-contract positions. Any positions that bank holding companies or their nonbank subsidiaries (except certain authorized dealer subsidiaries) take in financial contracts should reduce risk exposure, that is, not be speculative.
2. To determine whether prudent written policies, appropriate limitations, and internal controls and audit programs have been established and whether management information systems are sufficiently adequate to monitor risks associated with contracts involving futures, forwards, and options (including caps, floors, and collars).
3. To determine whether policy objectives concerning the relationship of subsidiary banking organizations and the parent bank holding company specify that each banking organization in a holding company system must be treated as a separate entity.
4. To determine reporting compliance in accordance with the Board’s bank holding company policy statements. See section 2130.0.17 for the appropriate cites.

2130.0.13 INSPECTION PROCEDURES

The term “banking organization” is used generally to refer to a bank holding company, the parent company, or nonbank subsidiary.

1. Determine if the banking organization’s financial-contract activities are related to the basic business of banking.

   Consider whether the financial-contract activities are closely related to the basic business of banking; that is, taking deposits, making and funding loans, providing services to customers, and operating at a profit for shareholders without taking undue risks. Taking financial-contract positions solely to profit upon interest-rate forecasts is considered to be an unsafe and unsound practice. Profitability of contract activities is not the criterion for evaluating such activities. It is quite probable that a bona fide hedge strategy could result in a contract loss which would be offset by increased interest earnings or a higher price for an asset sold, for example, a pool of mortgages. Criticize contracts placed solely to profit upon interest-rate movements. Verify that contract activities are conducted in accordance with the Board’s policy statement. Where contract positions are of excessive size and could jeopardize the financial health of the entity under examination, the gains or losses realized because of financial-contract activities should be criticized.
2. Ascertain whether policy objectives highlight the circumstances under which financial contracts should be used.

   Determine whether management and operating personnel have received sufficient guidance. Carefully constructed policy objectives should be formulated with the knowledge that although proper utilization of financial contracts limits loss potential, such utilization also limits potentials for gains. Policy objectives should be formulated to limit required resources (margin monies, commissions, and personnel to execute, monitor, and audit contract activities). A well-constructed policy should be designed to preclude various operating areas of a banking organization from taking offsetting financial contract positions. Finally, there should be established benchmarks for determining whether financial contracts are meeting desired objectives.

3. Determine if policy objectives concerning the relationship of subsidiary banking organizations and the parent bank holding company comply with the Board's directives.

   Each banking organization in a holding company system must be treated as a separate entity. The policy statement accommodates centralized holding companies in that the holding companies are free to provide guidance to subsidiary banking organizations and execute contracts as agent on behalf of the banking organization, provided that each banking organization maintains responsibility for financial contract transactions executed on its behalf. Accordingly, a holding company that has centralized management could, and perhaps should, consider the interest-rate exposure of its subsidiary banks on a consolidated basis in determining whether future contracts can usefully be employed to reduce that exposure, but any future contracts that are executed must be recorded on the books and records of a subsidiary bank that will directly benefit from such contracts.

   The question concerning the relationship of a subsidiary bank to its holding company may also lead one to consider the relationship of a subsidiary bank with its correspondent bank or broker. One might also query to what extent may less sophisticated institutions rely upon brokers and/or correspondent banking organizations for advice in this area?

   Less sophisticated institutions can place only limited reliance on others for advice in this area. The bank holding company policy statement[9] emphasizes that responsibility for financial-contract activities rests solely with management. Additional information on securities transactions and the selections of securities dealers can be found in section 2126.1.

4. Ascertain whether policy objectives and/or position limits require prudence on the part of authorized personnel entering into these new activities. If discretion is left to senior managers, determine whether management has issued instructions to ensure that the level of financial-contract activity is prudent relative to the capabilities of persons authorized to execute and monitor contracts.

   A new activity such as financial contracts should, as a general rule, be entered slowly. In developing expertise, management should mandate a low level of activity until persons authorized to execute contracts gain sufficient expertise or until new personnel are employed that have sufficient training and experience to engage in financial-contract activities on a larger scale. Senior management must develop the expertise to understand and evaluate techniques and strategies employed to ensure that an experienced professional does not engage in improper or imprudent activities.

5. If a banking organization uses financial contracts as part of its overall asset-liability management strategy, determine whether the organization developed an adequate system for evaluating its interest-rate risk.

   Without a system for identifying and measuring interest-rate risk, it is impossible to engage in hedging activity in an informed and meaningful manner. Failure to identify the mismatches in the organization's asset-liability mix would make it difficult to select the proper number and types of financial contracts—for example, bond or bill financial contracts—to provide an appropriate amount of interest-rate-risk protection. Evaluate whether the organization's interest-rate-risk measurement techniques appear reasonable to determine whether the financial contracts employed were successful in providing the proper amount of futures gains (losses) to cover the hedged risk position.

6. Determine if the recordkeeping system is sufficiently detailed to permit personnel to document and describe in detail how financial-contract positions taken have contributed to the attainment of the banking organization's stated objectives.

   There is no universal, adequate recordkeeping system for this purpose. Examiners must evaluate each individual system relative to the organization's stated objectives and activities. If the recordkeeping system cannot be used to illustrate how financial contracts contributed to the attainment of the banking organization's stated objectives, the

9. The Board's policy statement on engaging in futures, forwards, and option contracts.

recordkeeping system is inadequate. BHCs with inadequate recordkeeping systems should be instructed to make appropriate modifications.

7. Ascertain whether the banking organization's board of directors has established written limitations with respect to financial-contract positions.

   NOTE: The bank holding company policy statement requires that the board of directors establish written policies and position limitations in connection with financial-contract activities. If a committee has been delegated similar responsibilities within the organization, and a committee makes the decision, its recommendation should be ratified by the board of directors.

8. If there is the potential to exceed the above limitations in certain instances, determine whether there are firm, written procedures in place concerning the authorizations necessary to exceed limits.
9. Determine whether the board of directors, a duly authorized committee thereof, or internal auditors review at least monthly financial-contract positions to ascertain conformance with limitations. (See item (b) of the bank holding company policy statement.)
10. Determine if the banking organization maintains general-ledger memorandum accounts or commitment registers to adequately identify and control all financial-contract commitments to make or take delivery of securities or money market instruments.
11. Determine if the banking organization issues or writes option contracts expiring in excess of 150 days which give the other party to the contract the option to deliver securities to it.

    Examiners should review the facts surrounding standby contracts issued by holding companies. Examiners should also review accounting entries connected with bank holding company standby contracts to determine whether standbys were issued to earn fee income "up front" and exploit the lack of generally accepted accounting principles.

12. Determine whether financial-contract positions are properly disclosed in notes to the statements of financial condition and income and that the contract positions have been properly reported on FR Y-9C, Schedule HC-F, "Off-Balance-Sheet Items."
13. Determine whether the banking organization has implemented a system for monitoring credit-risk exposure associated with various customers and dealers with whom operating personnel are authorized to transact business.

    All financial-contract trading involves market risks. However, forward and OTC options trading, as well as swap activities, also involve credit risk. The key concern is whether the contra party to a transaction will be ready, willing, and able to perform on contract settlement and payment dates. While maintaining control over credit-risk exposure should ensure that a financial organization will not enter excessive (relative to the financial condition of the contra party) forward or standby contracts, monitoring such exposure may not prevent default in all instances.

14. Ascertain whether the banking organization has implemented internal controls and internal audit programs to ensure adherence to written policies and prevent unauthorized trading and other abuses.
15. Determine if the Reserve Bank was notified at the inception of bank holding company futures, forward, and option activities as required by paragraph (f) of the holding company policy statement (*Federal Reserve Regulatory Service* 4–830).
16. Determine if the personnel engaged in financial-contract activities have sufficient knowledge and understanding of the markets to perform those functions.

2130.0.13.1 Evaluating the Risks of Contract Activities

Evaluating the organization's stated objectives and their effects on overall risk is a difficult task involving legitimate cause for concern because of the high degree of leverage involved in contract activities. Although there is an emerging trend towards dealers requiring margin on forward trades, forward contract transactions generally have not required margin deposits, and thus, grant users unlimited leverage. Although the amount of margin required for futures trades is extremely small (for example, \$1,500 initial margin to take a \$1 million futures position), the rules of the exchanges do require a daily mark to market and a requirement that members of the futures exchanges meet maintenance margin calls on behalf of their customers. Customers, of course, are generally required to promptly reimburse brokers for margin posted on their behalf.

Nevertheless, engaging in contract activities requires market participants to assume the market risks of either owning securities or ‘‘shorting’’ securities. Issuing (or selling) standby contracts granting the other party to the contract the option to deliver securities is a practice which results in the issuer functioning as an insurer against downside market risk for the other party; in essence, the party receiving the standby fee assumes all of the interest-rate risks of security ownership, but receives none of the benefits.

2130.0.13.2 Reviewing Financial-Contract Positions

The preceding questions were designed to focus the examiner's attention on a bank holding company's stated objectives for engaging in financial contract activities and the manner in which such activities are conducted. It is also vital to review position records with respect to financial contracts or, if necessary, prepare a schedule grouping similar contracts by maturity. Once the various positions have been scheduled it will be possible to evaluate the risk of contract positions relative to the organization under inspection.

2130.0.13.3 Factors to Consider in Evaluating Overall Risk

To determine whether contract positions are reasonable, an examiner must evaluate positions in light of certain key factors: the size of the organization, its capital structure, its business needs, and its capacity to fulfill its obligations. For example, open contracts to purchase $7 million of GNMA securities would be viewed differently in a BHC with $24 million of assets than in a BHC with $1 billion of assets.

There is no guaranty that financial contract prices and cash market prices will move in the same direction at the same velocity; however, contract prices and cash market prices ultimately move towards price convergence in the delivery month. Keeping this fact in mind, the risk evaluating process can be simplified by thinking of the securities underlying the various contracts as a frame of reference. For example, if a BHC holds ‘‘long’’ futures contracts on $10 million (par value) of Treasury bonds the examiner should first evaluate the effect (excluding tangible benefits of ownership, e.g., interest income, pledging, etc.) on the organization of holding $10 million of bonds in its portfolio and the resultant appreciation or depreciation if interest rates rise or fall by a given amount. A ‘‘short’’ contract of $10 million Treasury bonds would be evaluated as if the banking organization had executed a short sale for $10 million. In addition, the examiner would have to consider the positive or negative flow of funds received or disbursed as margin to reflect daily contract gains and losses. While commissions on futures contracts are not a major factor in hedging transactions, they also should be considered in this evaluation. Typically, commissions are charged on a ‘‘round turn’’ basis—meaning that commissions are charged based upon an assumption that each futures contract will be offset prior to maturity. Since each contract will have to be offset, or securities bought or delivered, it should be determined whether funds will be available to offset contracts or fund delivery. In the case of certain short contracts, a determination must be made as to whether deliverable securities are held or committed for purchase by the banking organization.

2130.0.13.4 Contract Liquidity

In addition to looking at the ‘‘big picture,’’ examiners should consider a position in a given contract maturity month relative to the volume of contracts outstanding. For example, in futures trading there is generally a greater open interest in the next contract maturity month and perhaps the following one or two contract maturity months. As one moves away from the near term contracts, there is generally less trading and less ‘‘open interest’’ in the more distant contracts. ‘‘Open interest’’ or the amount of contracts outstanding is reported in financial newspapers and other publications. Generally, the contracts with the largest open interest and daily trading volume are considered to be the most liquid.

To illustrate the concept discussed above, one should consider the following example. A ‘‘red flag’’ should be apparent if a contract review discloses that the organization has taken a sizeable position in a contract expiring in two years. When the examiner checks financial newspapers and other publications, he or she may discover that the BHC's position represents 20 percent of the open interest in that contract. Such a situation would clearly be unsafe and unsound because the relatively huge position coupled with the typically less liquid conditions in distant contracts makes it highly unlikely that the BHC could quickly close out its position if necessary. In addition, one should also question why the distant maturity was chosen since there is no immediate reason to expect a close correlation to the cash market for the underlying security.

With respect to forward contracts, there is an active forward market for GNMA securities specifying delivery of the underlying securities up to four or five months in the future. If a banking organization is executing contracts for more distant maturities, management should be queried as to why it is necessary to trade outside the normal trading cycle.

2130.0.13.5 Relationship to Banking Activities

In evaluating contract activities, examiners should verify that contract strategies are carried to fruition in connection with their relationship to overall objectives. Examiners may find it useful to recommend additional recordkeeping in borderline cases when they encounter situations where financial-contract positions are closed out frequently during the hedge period, but not frequently enough to be considered trading rather than hedging activities. Examiners should suggest proper documentation with regard to financial contracts executed and any additional recordkeeping as needed. Specifically, users could be requested to establish written criteria specifying what circumstances will trigger the closing of such contracts. Then users would be judged by how well they adhered to the criteria as well as whether the plan reduced risk. Hopefully, such recordkeeping would give users the latitude to close out a financial-contract position working against them (as determined by some prearranged benchmark), yet still require sufficient discipline to prevent users from selectively executing financial contracts merely to profit upon interest-rate forecasts.

The preceding discussion should reinforce the fact that the actual utilization of financial contracts is not a clear-cut issue in terms of hedging verses speculation. However, certain key concepts should be kept in mind. First, a decision to hedge with futures or forward contracts involves making a decision that one is content to lock in an effective cost of funds, a sale price of a specific asset, etc. However, the decision to hedge which gives downside protection also means forfeiting the benefits which would result from a favorable market movement. Thus, in evaluating hedge strategies, the organization should be judged as to whether it maintained hedge positions long enough to accomplish its objectives.

Caution should be employed in performing the analysis of financial contracts used to obtain targeted effective interest rates. Examiners should not evaluate transactions solely on a “paired” basis, that is, looking at paired cash market and financial-contract positions and forgetting about financial-contract positions relative to the organization’s entire balance sheet, nor should examiners fail to review the overall nature of financial-contract activities. For example, individual opening and closing of financial contracts could appear reasonable, but the aggregate activities may be indicative of an organization that is in reality operating a futures trading account solely to profit on interest-rate expectations.

2130.0.13.6 Parties Executing or Taking the Contra Side of a Financial Contract

In addition to monitoring contra-party credit risk, serious efforts should be made to ensure that the banking organization carefully scrutinizes the selection of brokers and dealers. In the case of futures contracts, the Commodity Exchange Act requires that an entity functioning as a futures commission merchant be registered with the CFTC. However, not every FCM may be a member of a commodities exchange. Members of an exchange are given additional supervision by the exchange, while nonmembers are subject to audit by the National Futures Association. In selecting any broker or dealer, an organization should give careful consideration to its reputation, financial viability, and length of time in business. If an organization intends to deal with a newly established FCM or broker-dealer, special efforts should be made to verify the reputation and integrity of its principals. (For additional discussion, see *Federal Reserve Regulatory Service* 3–1562). Although such measures cannot ensure that problems will not subsequently develop with an FCM or broker-dealer, some careful forethought can tend to ensure that relationships will not be developed with persons or firms who had serious problems in the past.

2130.0.14 ACCOUNTING FOR FUTURES CONTRACTS

All futures contracts, except for foreign-currency futures contracts, shall be reported in the Consolidated Financial Statements for Bank Holding Companies in accordance with Financial Accounting Standards Board (FASB) Statement No. 80, "Accounting for Futures Contracts." Foreign-currency futures contracts shall be reported in accordance with the guidance in FASB Statement No. 52, "Foreign Currency Translation."

2130.0.14.1 Performance Bonds under Futures Contracts

When the reporting banking organization, as either buyer or seller of futures contracts, has posted a performance bond in the form of a margin account deposited with a broker or exchange, the current balance (as of the report date) of that margin account shall be reported in Other Assets. The balance in the margin account includes the following:

1. the original margin deposit, plus (less)
2. any additions (deductions) as a result of daily fluctuations in the market value of the related contracts (i.e., "variation margin"), plus
3. any additional deposits made to the account to meet margin calls or otherwise (i.e., "maintenance margin"), less
4. any withdrawals of excess balances from the account

When the performance bond takes the form of a pledge of assets with a broker rather than a margin account, the pledged assets shall be maintained on the books of the pledging banking organization and no other balance-sheet entry is made for the performance bond. In this case, gains and losses resulting from daily fluctuations in the market value of the related contracts are generally settled with the broker in cash. However, if the pledging banking organization also maintains a working balance with the broker against which recognized daily market gains and losses are posted, the working balance should be reported in Other Assets, and treated in the same manner as a margin account.

2130.0.14.2 Valuation of Open Positions

All open positions in futures contracts must be reviewed at least monthly (or more often, if material) and their current market values determined. The market value of a futures contract is to be based on published price quotations. These futures positions must be revalued at their current market values on these valuation dates and any changes in these values reported in accordance with the guidance presented below for hedge or nonhedge contracts, as appropriate.

2130.0.14.3 Criteria for Hedge-Accounting Treatment

A futures contract shall be accounted for as a hedge when the following conditions are met:

1. The banking organization must have determined that the item or group of items to be hedged (that is, the identifiable assets, liabilities, firm commitments, or anticipated transactions) will expose it to price or interest-rate risk.
2. The futures contract must reduce the exposure to risk. This will be demonstrated if, at the inception of the hedge and *throughout the hedge period, high correlation* is expected to exist between the changes in the prices of both the contract and the hedged item or group of items.[10] In other words, the banking organization must monitor the price movements of both the hedge contract and the hedged items to determine that it is probable that changes in the market value of the futures contract will offset the effects of price changes on the hedged items.
3. The futures contract must be designated in writing as a hedge by management at the inception of the hedge.

   In order for a futures contract to qualify as a hedge of an anticipated transaction, the following two additional criteria must be met:
   a. The significant characteristics and expected terms of the anticipated transaction must be identified.
   b. The occurrence of the anticipated transaction must be probable.[11]

2130.0.14.4 Gains and Losses from Monthly Contract Valuations of Futures Contracts That Qualify as Hedges

If the hedge criteria are met, the accounting for the futures contract shall be related to the

10. Generally, banking practice maintains that correlation in the changes in the market values of the futures contract and the hedged item must be at least 80 percent for the ''high correlation'' criteria in FASB Statement No. 80 to be met.

11. It will be particularly difficult to meet this criteria when an anticipated transaction is not expected to take place in the near future.

accounting for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized. If a banking organization must include unrealized changes in the fair value of a hedged item in income, a change in the market value of the related futures contract shall be recognized in income when the change occurs. Otherwise, a change in the market value of a futures contract that qualifies as a hedge of an existing asset or liability shall be recognized as an adjustment of the carrying amount of the hedged item. A change in the market value of a futures contract that is a hedge of a firm commitment shall be included in the measurement of the transaction that satisfies the commitment. A change in the market value of a futures contract that is a hedge of an anticipated transaction shall be included in the measurement of the subsequent transaction.

Once the carrying amount of an asset or liability has been adjusted for the change in the market value of a futures contract, the adjustment must be recognized in income in the same manner as other components of the carrying amount of that asset or liability (for example, using the interest method). If the item being hedged is an interest-bearing financial instrument otherwise reported at amortized historical cost, then the changes in the market value of the hedge contract that have been reflected as adjustments in the carrying amount of the financial instrument shall be amortized as an adjustment of interest income or expense over the expected remaining life of the hedged item.

If a futures contract that has been accounted for as a hedge of an anticipated transaction is closed before the date of the related transaction, the accumulated change in value of the contract shall be carried forward (assuming high correlation continues to exist) and included in the measurement of the related transaction. When it becomes probable that the quantity of the anticipated transaction will be less than that originally hedged, a pro rata portion of the futures results that would have been included in the measurement of the transaction shall be recognized as a gain or loss.

When futures contracts that are hedges are terminated, the gain or loss on the terminated contracts must be deferred and amortized over the remaining life of the hedged item.

2130.0.14.5 Gains and Losses from Monthly Contract Valuations of Futures Contracts That Do Not Qualify as Hedges

For futures contracts that are not accounted for as hedges, the change that has occurred in the market value of open positions since the last call report date shall be reflected in current income, either as "other noninterest income" for net gains or "other noninterest expense" for net losses.

If high correlation ceases to exist, the banking organization should discontinue accounting for a futures contract as a hedge. When this occurs, the portion of the change in the market value of the contract that has not offset the market value changes of the hedged item, since the inception of the hedge, must be reflected in the Report of Income as "other noninterest income" or "other noninterest expense," as appropriate. The contract should thereafter be accounted for as a nonhedge contract with subsequent changes in the contract's market value reflected in current period income.

When futures contracts that are not hedges are terminated, the gain or loss on the terminated contract must be recognized currently in the Report of Income as "other noninterest income" or "other noninterest expense," as appropriate.

There is the potential for holding companies and nonbank subsidiaries to follow the referenced accounting applications and break "hedges" with unrealized futures gains to recognize income, and maintain hedges with futures losses and adjust the carrying basis of the paired, that is, "hedged" asset. Examiners should look for patterns of taking gains and losses with a view to determining whether the opening and closing of contracts is consistent with the organization's risk-reducing strategies.

2130.0.15 PREPARING INSPECTION REPORTS

Unsatisfactory comments pertaining to a bank holding company's financial-contract activities should be noted on the "Examiner's Comments," "Policies and Supervision," and "Analysis of Financial Factors" or other appropriate page depending on the severity of the comments within the bank holding company inspection report.

2130.0.16 INTERNAL CONTROLS AND INTERNAL AUDIT

The following is designed to illustrate desirable internal controls and internal audit procedures applicable to the organization's activities in financial contracts. This illustration is not intended to serve as an absolute standard relating to contract activities, but is designed to supplement examiners' knowledge relating to internal controls and internal audits in this context. In evaluating internal controls and audits, the examiner will need to evaluate the scope of futures, forward, and options activities to determine whether internal controls and audit procedures are adequate in relation to the volume and nature of the activities.

2130.0.16.1 Internal Controls

It is a management's responsibility to minimize the risks inherent in financial-contract activities through the establishment of policies and procedures covering organizational structure, segregation of duties, operating and accounting system controls, and comprehensive management reporting. Formal written procedures should be in place in connection with purchases and sales, processing, accounting, clearance and safekeeping activities relating to these transactions. In general, these procedures should be designed to ensure that all financial contracts are properly recorded and that senior management is aware of the exposure and gains or losses resulting from these activities. Some examples of desirable controls follow:

1. Written documentation indicating what types of contracts are eligible for purchase by the organization, which individual persons are eligible to purchase and sell contracts, which individual persons are eligible to sign contracts or confirmations, and the names of firms or institutions with whom employees are authorized to conduct business.
2. Written position limitations for each type of contract established by the banking organization's board of directors and written procedures for authorizing trades, if any, in excess of those limits.
3. A system to monitor the organization's exposure with customers and those broker-dealers and institutions eligible to do business with it. To implement this, management must determine the amount of credit risk permissible with various parties and then institute surveillance procedures to ensure that such limits are not exceeded without written authorization from senior management.
4. Separation of duties and supervision to ensure that persons executing transactions are not involved in approving the accounting media and/or making accounting entries. Further, persons executing transactions should not have authority to sign incoming or outgoing confirmations or contracts, reconcile records, clear transactions, or control the disbursement of margin payments.
5. A clearly defined flow of order tickets and confirmations. Confirmations generated should, preferably, be prenumbered. In addition to promptly recording all commitments in a daily written commitment ledger, the related documentation should be filed separately for purposes of audit and examination. The flow of confirmations and order tickets should be designed to verify accuracy and enable reconciliations throughout the system, for example, to ensure that a person could not execute unauthorized transactions and bypass part of the accounting system, and to enable the reconcilement of traders' position reports to those positions maintained by an operating unit.
6. Procedures to route incoming confirmations to an operations unit separate from the trading unit. Confirmations received from brokers, dealers, or others should be compared to confirmations (or other control records) prepared by the banking organization to ensure that it will not accept or make delivery of securities, or remit margin payments, pursuant to contracts unless there is proper authorization and documentation.
7. Procedures for promptly resolving fails to receive or fails to deliver securities on the date securities are due to be received or sent pursuant to contracts.

8. Procedures for resolving customer complaints by someone other than the person who executed the contract.
9. Procedures for verifying brokers' reports of margin deposits and contract positions (use an outside pricing source), and reconciling such reports to the records.
10. Procedures for daily review of outstanding contracts and supervision of traders. In addition, there should be periodic reports to management reflecting the margin deposits and contract positions.
11. Selecting and training competent personnel to follow the written policies and guidelines.

2130.0.16.2 Internal Audit

The scope and frequency of the internal audit program should be designed to review the internal control procedures and verify that the internal controls purported to be in effect are being followed. Further, the internal auditor should verify that there are no material inadequacies in the internal control procedures that would permit a person acting individually to perpetrate errors or irregularities involving the records of the organization or assets that would not be detected by the internal control procedures in time to prevent material loss or misstatement of the banking organization's financial statements or serious violation of applicable banking, bank holding company, or securities rules or regulations. Any weaknesses in internal control procedures should be reported to management, along with recommendations for corrective action. If internal auditors do not report to an audit committee, the person to whom they report should not be in a position to misappropriate assets. In addition, auditors should occasionally spot-check contract prices and mark-to-market adjustments.

2130.0.17 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Statement of policy concerning bank holding companies engaging in futures, forward, and options contracts on U.S. government and agency securities and money market instruments		225.142	4–830	
Policy Statement on Financial Contracts			3–1535	
Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities			3–1562	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Financial institutions, including bank holding company subsidiaries, are lending securities with increasing frequency, and, in some instances, a financial institution may lend its own investment or trading-account securities. Financial institutions lend customers' securities held in custody, safekeeping, trust, or pension accounts. Because the securities available for lending often greatly exceed the demand for them, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

2140.0.1 SECURITIES-LENDING MARKET

Securities brokers and commercial banks are the primary borrowers of securities. They borrow securities to cover securities fails (securities sold but not available for delivery), short sales, and option and arbitrage positions. Securities lending, which used to involve principally corporate equities and debt obligations, increasingly involves loans of large blocks of U.S. government and federal-agency securities.

Securities lending is conducted through open-ended ''loan'' agreements, which may be terminated on short notice by the lender or borrower. Repurchase agreements are generally used by owners of securities as financing vehicles and, in certain respects, are closely analogous to securities lending. The objective of securities lending, however, is to receive a safe return in addition to the normal interest or dividends. Securities loans in industry practice are generally collateralized by U.S. government or federal-agency securities, cash, or letters of credit.[1] At the outset, each loan is collateralized at a predetermined margin. If the market value of the collateral falls below an acceptable level during the time a loan is outstanding, a margin call is made by the lender institution. If a loan becomes over-collateralized because of appreciation of collateral or market depreciation of a loaned security, the borrower usually has the opportunity to request the return of any excessive margin.

When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower. Fees received on securities loans are divided between the lender and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower, and the remainder is divided between the lender and the customer account that owns the securities.

1. Broker-dealers borrowing securities are subject to the restrictions of the Federal Reserve's Regulation T (12 C.F.R. 220.10), which specifies acceptable borrowing purposes.

2140.0.2 DEFINITIONS OF CAPACITY

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender is acting. For the purposes of these guidelines, the relevant capacities are as follows:

1. *Principal.* A lender offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.
2. *Agent.* A lender offering securities on behalf of a customer-owner is acting as an agent. For the lender to be considered a bona fide or ''fully disclosed'' agent, it must disclose the names of the borrowers to the customer-owners (or give notice that names are available upon request), and must disclose the names of the customer-owner to borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, ''blind brokerage'' transactions in which participants cannot determine the identity of the contra party, are treated as if the lender was the principal.
3. *Directed agent.* A lender which lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.
4. *Fiduciary.* A lender which exercises *discretion* in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For purposes of these guidelines,

the underlying relationship may be as agent, trustee, or custodian.

5. *Finder.* A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is direct between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

2140.0.3 GUIDELINES

All bank holding companies or their subsidiaries that participate in securities lending should establish written policies and procedures governing these activities. Other than commercial banks with trust departments, the bank holding company subsidiaries most likely to be engaged in securities lending are non-deposit-taking trust companies and certain discount brokers which provide custody services and make margin loans. At a minimum, policies and procedures should cover each of the topics in these guidelines.

2140.0.3.1 Recordkeeping

Before establishing a securities-lending program, a financial firm or institution must establish an adequate recordkeeping system. At a minimum, the system should produce daily reports showing which securities are available for lending, and which are currently lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans, that adequate collateral is required and maintained, and that policies and concentration limits are being followed.

2140.0.3.2 Administrative Procedures

All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis.

In addition, written procedures should outline how to choose the customer account that will be the source of lent securities when they are held in more than one account. Possible methods include loan volume analysis, automated queue, a lottery, or some combination of these. Securities loans should be fairly allocated among all accounts participating in a securities-lending program.

Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records, the timeliness of management reports, and the lender's overall compliance with established policies and the firm's procedures.

2140.0.3.3 Credit Analysis and Approval of Borrowers

In spite of strict standards of collateralization, securities-lending activities involve risk of loss. Such risks may arise from malfeasance or failure of the borrowing firm or institution. Therefore, a duly established management or supervisory committee of the lender should formally approve, in advance, transactions with any borrower.

Credit and limit approvals should be based upon a credit analysis of the borrower. A review should be performed before establishing such a relationship and reviews should be conducted at regular intervals thereafter. Credit reviews should include an analysis of the borrower's financial statement, and should consider capitalization, management, earnings, business reputation, and any other factors that appear relevant. Analyses should be performed in an independent department of the lender, by persons who routinely perform credit analyses. Analyses performed solely by the person(s) managing the securities-lending program are not sufficient.

2140.0.3.4 Credit and Concentration Limits

After the initial credit analysis, management of the lender should establish an individual credit limit for the borrower. That limit should be based on the market value of the securities to be borrowed, and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral. Credit and concentration limits should take into account other extensions of credit by the lender to the same borrower or related interests.

Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

2140.0.3.5 Collateral Management

Securities borrowers generally pledge and maintain collateral at a level equal to at least 100 percent of the value of the securities borrowed.[2] The minimum amount of excess collateral, or "margin," acceptable to the lender should relate to price volatility of the loaned securities and the collateral (if other than cash).[3] Generally, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus, for debt securities, any accrued interest.

Collateral must be maintained at the agreed margin. A daily "mark-to-market" or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities.

Securities should not be lent unless collateral has been received or will be received simultaneously with the loan. As a minimum step toward perfecting the lender's interest, collateral should be delivered directly to the lender or an independent third-party trustee.

2140.0.3.6 Cash as Collateral

When cash is used as collateral, the lender is responsible for making it income productive. Lenders should establish written guidelines for selecting investments for cash collateral. Generally, a lender will invest cash collateral in repurchase agreements, master notes, a short-term investment fund (STIF), U.S. or Eurodollar certificates of deposit, commercial paper, or some other type of money market instrument. If the lender is acting in any capacity other than as principal, the written agreement authorizing the lending relationship should specify how cash collateral is to be invested.

Using cash collateral to pay for liabilities of the lender or its holding company would be an improper *conflict of interest* unless that strategy was specifically authorized in writing by the owner of the lent securities.

2140.0.3.7 Letters of Credit as Collateral

If a lender plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the banks issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated. The lender should also establish concentration limits for the banks issuing letters of credit, and procedures should ensure they are not exceeded. In establishing concentration limits on letters of credit accepted as collateral, the lender's total outstanding credit exposures from the issuing bank should be considered.

2140.0.3.8 Written Agreements

Securities should be lent only pursuant to a written agreement between the lender and the owner of the securities, specifically authorizing the institution to offer the securities for loan. The agreement should outline the lender's authority to reinvest cash collateral (if any) and responsibilities with regard to custody and valuation of collateral. In addition, the agreement should detail the fee or compensation that will go to the owner of the securities in the form of a fee schedule or other specific provision. Other items which should be covered in the agreement have been discussed earlier in these guidelines.

A lender must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party. A written agreement may detail acceptable types of collateral (including letters of credit); standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market, and margin calls; methods for transmitting coupon or dividend payments received if a security is on loan on a payment date; conditions which will trigger the termination of a loan

2. Employee benefit plans subject to the Employee Retirement Income Security Act are specifically required to collateralize securities loans at a minimum of 100 percent of the market value of loaned securities (see section 2140.0.3.10 below).

3. The level of margin should be dictated by level of risk being underwritten by the securities lender. Factors to be considered in determining whether to require margin above the recommended minimum include the type of collateral, the maturity of collateral and lent securities, the term of the securities loan, and the costs which may be incurred when liquidating collateral and replacing loaned securities.

(including events of default); and acceptable methods of delivery for loaned securities and collateral.

2140.0.3.9 Use of Finders

Some lenders may use a finder to place securities, and some financial institutions may act as finders. A finder brings together a borrower and a lender for a fee. Finders should not take possession of securities or collateral. The delivery of securities loaned and collateral should be direct between the borrower and the lender. A finder should not be involved in the delivery process.

The finder should act only as a fully disclosed intermediary. The lender must always know the name and financial condition of the borrower of any securities it lends. If the lender does not have that information, it and its customers are exposed to unnecessary risks.

Written policies should be in place concerning the use of finders in a securities-lending program. These policies should cover circumstances in which a finder will be used, which party pays the fee (borrower or lender), and which finders the lender institution will use.

2140.0.3.10 Employee Benefit Plans

The Department of Labor has issued two class exemptions which deal with securities-lending programs for employee benefit plans covered by the Employee Retirement Income Security Act (ERISA): Prohibited Transaction Exemption 81-6 (46 FR 7527 (January 23, 1981) and correction (46 FR 10570 (February 3, 1981))), and Prohibited Transaction Exemption 82-63 (47 FR 14804 (April 6, 1982)). The exemptions authorize transactions which might otherwise constitute unintended ‘‘prohibited transactions’’ under ERISA. Any firm engaged in the lending of securities for an employee benefit plan subject to ERISA should take all steps necessary to design and maintain its program to conform with these exemptions.

Prohibited Transaction Exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be ‘‘parties in interest’’ with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions, neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities.

Prohibited Transaction Exemption 82-63 permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. The exemption details certain conditions which must be met.

2140.0.3.11 Indemnification

Certain lenders offer participating accounts indemnification against losses in connection with securities-lending programs. Such indemnifications may cover a variety of occurences including all financial loss, losses from a borrower default, or losses from collateral default. Lenders that offer such indemnification should obtain a legal opinion from counsel concerning the legality of their specific form of indemnification under federal and/or state law.

A lender which offers an indemnity to its customers may, in light of other related factors, be assuming the benefits and, more importantly, the liabilities of a principal. Therefore, lenders offering indemnification should also obtain written opinions from their accountants concerning the proper financial statement disclosure of their actual or contingent liabilities.

2140.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Securities Lending policy statement of the Federal Financial Institutions Examination Council, adopted by the Federal Reserve Board on May 6, 1985			3–1579.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell (reverse repurchase agreements),[2] have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.[3]

The following minimum guidelines address the need for managing credit risk exposure to counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed when entering into repurchase agreements with securities dealers and others.

Depository institutions and nonbank subsidiaries that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the Federal Reserve should review written policies and procedures of dealers to determine their adequacy in light of these minimum guidelines and the scope of each subsidiary's operations.

2150.0.1 CREDIT POLICY GUIDELINES

The apparent safety of short-term repurchase agreements which are collateralized by highly liquid, U.S. Government and Federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transactions, and have not taken adequate steps to assure control of the securities covered by the agreement.

All firms that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:

Written policies should establish "know your counterparty" principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and Federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.

It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. Know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.

In certain situations firms may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Do not enter into undisclosed agency or "blind brokerage" repurchase transactions in which the counterparty's name is not disclosed.

2150.0.1.1 Dealings with Unregulated Securities Dealers

A dealer in U.S. Government and Federal agency obligations is not necessarily a Federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Com-

1. A repurchase agreement is a transaction involving the *sale* of assets by one party to another, subject to an agreement by the seller to repurchase the assets at a specified date or in specified circumstances.

2. In order to avoid confusion among market participants who sometimes use the same term to describe different sides of the same transaction, the term "repurchase agreement" will be used in the balance of this statement to refer to both repurchase and reverse repurchase agreements. A repurchase agreement is one in which a party that owns securities acquires funds by transferring the securities to another party under an agreement to repurchase the securities at an agreed upon future date. A reverse repurchase (resale) agreement is one in which a party provides funds by acquiring securities pursuant to an agreement to resell them at an agreed upon future date.

3. Throughout this document repurchase agreements are generally discussed in terms of secured credit transactions. This usage should not be deemed to be based upon a legal determination.

mission. Therefore, the dealer firm may not be subject to any Federal regulatory oversight.

A firm doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2:1). This ratio can be calculated by a dealer using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c31) or the Federal Reserve Bank of New York's Capital Adequacy Guidelines for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

1. A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard;
2. Audited financial statements which demonstrate that as of the audit date the dealer was in compliance with the standard and the amount of liquid capital; and
3. A copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.[4]

Periodic evaluations of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

Prior to engaging in initial transactions with a new counterparty, obtain audited financial statements and regulatory filings (if any) from counterparties, and insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

The counterparty credit analysis should consider the financial statements of the entity that is to be the counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the firm should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the counterparty or its affiliates by State or Federal securities regulators.

Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

2150.0.2 GUIDELINES FOR CONTROLLING REPURCHASE AGREEMENT COLLATERAL

Repurchase agreements can be a useful asset and liability management tool, but repurchase agreements can expose a firm to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk by negotiating written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome, other asset/liability management tools should be used.

The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid Government securities. However, experience has shown that the collateral securities will probably *not* serve as protection if the counterparty becomes insolvent or fails, and the purchasing firm does not have control over the securities. Ultimate responsibility for establishing adequate control procedures rests with management of the firm. Management should obtain a written legal opin-

4. This letter should be similar to that which must be given to the SEC by registered broker/dealers.

ion as to the adequacy of the procedures utilized to establish and protect the firm's interest in the underlying collateral.

A written agreement specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:

- Acceptable types and maturities of collateral securities;
- Initial acceptable margin for collateral securities of various types and maturities
- Margin maintenance, call, default and sellout provisions;
- Rights to interest and principal payments;
- Rights to substitute collateral; and
- The persons authorized to transact business on behalf of the firm and its counterparty.

2150.0.2.1 Confirmations

Some repurchase agreement confirmations may contain terms that attempt to change the firm's rights in the transaction. The firm should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.

2150.0.2.2 Control of Securities

As a general rule, a firm should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:

- delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated under a written custodial agreement which explicitly recognizes the firm's interest in the securities as superior to that of any other person; or
- appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the firm and the counterparty, ensuring adequate segregation and identification of either physical or book-entry securities.

Where control of the underlying securities is not established, the firm may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, *substantial losses are likely to be incurred.* Accordingly, a firm should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) it is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre-approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty; (3) periodic credit evaluations of the counterparty are conducted; and (4) the firm has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential internal procedures of these types are instituted and observed, the firm may be cited for engaging in unsafe or unsound practices.

All receipts and deliveries of either physical or book-entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a firm's name with a custodian; the firm should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the firm. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the firm or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the firm.

Substitution of securities should not be allowed without the prior consent of the firm. The firm should give its consent before the delivery of the substitute securities to it or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."

2150.0.2.3 Margin Requirements

The amount paid under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements on U.S. Government and Federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily mark-to-market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the firm or its custodian bank to maintain the margin within the predetermined level.

Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass-through securities, anticipated principal reductions should also be considered when determining margin adequacy.

Prudent management procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without maturity dates may be regarded as an unsafe and unsound practice unless the firm has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short-term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as an unsafe and unsound practice. If additional margin is not deposited when required, the firm's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.

2150.0.2.4 Overcollateralization

A firm should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold may be viewed as an unsecured loan to the counterparty subject to the unsecured lending limitations for the firm and should be treated accordingly for credit policy and control purposes.

2150.0.3 OPERATIONS

A firm's operational functions should be designed to regulate the custody and movement of securities and to adequately account for trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

In some cases, a firm may not receive or deliver a security by settlement date. When a firm fails to receive a security by the settlement date, a liability exists until the transaction is consummated or cancelled. When the security is not delivered to the contra-party by settlement date, a receivable exists until that ''fail'' is resolved. ''Fails'' to deliver for an extended time, or a substantial number of cancellations, are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multicopy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

2150.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Federal Financial Institutions Examination Council policy statement, adopted by the Federal Reserve Board on November 12, 1985, on repurchase agreements			3–1579	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Risk management is an important responsibility of any bank holding company. The objective of this responsibility is to determine and limit the extent of the holding company organization's vulnerability to uncontrollable variables. While all companies perform risk evaluation in some form and exercise some degree of control over its magnitude, the precise processes used differ considerably across organizations in terms of formality, extensiveness, and effectiveness. It should be recognized that many organizations have only an implicit risk evaluation process, and that it may be appropriate to recommend that this process be formalized. Ultimately, the board of directors of the parent company should be held accountable for the consolidated risk evaluation and control.

Risk management at any level involves two basic elements: evaluation and control. Risk evaluation involves three steps: determination of exposures; specification of uncontrollable variables that have an impact on each exposure; and quantification of the expected effect of each variable on exposure. After the extent of existing or potential risk is determined, decisions to limit or control risk are made. This procedure is ever present, since most transactions create exposure, and every exposure has some element of risk. The following two sections discuss the risk evaluation and the risk control processes in very broad terms in an attempt to provide a framework that can be applied to most organizations.

2160.0.1 RISK EVALUATION

The risk identification process begins with a determination of exposures that an institution has to the environment.

Exposure conceptually occurs in every transaction undertaken by a banking organization. Because of the magnitude of the list of potential exposures, institutions generally limit their efforts to extremely large exposures, to areas where losses appear likely, and to activities where the market is changing and new exposures are created. The size of an exposure generally is dependent on the size of a transaction. This is true both for transactions recorded on accounting balance sheets and for those which occur off balance sheet. Exposure is not necessarily determined by the likelihood of loss. For example, many holding company organizations have a large "exposure" in Treasury bills, but do not consider these transactions to be risky.

The list of exposures that banks commonly identify has increased dramatically in the past decade. Historically, the primary focus has been on the exposure of the loan portfolio centering on the financial security of each individual loan; recently industry and geographical exposure of loans has increased in importance. The exposure of fixed assets, such as buildings, to fires, floods and other problems also has been recognized. In more recent years, exposure of mismatched maturities of assets and liabilities to interest rate movements has increased in importance as interest-rate movements have sharply fluctuated. While this exposure had always existed, it had not been recognized as particularly dangerous until recently. Another example of an exposure that historically was considered safe is repurchase agreements backed by government securities. When Drysdale Government Securities, Inc. failed, several risks were brought to light—whether the instrument is a loan (that would be tied up in case of bankruptcy) or a sale and potential liability when serving as an agent of a government securities firm that fails. A particularly difficult area to evaluate is exposure to legal action. For example, a suit against a bank over lending terms and representations is difficult to anticipate and the exposure could be significant.

Numerous exposures exist that many holding company organizations may not recognize. For example, the Federal Reserve System encourages evaluation of wire transfer exposure. This exposure is very large and theoretically a breakdown on the framework or compromise of internal systems could result in major failures. Exposure from foreign exchange contracts also can be large, and may not always be recognized. Fraud and exposure of management to kidnapping continue to increase in importance. And finally, some major holding company organizations have found that dependence on short-term market funds creates a risky exposure. When access to a funding market may be suddenly withdrawn, the exposure of the entire funding process is an issue.

The second step of the risk identification process is specification of the variables that could affect an exposure and determination of what the impact would be.

This process is difficult, since any number of variables may influence an exposure. Furthermore, as the environment changes new variables may appear relevant and the effects of variables may change. For example, the recent problems of public sector lending to foreign countries with loans denominated in dollars having floating interest rates during inflationary periods may not have been fully evaluated at the time of the lending process.

Determining influential variables is particularly difficult with new products. A historical examination cannot be made of these new products and questions may go unanswered regarding the stability of the new markets. For example, problems have occurred in hedging operations as underlying instruments did not move as expected, thus negating the hedging contract. Consequently, the hedge created an exposure rather than reducing an exposure.

The final step of the risk identification process is risk quantification.

Conceptually, this involves calculation of an expected loss of value related to variance of a particular environmental factor. This has two parts: (1) estimation of the probability that a given variance will occur; and (2) determination of the cost impact of each potential variance. Probabilities are often drawn up in general terms. In some cases historical records facilitate estimation of probabilities. Measurement of credit risk in an organization that specializes by industry or geography may be an example of this. In the most recent recession, however, many past records have proven not to be accurate predictors. In other situations, the holding company organization may evaluate the effect of a change but be unwilling to estimate probabilities of the change occurring. An example of this is managing asset and liability maturities. The effect of a change in interest rates on profits may be determined; but, in many cases, institutions will not derive probabilities on the direction and/or magnitude of interest rate movements.

The difficulty of quantifying costs and probabilities is exacerbated by emergence of new products and by environmental changes. With a new product, it is particularly difficult to determine the cost of a variance. For example, attention to interest rate risk has induced organizations to resort to hedging to reduce exposure. Innovative instruments are difficult to hedge, however, since the issuer may inaccurately gauge price movements. In this case, the exposure results not from price movements, but from inability to predict the relationship between market and price fluctuations. Furthermore, as the environment changes, the effect of a variable on an exposure changes as does the cost and probability of the occurrence. For example, in the 1970's the impact of inflation on the banking system would have been very different without the concurrent economic downturn and the technological advances.

2160.0.2 RISK CONTROL

After management has identified and evaluated risk, they may decide the risk or cost of an action is sufficiently low (and management is confident all possible variables have been identified) that the holding company can take on the risk as it is; if not there are a number of options that can be used to control the risk. Attempts to control risk can be accomplished through a combination of three general techniques: purchase of insurance, limitation of exposure size, and reduction of the expected cost associated with a variance. The use of insurance to decrease the effect of a loss on the corporation is common for exposure to fire, theft, kidnapping, and internal fraud. Various types of loans are underwritten by third parties. The innovative use of insurance may prove to have various applications to risk control in the banking industry. As with other contracts, the financial strength and reputation of the counterparty (the insurer) are important, and the organization's method of selecting and monitoring underwriters should be evaluated.

Management generally limits the level of exposure in relationship to the size of assets, capital or earnings. In most situations, relating the level of exposure to capital would appear appropriate. Reduction of exposure will automatically reduce risk, assuming other variables remain constant. Constraints should be determined by line management at a seniority level commensurate with the degree of perceived risk. Depending on the degree of risk, there may be a need for the board of directors to approve the constraints.

The third method of reducing the potential loss to the corporation involves decreasing the probability of a variance occurring or decreasing the probable effect when a variance occurs. This is exemplified by the exposure to fire. Installation of fire alarms and other precautions could reduce the expected loss substantially. Similarly, hedging with financial futures is a method used to reduce the effect of interest rate movement on the profits of the holding company organization when the maturities of assets and liabilities are not equal.

The final option management has, after risk has been evaluated, is simply not to participate in the activity if the risk is determined to be too high for the expected return.

The inspection procedures should include a broad-based evaluation of parent level risk management. Management's effectiveness in identifying risk, its willingness to accept risk, and its ability to control risk should be regularly evaluated. In an environment of rapid change and emerging financial instruments, there needs to be sufficient expertise to recognize the existence of ''new'' sources of risk concentration to evaluate the company's command of those sources.

2160.0.3 INSPECTION OBJECTIVES

1. To review the risk evaluation and control process.
2. To determine if management's system of identifying risks is effective, and if the parent company is adequately informed of risks throughout the organization.
3. To determine management's recognition of new risks that may arise from the changing environment.
4. To determine the reasonableness of the holding company's exposure-risk figures.
5. To assess the effect on the holding company's financial condition if the risk figures are realized.
6. To determine what actions are necessary to rebalance transactions of a holding company organization to a prudent level.

2160.0.4 INSPECTION PROCEDURES

1. Review the financial condition and the operations of the holding company organization to detect substantive exposure-risk situations.
2. Review management's policies, procedures, and practices in recognizing exposure-risk factors.
3. Determine awareness that all management levels need to be cognizant of exposures related to transactions of their respective operations.
4. Review the holding company's exposure-risk figures, or constraints placed on types of transactions.
5. Discuss with management the significance of exposure-risks facing the holding company and whether or not those risks are set at seemingly prudent levels.
6. Recommend that the organization address any areas where the holding company is perceived to have assumed an imprudent level of risk.

2175.0.1 INTRODUCTION

Banking organizations have become increasingly involved in marketing third-party uninsured annuities to their retail customers either directly or through third-party companies. As annuity sales have grown, so have concerns that some methods used to sell these instruments could give purchasers the impression that the annuities are federally insured deposits or that they are obligations of a bank. In the event of default by an annuities underwriter, this impression could cause a loss of public confidence in a depository institution, leading to unexpected withdrawals and liquidity pressures. Moreover, a bank or bank holding company that advertises or markets annuities in a way viewed as misleading could potentially be held liable for losses sustained by annuity holders.

This manual section provides guidelines to examiners for reviewing the sale of uninsured annuities by bank holding companies and banks that have legal authority to act as agent in the sale of annuities. State member banks and bank holding companies should not market, sell, or issue uninsured annuities or allow third parties to market, sell, or issue uninsured annuities on depository-institution premises in a manner that conveys the impression or suggestion that such instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by an insured depository institution. Consequently, state member banks should not sell these instruments at teller windows or other areas where retail deposits are routinely accepted.

2175.0.2 PERMISSIBILITY OF UNINSURED ANNUITY SALES

The legal status of annuities under the Bank Holding Company Act is somewhat uncertain at the present time. The Office of the Comptroller of the Currency has authorized national banks to act as agent in the sale of annuities on the basis that variable-rate annuities are securities and fixed-rate annuities are financial investment instruments.[1] These determinations, however, have been challenged by insurance associations on the basis that annuities are insurance products and, therefore, may be sold by national banks only in a town of less than 5,000.[2]

State member banks generally have been permitted to engage in the brokerage of both variable- and fixed-rate annuities consistent with their general corporate powers. In order to engage in this activity without filing a formal application, staff has advised interested banks that the brokerage of annuities must be expressly authorized under state law (or by the state banking regulatory agency on a case-by-case basis) and constitute an activity incidental to the bank's banking activities.

The authority of state member banks to continue to engage in this activity, in the same manner and subject to the conditions discussed above, does not appear to depend on a resolution of the issues.[3] State member banks have been permitted to engage in general insurance agency activities since 1937,[4] and to engage in brokerage activities under the same limitations applicable to bank holding companies. In addition, the Board has determined that the nonbanking restrictions in the Bank Holding Company Act do not apply to the direct activities of banks owned by a bank holding company.[5]

The authority of bank holding companies to engage directly or through a nonbanking subsidiary in the sale of annuities has not yet been determined. In *Norwest Corporation*,[6] the Board considered a proposal by a nonbanking affiliate to engage in the sale of variable- and fixed-rate annuities. The Board concluded that, under the specific facts of that case, it was unnecessary to reach the question of whether the sale of annuities is an insurance agency activity because Norwest is one of a small number of bank holding companies entitled to act as agent in the

1. Interpretive Letter No. 331, April 4, 1985, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,501; OCC Interpretive Letter No. 499 (February 12, 1990), *reprinted in* [1989–1990] Fed. Banking L. Rep. (CCH) ¶83,090. National banks are authorized to buy and sell securities for the account of customers and broker financial investment instruments.

2. *The Variable Annuity Life Insurance Company v. Clarke*, No. H-91-1016 (S.D. Tex. filed Apr. 16, 1991) ("NCNB litigation").

3. NCNB litigation.

4. Prior to 1937, the Board imposed as a condition of membership in the Federal Reserve System that a bank discontinue all insurance activities other than insurance activities in a town of less than 5,000. The purpose of this restriction was to conform insurance activities allowed for state member banks to those allowed for national banks.

5. *Merchants National Corp.*, 75 Federal Reserve Bulletin 388 (1989), *aff'd*, 890 F.2d 1275 (2d Cir. 1989), *cert. denied*, 111 S. Ct. 44 (1990).

6. 76 Federal Reserve Bulletin 873 (1990).

sale of any type of insurance pursuant to Exemption G of the Garn Act.[7]

2175.0.3 CHARACTERISTICS OF ANNUITY INSTRUMENTS

An annuity is an investment from which a person receives periodic payments based on earlier payments made to the obligor. Annuities are commonly underwritten by insurance companies, then marketed and sold either directly or through third parties, such as banks. Insurance companies retain the actuarial and underwriting risks on these annuities.

Annuities may be either variable or fixed-rate. An investor in a variable annuity contract purchases a share in an investment portfolio and then receives payments that vary according to the performance of the portfolio. A purchaser of a fixed-rate annuity contract, in contrast, receives a fixed-rate payment or minimum level of payments. Annuity payments can usually be received monthly, quarterly, semi-annually, or annually.

Variable- and fixed-rate annuities may be purchased in a single lump sum (‘‘single premium’’) or in periodic contributions (‘‘flexible premium’’). Minimum and maximum contributions to annuities vary among vendors. Some single-premium annuities have ‘‘bail-out’’ features which allow holders to withdraw all funds if the rate of return on the annuity contract falls below a specified rate.

The ability to take money out of an annuity prior to maturity varies by product, as does the imposition of a surrender penalty by the insurer when withdrawal occurs prior to maturity. When a penalty is imposed, the insurer generally calculates the penalty as a percentage of the annuity product’s accumulated value. The penalty for withdrawal generally declines with the annuity’s age. Normally, funds may not be withdrawn prior to the first anniversary date of the annuity.[8]

Annuities sold at depository institutions often include rate guarantees over the life of the instrument. They also frequently mature in one, three, or five years, similar to maturity ranges on certificates of deposit.

Insurance companies arrange for the sale of annuities on the premises of depository institutions in different ways. Some insurance companies approach banks directly. At other times, wholesalers (who market the products of a number of different insurance companies) may approach a bank. Depending on state restrictions on insurance activities, sales might be conducted by bank employees, employees of bank subsidiary insurance agencies, or by third-party insurance agents leasing space on the bank’s premises.

Sales commissions on annuities vary by the type of annuity. Commissions earned on single-premium products generally vary from 4 percent to 6 percent, but they decline sharply when the product sold includes a ‘‘bail-out’’ provision. Wholesalers may also give retailers a commission when the annuity is renewed, based on the accumulated value of the annuity. Commissions in some instances are paid on a variable basis, rising as the volume of sales increases.

2175.0.4 IMPROPER MARKETING PRACTICES

Banks have become involved in the sale of uninsured annuities through marketing programs designed to appeal specifically to their retail customers. It is important that these programs not employ marketing practices that could mislead the bank’s customers. For example, the use in annuities advertisements of terms such as ‘‘CD,’’ ‘‘deposit,’’ and ‘‘interest plan’’ to imply that the instruments are insured deposits would be inappropriate. Also, advertisements that prominently display the bank’s name and logo in a way that suggests the product is an obligation of the bank are similarly inappropriate. Disclosure that the annuities are not federally insured and are not obligations of the bank should be displayed prominently in annuity contracts and related documentation, on printed

7. The Garn Act amended section 4(c)(8) of the Bank Holding Company Act to prohibit generally bank holding companies from engaging in insurance activities as a principal, agent, or broker with certain exceptions. Under the express language of the Garn Act, the sale of insurance is not ‘‘closely related to banking’’ and is not permissible for a bank holding company unless it qualifies under one of the seven specified exceptions (Exemptions A–G) in the Garn Act. Exemption G applies to a limited number of bank holding companies that received approval from the Board prior to January 1, 1971, to conduct insurance agency activities. In order to utilize Exemption G or any other Garn Act exemptions that may be applicable, the bank holding company must file an application and would be subject to the proposed restrictions through the application process.

8. If an investor withdraws tax-deferred income from an annuity before the investor is 59½ years old, the IRS levies a tax penalty on the person equal to 10 percent of the amount of tax-deferred income withdrawn. This penalty may be avoided only if the person reinvests annuity proceeds in another tax-deferred investment within 60 days of the withdrawal.

advices, and verbally emphasized in telemarketing contacts. Finally, personnel selling uninsured annuities should be distinguishable from bank employees conducting normal retail deposit-taking operations.

2175.0.5 INSPECTION OBJECTIVES

1. To review the marketing and sale of uninsured annuities sold by the bank holding company and its member banks, or those sold through a third party.
2. To determine whether the bank holding company and its banks have adequate policies and procedures in place and if they are monitored by the parent company.
3. To determine if, prior to agreeing to sell annuities, a comprehensive financial analysis is made of the financial condition of the annuities underwriter and whether products of only financially secure underwriters are sold.
4. To determine whether the contract and advertising and related documents disclose prominently that the annuities do not represent deposits or obligations of an insured depository institution and that they are not insured by the Federal Deposit Insurance Corporation.
5. To ascertain that annuities are not sold at teller windows or other areas where deposits are routinely accepted.

2175.0.6 INSPECTION PROCEDURES

1. Determine whether the bank holding company and its banks have adequate policies and procedures in place:

a. to assess the financial condition of the annuities underwriter;

Banking organizations engaged in the sale of annuities are expected to sell only products of financially secure underwriters. Prior to agreeing to sell annuities, a comprehensive financial analysis of the obligor should be performed and reviewed with the banking organization's directors. The policies should also include a program to evaluate the underwriter's financial condition at least annually and to review the credit ratings assigned to the underwriter by the independent agencies evaluating annuity underwriters.

b. to ensure that the marketing and sale of uninsured annuities is not misleading and is separated and distinguished from routine retail deposit-taking activities.

(1) With regard to the sale of annuities, determine whether the contract, advertising, and all related documents disclose prominently in bold print that the annuities:

(a) are not deposits or obligations of an insured depository institution; and

(b) are not insured by the Federal Deposit Insurance Corporation.

(2) State member banks should not sell annuity instruments at teller windows or other areas where retail deposits are routinely accepted. In assessing the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function, examiners should take into account whether:

(a) advertisements *do not* contain words, such as ‘‘deposit’’, ‘‘CD’’, etc., or a logo that could lead an investor to believe an annuity is an insured deposit instrument;

(b) the obligor of the annuity contract is prominently disclosed, and names or logos of the insured depository institution are not used in a way that might suggest the insured depository institution is the obligor;

(c) adequate verbal disclosures are made during telemarketing contacts and at the time of sale;

(d) retail deposit-taking employees of the insured depository institution *are not engaged* in the promotion or sale of uninsured annuities;

(e) information on uninsured annuities *is not* contained in retail deposit statements of customers or in the immediate retail deposit-taking area;

(f) account information on annuities owned by customers *is not* included on insured deposit statements; and

(g) officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary.

(3) If a bank allows a third-party entity to market annuities on depository institution premises, examiners should take into account whether:

(a) the depository institution has assured itself that the third-party company is properly registered or licensed to conduct this activity;

(b) depository institution personnel *are not* involved in sales activities conducted by the third party;

(c) desks or offices *are not* used to market or sell annuities, are separate and distinctly identified as being used by an outside party; and

(d) depository institution personnel *do not* normally use desks or offices used by a third party for annuities sales.

2. Determine that advertisements do not prominently display the bank's name and logo that suggests the product is an obligation of a BHC bank.

3. Determine whether the banks obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the depository institution, that the depository institution is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC insured.

On January 5, 2004, the federal banking and thrift agencies (the agencies) issued an interagency policy to alert banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of and the legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries, or affiliates (that is, affiliated investment funds).[1] A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the associated risks are not effectively controlled. In addition, bank-affiliated investment advisers are encouraged to establish alternative sources of financial support to avoid seeking support from affiliated banks. (See SR letter 04-1, "Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization," and SR letter 94-53, "Investment Adviser Activities.")

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise includes credit extensions, cash infusions, asset purchases, and the acquisition of fund shares. In very limited circumstances, certain arrangements between banks and the funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns. Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR part 223) place quantitative limits and collateral and market-terms requirements on many transactions between a bank and certain of its advised funds.

2178.0.1 POLICY ON BANKS PROVIDING FINANCIAL SUPPORT TO ADVISED FUNDS

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank-advised investment funds.[2] Such policies and procedures should be designed to ensure that the bank will *not* (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities that include:

- Establishing alternative sources of emergency support from the parent holding company, nonbank affiliates, or external third parties prior to seeking support from the bank.
- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the

1. The federal banking and thrift agencies include the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) abolished the OTS, which had been responsible for regulating state and federal savings associations and their holding companies. See 12 USC 5413 (Dodd-Frank Act 313). The OTS's functions and powers were transferred to the OCC, FDIC, and the Board. The Board acquired regulatory and rulemaking authority over savings and loan holding companies. See 12 USC 5412 (Dodd-Frank Act 312). The OCC acquired supervisory and rulemaking authority over federal savings associations. The FDIC acquired supervisory and rulemaking authority over state-chartered savings associations. Bank-advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice. For purposes of the guidance, "banks" includes banks and savings associations.

Bank-advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice. For purposes of the guidance, "banks" includes banks and savings associations.

2. For more information on examination objectives and procedures in reviewing banks providing financial support to advised funds, see the appropriate "Investment-Funds Support" sections of the *Commercial Bank Examination Manual*.

limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board-designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to ensure that appropriate policies and procedures were followed.
- Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.
- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.
- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with Accounting Standards Codification (ASC) subtopic 450-20, Contingencies: Loss Contingencies, and fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities in accordance with the instructions for completing Call Report Schedule RC-T (Fiduciary and Related Services).

2178.0.2 NOTIFICATION AND CONSULTATION WITH THE PRIMARY FEDERAL REGULATOR

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.

Existing regulations permit banks and bank holding companies to engage in a wide range of securities activities in overseas markets. For a number of years these activities were not considered to be significant in the context of total bank and bank holding company assets. Indigenous rules and market practice served to constrain to a degree securities activities of U.S. banking organizations overseas.

Changes in local rules now make it possible for members of the London stock exchange to be wholly-owned by non-member companies and by year-end 1986 will allow stockbrokers to act as principals or market makers in securities. These new rules are expected to change significantly the complexion of the London securities market. In this context, U.S. banking organizations are making substantial investments in U.K. securities firms, and are also significantly expanding their securities business in other foreign and international markets.

The Board has expressed its concerns, in connection with an application by a banking organization to expand its securities activities overseas, that proper safeguards, limits, and controls will be exercised to protect the organization from undue risk. Applications generally state the methods through which the banking organization plans to control risk and establish oversight over securities operations. While these safeguards are initially evaluated at the time the application is made, nevertheless, examinations of bank holding companies and Edge corporations should incorporate an assessment of all overseas securities activities in order to determine the degree to which these activities conform to high standards of banking and financial prudence. The affiliation of a securities company, especially one engaged in corporate debt and equities transactions, with a banking organization raises a potential for conflict of interest and in some cases could pose substantial additional risk to the institution.

In those U.S. banking organizations where overseas securities trading and brokering are significant in scope or are prominent in the scale of the local market, examination procedures must incorporate an assessment of the controls, limits, and safeguards implemented by the organization to monitor and contain risk. Securities activities should be subject to the same degree of scrutiny and rigorous assessment of risk as bank lending activities. In addition, examiners should monitor the substance and nature of all transactions.

In particular, the following kinds of activities should be reviewed to determine whether they raise considerations of safety and soundness or otherwise do not conform to standards of prudence required of U.S. banking organizations:

- The degree of lending by a bank holding company to its securities affiliate, especially when loans are extended to support or enhance the obligations underwritten by the securities affiliate;
- The extent to which securities underwritten by an affiliate are purchased by the bank holding company as principal or trustee; and,
- The extent to which the parent is liable to an exchange for any losses incurred by the affiliate due to failure to deliver securities or settle contracts.

Targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, have found banks in violation of Regulation U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock, (12 C.F.R. 221) when their trust departments, using bank or other fiduciary funds, have extended credit to individuals involved in illegal day trading or free-riding schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T, Credit by Brokers and Dealers (12 C.F.R. 220), and Regulation X, Borrowers of Securities Credit, (12 C.F.R. 224).

Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchases with the proceeds of the sale. Banking organizations[1] engaging in such illegal activities may subject themselves to disciplinary proceedings, as well as to substantial credit risk.

Federal Reserve examiners should ensure that banks and bank holding companies (including the broker-dealer and trust activities of banking and nonbanking subsidiaries of state member banks and bank holding companies) are not engaged in such illegal activities. Examiners must make certain that these entities have taken all steps necessary to prevent their customers from involving them in free-riding. Prompt enforcement action may be needed to eliminate free-riding activities. (See SR-93-13.)

2187.0.1 TYPICAL DAY TRADING OR FREE-RIDING ACTIVITIES

The free-riding conduct in question typically involves trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride, that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment (DVP) transaction, a bank that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that subjects the banks to Regulation U.

The typical free-riding scheme involves a new customer's opening a custodial agency account into which a number of broker-dealers will deliver securities or funds in DVP transactions. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit, causing the financial institution to extend its own credit to meet the payment and delivery obligations of the account. Therefore, although the financial institution may be earning fees as a result of the activity in these accounts, it is subjecting itself to substantial losses if the market prices for the purchased securities fall or the transactions otherwise fail. In addition, other liabilities under federal banking and securities laws may be involved.

2187.0.2 SECURITIES CREDIT REGULATIONS

2187.0.2.1 Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks

Any extension of credit in the course of settling customer securities transactions, including those occuring in a trust department or trust subsidiary of a bank holding company, must comply with all of the provisions of Regulation U.[2] Regulation U requires all extensions of credit for the purpose of buying or carrying margin

1. The use of the term "banking organization" in this section, with regard to Regulation U, means a bank, trust department of a bank, or trust company of a bank holding company that is subject to Regulation U. Regulation U includes any nondealer nonbank subsidiary of a bank holding company that extends purpose credit by margin stock. With regard to Regulation T, it refers to any nonbank company that conducts broker-dealer activities.

2. For purposes of the regulation, the definition of "bank" specifically includes institutions "exercising fiduciary powers." (See 12 C.F.R. 221.2, 15 U.S.C. 78(c)(a)(6), and *Federal Reserve Regulatory Service* at 5–795 (1946).) When used in discussing a bank's trust department or any other type of financial institution exercising fiduciary powers, the term "extension of credit" includes overdrafts in settling customer's accounts that may be covered by advances from the banking organization, from other fiduciary customers, or from a combination of both.

stock that are secured by margin stock to be within the 50 percent limit. To avoid violations of the Board's securities credit regulations, on settlement date, the customer's account must hold sufficient funds, excluding the proceeds of the sale of the security, to pay for each security purchased. Although Regulation U applies only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could result in a banking organization's aiding and abetting violations of Regulations T and X and other securities laws, and could raise financial safety-and-soundness issues.

2187.0.2.2 Regulation T, Credit by Brokers and Dealers, and Regulation X, Borrowers of Securities Credit

Because the custodial agency accounts are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash-account transactions are predicated on the customer's agreement that the customer will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-riding is prohibited in a cash account. A customer who instructs his or her agent financial institution to pay for a security by relying on the proceeds of the sale of that security in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in violation of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations[3] involved in customer free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers who deliver securities or funds to the banking organization's customers' accounts. As long as a financial institution uses its funds to complete a customer's transactions, broker-dealers may not discover that they are selling securities to the customer in violation of Regulation T. A similar aiding and abetting violation of Regulation X could occur if a customer used the financial institution to induce a broker-dealer to violate Regulation T.

3. For a discussion of Regulation T as it applies to a bank holding company's broker-dealer nonbank subsidiary, see section 3230.0.

2187.0.3 NEW-CUSTOMER INQUIRIES AND WARNING SIGNALS

Examiners should make certain that all banks and other financial-institution subsidiaries of a bank holding company are administering and following appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. Such policies and procedures should address, among other things, ways an institution can protect itself against free-riding schemes. One way is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain credit to use with the account. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not using the margin-account services of its broker-dealers. If the account is to be used as a margin account, a financial institution must obtain Form FR U-1 from the customer and must sign and constantly update the form.

The financial institution should obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account in DVP transactions. If a number of broker-dealers may be used, the institution should obtain from the customer a written statement that all transactions with the broker-dealer will conform with Regulations T and X and that the customer is aware that a security purchased in a cash account is not to be sold until it is paid for. Similarly, when obtaining instructions for settling DVP transactions for a customer, the financial institution should clarify that it will not rely upon the proceeds from the sale of those securities to pay for the purchase of the same securities.

2187.0.4 SCOPE OF THE INSPECTION FOR FREE-RIDING ACTIVITIES

Examiners, bank holding companies, state member banks, and financial-institution and trust subsidiaries owned by bank holding companies (also U.S. branches and agencies of foreign banks exercising trust powers) should ensure that their banking organizations monitor accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and to ensure that sufficient funds or margin collateral are on deposit at all times. Frequent transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. If it appears that a customer is attempting to free-ride, the financial institution should immediately alert the broker-dealers involved in transferring securities and take steps to minimize its own credit risk and legal liability.

At a minimum, examiners should also evaluate a trust institution's ability to ensure that it does not extend to a customer more credit on behalf of a bank or other financial institution than is permitted under Regulation U. If there are any questions in this regard, examiners should consult with their Reserve Bank's trust examiners. Any overdraft that is related to a purchase or sale of margin stock, and that is secured by margin stock, is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff have published a number of opinions discussing the application of Regulation U to various transactions relating to free-riding.

Free-riding violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits), as well as significant violations that were previously noted but have not yet been corrected, should be noted in the inspection report. Violations of the Board's Regulation T, U, or X, as applicable to the inspection, should be reported on the Examiner's Comments and Violations report pages. The report should discuss what action has or will be taken to correct those violations.

2187.0.5 SEC AND FEDERAL RESERVE SANCTIONS AND ENFORCEMENT ACTIONS

The SEC, in exercising its broad authority to enforce the Board's securities credit regulations, requires banks to (1) establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities-clearance business, (2) establish training programs for bank personnel responsible for the conduct of their securities-clearance business, and (3) submit to outside audits to verify their compliance with the conditions of injunctions. The Board may also institute enforcement proceedings against the banking organizations it supervises and against any institution-affiliated parties involved in these activities, including cease-and-desist orders, civil money penalty assessments, and removal and permanent-prohibition actions.

2187.0.6 INSPECTION OBJECTIVES

1. To make certain that policies of the bank holding company's board, and the supervisory operating procedures, internal controls, and audit procedures will ensure, in the course of settling customers' securities transactions—
   a. that bank extensions of credit within the holding company comply with the provisions of Regulation U (including the requirement that initial extensions of credit that are secured by margin stock are within the initial 50 percent margin limit) and
   b. that customer accounts hold sufficient funds on the settlement date for each security purchased.
2. To determine—
   a. whether the banking organizations of the bank holding company can adequately monitor compliance with Regulation U through systems of internal controls, training, and compliance procedures (i.e., use of credit compliance committees) that address free-riding activities within the "back-office function"[4] and
   b. whether noncompliance is properly reported.
3. To initiate corrective action when policies, practices, procedures, or internal controls are not sufficient to prevent free-riding schemes, and when violations of the Board's regulations have been noted by bank examiners or self-regulatory organizations.

2187.0.7 INSPECTION PROCEDURES

1. Review the bank holding company's board of directors' policies for its banking institution subsidiaries regarding supervisory operational policies, procedures, and internal controls for loans extended for the purpose

4. Refers to the movement of cash and securities relating to trades and to the processing and recording of trades. This process is also called the "securities-clearance cycle."

of buying or carrying margin stock and secured directly or indirectly by margin stock.

a. Determine whether the policies require, for *each* extension of credit not specifically exempted under Regulation U, that a Form FR U-1 be executed and signed by the customer and accepted and signed by a duly authorized officer of the banking organization acting in good faith.

b. Determine whether the policies limit extensions of credit to no more than the maximum allowed loan value of the collateral, as set by section 221.7 of Regulation U, and whether those policies require adherence to margin requirements.

2. Review the bank holding company's board of directors' credit policies and operating policies, internal controls, and internal audit procedures to determine if they provide adequate safeguards against customers' free-riding practices. In so doing—

   a. determine if new-customer accounts are required to be approved by appropriate personnel; and

   b. establish whether the bank holding company's credit-system policies require—

   - controlling securities positions and financial-instrument contracts that serve as collateral for loans;
   - monitoring established restrictions and limits placed on the amounts and types of transactions to be executed with each customer and the dollar amounts placed on unsettled trades;
   - obtaining appropriate documentation consisting of essential facts pertaining to each customer, and in particular, financial information evidencing the customer's ability to pay for ordered securities, repay extensions of credit, and meet other financial commitments;
   - monitoring the location of all collateral;
   - ensuring that there are no overdrawn margin accounts; and
   - monitoring the status of failed transactions for the purpose of detecting free-riding schemes.

3. Determine if the bank holding company's audit committee or its internal or external auditors are required to review a selected random sample of individual or custodial agency accounts for customer free-riding activities.

2187.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Credit by brokers and dealers		220 (Reg. T)		
Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks		221 (Reg. U)		
Purpose credit—delivery-versus-payment transactions			5–942.15, 5–942.18, 5–942.2, 5–942.21, 5–942.22	
Borrowers of securities credit		224 (Reg. X)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2220.3.1 NOTE ISSUANCE FACILITY (NIF)

One type of off-balance-sheet activity is the note issuance facility (NIF). The first public facility was arranged in 1981. A NIF is a medium-term arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as 7 days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and for nonbank borrowers it would generally be promissory notes (Euronotes). NIF is the most common term used for this type of arrangement. Other terms include the revolving underwriting facility (RUF), and the standby note issuance facility (SNIF). NIFs, RUFs, and SNIFs are essentially the same credit product. The NIF is usually structured for 5 to 7 years.

Euronotes are denominated in US dollars and are issued with high face values (often $500,000 or more), being intended for the more sophisticated investor (professional or institutional investors). Holders of the notes show them as an asset on their balance sheets. The underwriting commitment represents an off-balance sheet item. The NIF allows the various functions performed by a single institution in a syndicated credit to be separated and performed by different institutions.

Instead of lending money, as in a syndicated credit, the NIF arranger provides a mechanism for placing notes with other investors when funds are needed. The underwriting commitment transforms the maturity, assuring the borrower access to short-term funds over the medium term, which remains off-balance sheet, unless drawn upon. The underwriters take the short-term credit risk since they face the risk of lending to a borrower that has difficulty in obtaining full confidence from investors.

NIFs can be arranged with an issuer-set margin whereby the issuer determines the margin over LIBOR (the London Interbank Offered Rate), or some other index at which notes will be offered. The issuer thus benefits from any improvement in market conditions. The notes are placed by the placing agent, but senior underwriters have the option of purchasing a prearranged share of any notes issued. Any notes not taken up at the issuer-set margin are distributed to underwriters at the pre- established maximum (cap) rate.

2220.3.2 REVOLVING UNDERWRITING FACILITY (RUF)

Another type of facility, a revolving underwriting facility (RUF), was introduced in 1982. A revolving underwriting facility is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker and the providers of the funding (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A revolving underwriting facility (RUF) differs from a (NIF) in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger) acts as the only placing agent. The arranger retains total control over the placing of the notes. The lead bank provides assistance to a borrower who forms a lending group of banks. The borrower, assisted by a lead bank (arranger), obtains a medium term revolving commitment that guarantees the sale of short-term negotiable promissory notes at or below a pre-determined interest rate. The participating group of banks arrange the funding, subject to certain lending conditions and rates, for the duration of the facility. In return, the borrower pays a facility fee to the revolving credit banks.

When the borrower desires funds, a placement agent or tender panel[1] places short-term notes with other banks and institutional investors (usually having maturities of 90 days, 180 days or 12 months). The short term notes can be issued to these investors at significantly lower interest rates than would be available from a revolving credit facility that the same banks would have been willing to provide. The note purchasers generally have a rollover option at maturity and new note purchasers are added as needed. The note purchasers bear the risk of loss in the event of default by the borrower. New note purchasers are added as needed. In the event the full line of credit is not placed with the note purchasers on any rollover date, the revolving credit banks must make funding available for the difference at the previously committed revolving credit interest rates, subject to the terms and conditions within the agreement.

With the RUF, and the use of a sole placing agent, the underwriters are not assured of securing any notes that they could place themselves nor can they benefit from any improvement in terms available in the market. The hindrance is removed by the use of NIFs with an issuer-set margin whereby the issuer determines the margin over an index at which notes will be offered.

Another form of a RUF is a transferable revolving underwriting facility (TRUF). With this arrangement the underwriter is able, with the borrower's approval, to transfer all rights and obligations under the underwriting commitment to another institution at any time during the life of the facility.

2220.3.3 RISK

The loan commitments involved in NIF and RUF transactions contain substantially the same terms as other loan commitments extended to similar borrowers. The failure of the borrower to satisfy the revolving standby agreement relieves the banks of any obligation to fund the transaction. The major source of risk is thus the liquidity risk that is derived from the uncertainty of the timing or amount of required funding. If the underlying notes cannot be marketed at or below the interest rate specified in the agreement, the bank would need to discount the notes to whatever rate would be necessary to make the notes attractive to investors, perhaps taking an up-front loss to avoid funding a low margin loan.

NIFs and RUFs involve less credit risk than extensions of credit because of the additional step that is required before funding takes place, a step that is not present with a revolving credit agreement. In other words, no funding is required until: (1) a decision is made by the borrower to issue notes; and (2) the placing agent becomes unable to place the short-term notes with short-term investors. Further, the risk of loss rests with the note investors. The underwriter's risk of nonpayment is not present until the rollover date. If there has been a significant deterioration in the issuer/borrower's financial condition on that date, the issuer/borrower may be prevented from drawing under the facility. This would be dependent on the funding conditions or the cancellation provisions stipulated in the agreement.

2220.3.4 PRICING AND FEES

The forms of compensation involving a NIF and RUF are: the underwriting and commitment fee; the one-time arrangement fee, and the periodic placement fees. An annual fixed underwriting fee is paid by the borrower on the amount of underlying commitment. This fee must be paid regardless of the frequency of usage of the facility or whether or not the underwriters are required to make any purchases of the short-term paper. This compensation is for the commitment to underwrite the issuance of the notes. The arranger receives a one-time arrangement fee based on a percentage of the amount of the facility. The issuer pays the borrowing costs on the notes issued, usually at a spread above or below an index. A portion of this borrowing fee is retained by the placement agent or the tender panel members as compensation for placing the paper.

Competitive pricing on NIFs and RUFS causes them to be very thinly margined. Commitment fees may be as low as 5 basis points for blue chip customers, while "BBB" credit-rated or equivalent borrowers might be charged as much as 20 basis points. Because of the thin spread some banks may only be serving as an

1. The tender panel was introduced in 1983. It is usually made up of several commercial investment banks and other institutional investors. The panel members bid for any notes issued, up to a predetermined maximum spread. The revolving credit banks can bid as part of the tender panel, but they are not required to do so. Any notes not bid for are purchased by the revolving credit banks or they extend credit of an equal amount. The tender panel may be a continuous tender panel whereby the underwriters are entitled to purchase notes from the lead manager up to their pro rata share at any time during the offer period, if available, at the market price.

arranger, preferring to not participate in the market. Typical fees for this service may consist of: an up-front arrangement fee of 20 basis points on the total principal amount of the facility, and an annual placement fee such as 12.5 basis points on the short-term notes sold. Revolving credit banks usually receive facility fees and annual maintenance fees.

If the underwriters have to purchase the notes, the backup rate of interest may be the index plus 10 to 15 basis points for blue chip companies to plus 37.5 basis points over the index for ''BBB'' rated borrowers. The interest rates charged (if funded) are usually lower because of market-pricing conventions (lower spreads) and the intense competition within the market.

2220.3.5 STANDBY RUFS

Some RUFS may provide for a utilization fee or may provide for a higher yield on the notes in the event that more than a nominal amount of paper is allocated to the underwriters. Such a provision would more likely be found in a standby facility. Standby facilities are backup commitments under which notes are not expected to be issued. This provision essentially protects the underwriter from having to book loans that are earning an insufficient yield. The structure of the facility generally determines its pricing depending upon the requirements of the issuer/borrower.

Standby RUFs substitute for committed bank lines which may be used, for example, as backup commitments for issuance of U.S. commercial paper. Commitment fees will be low because of the low probability that funds will need to be advanced. A standby facility will make borrowing from the underwriter very expensive in relation to what the issuer might have to pay. Otherwise, the underlying notes are issued on a regular basis, the maximum yield on the notes is set to approximate the normal market level for the issuer's short term borrowings.This facility would have a higher underwriting fee than a standby facility, because the regular issuances of notes increase the likelihood that the underwriting bank will have to purchase notes that cannot be placed.

2220.3.6 RUF DOCUMENTS

The *revolving credit agreement* is the primary document in a RUF. It includes the principal agreement of the transaction, executed by the revolving credit banks and the borrower. It contains the terms and conditions under which the borrower can draw on the facility. The document includes the financial covenants and events of default.

An *agency agreement* between the borrower and the placement agent designates the placement agent for the notes and sets forth the conditions of the agent's obligations for arranging the sale of the notes. Included are representations and warranties of the borrower regarding the authority to enter into the agreement and to issue the notes.

A description of the terms and conditions of the facility is contained within an *information memorandum*. Detail is provided with regard to the use of the proceeds, current and historical financial information, a description of the company, its finances and operations. It is distributed to prospective credit banks and note purchasers.

The *note* is the last document involving a RUF. Usually the notes will be unsecured obligations of the borrower and will include representations and warranties of the company regarding authorization and the absence of material litigation and bankruptcy proceedings. It will also contain a statement that a revolving credit facility is available to the borrower.

2231.0.1 INTRODUCTION

This manual section provides a brief summary of the Board's appraisal regulations and directs readers to the key pieces of guidance that the Board and other banking agencies have issued relating to real estate appraisals and evaluations. The Board's real estate appraisal regulation is found in Regulation Y, subpart G (12 CFR 225.61–67), and applies to bank holding companies, nonbank subsidiaries of bank holding companies, and state member banks. For state member banks, there is a cross reference to the Board's appraisal regulations in Regulation H (12 CFR 208.50–51). Appraisals are also discussed in the Interagency Guidelines for Real Estate Lending Policies, which are found in appendix C to Regulation H, (appendix C to 12 CFR part 208).

Regulation H's real estate lending standards (12 CFR part 208, subpart E) direct state member banks to adopt and maintain written real estate lending policies that are consistent with safe and sound lending practices. Such policies should reflect consideration of applicable regulations and guidance pertaining to real estate appraisals when developing a loan-to-value estimate.[1] Although Regulation H applies only to state member banks, bank holding companies and their nonbank subsidiaries are expected to conduct their real estate lending activities in a prudent manner consistent with safe and sound lending standards.

2231.0.2 REGULATORY BACKGROUND FOR APPRAISALS

The Board's policy on real estate appraisals emphasizes the importance of sound appraisal policies and collateral-valuation procedures as part of a supervised financial institution's real estate lending activity.[2] The Board and other federal financial regulatory agencies adopted regulations in August 1990 on the performance and use of appraisals by federally regulated financial institutions to implement statutory changes due to the passage of title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC 3331 et seq.).[3]

The Board's appraisal regulation requires, at a minimum, that real estate appraisals for federally related transactions be performed in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation, and that appraisals be in writing.[4] The regulation also sets forth additional appraisal standards, including that the appraisal contain sufficient information and analysis to support the supervised financial institution's decision to engage in the transaction; provide the real property's market value; be performed by state certified or licensed appraisers as required by the regulations; and analyze deductions and discounts for proposed construction projects, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.

The intent of title XI and the Board's appraisal regulation is to protect federal financial and public policy interests in federally related transactions.[5] Federally related transactions are defined as those real estate-related financial transactions that an agency engages in, contracts for, or regulates and that require the services of an appraiser.[6]

Appraisals are required under the appraisal regulation for all real estate-related financial transactions unless an exemption applies. The regulation contains a set of exemptions, including dollar value thresholds at or below which an appraisal is not required. The exemptions are

1. 12 CFR part 208, appendix C, defines "value" when used to refer to "loan-to-value" as an opinion or estimate set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agency's appraisal regulations and guidance.

2. The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (the agencies) have promulgated appraisal regulations pursuant to Title XI. See 12 USC 3339. The agencies' title XI appraisal regulations apply to transactions entered into by the agencies or by institutions regulated by the agencies that are depository institutions or bank holding companies or subsidiaries of depository institutions or bank holding companies. OCC: 12 CFR part 34, subpart C; Board: 12 CFR part 225, subpart G; 12 CFR part 208, subpart E; and FDIC: 12 CFR part 323, subpart A. Unless otherwise stated, "supervised financial institutions" include state member banks, bank holding companies, and nonbank subsidiaries of bank holding companies.

3. In June 1994, the agencies' appraisal regulations were materially revised to clarify, amend, and add several exemptions to the appraisal requirement.

4. See 12 CFR 225.64.

5. See 12 USC 3331.

6. See 12 USC 3350(4).

identified as categories of real estate-related financial transactions that do not require the services of an appraiser in order to protect federal financial and public policy interests or to satisfy principles of safe and sound banking. As such, the exempted transactions are not federally related transactions under the statutory and regulatory definitions. Exempted transactions are not subject to title XI nor the provisions of the agencies' regulations governing appraisals. Certain exemptions, however, require the use of an evaluation consistent with safe and sound banking practices. Interagency guidance has been issued to assist financial institutions in performing evaluations consistent with such practices.

In addition to federal regulations, each state has established a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with federally related transactions. Title XI designated the Appraiser Qualifications Board and the ASB of the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and licensing and the standards for the preparation of an appraisal. Title XI established the Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council. The ASC monitors state requirements for certifying and licensing appraisers who can perform appraisals for federally related transactions, state supervision, and registration of appraisal management companies, as well as certain title XI-related requirements established by the federal financial regulatory agencies. The ASC also monitors the Appraisal Foundation and its entities. If the ASC issues a finding that the policies, practices, or procedures of a state appraiser certifying and licensing agency are inconsistent with title XI, the services of licensed or certified appraisers from that state may not be used in connection with federally related transactions. The ASC also maintains the national registry of appraisers and appraisal management companies.[7]

7. Several provisions in title XI of FIRREA were amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), providing additional authority to the ASC in its oversight of states' appraiser regulatory programs. (See sections 1471–1473 of Pub. L. 111-203, 124 Stat. 1376 (2010).)

2231.0.3 THE APPRAISAL REGULATION

Regulation Y, 12 CFR part 225, Subpart G, Appraisal Standards for Federally Related Transactions

The appraisal regulation sets standards for appraisals in connection with federally related transactions and also contains a lists of transactions that do not require the services of an appraiser and, therefore, are exempt from the appraisal requirement of the regulation. In reviewing a real estate loan, examiners assess whether the appraisal supports the real estate value used by the supervised financial institution in its credit decision and whether the appraisal complies with the appraisal regulation. Further, examiners assess the adequacy of an institution's appraisal program to support its real estate lending activity. There are several key sections in the appraisal regulation, which are described in greater detail below. The regulation contains the following:

- *Minimum appraisal standards, section 225.64* The regulation establishes minimum standards necessary for all appraisals that are prepared for federally related transactions. Those appraisals must
  - — conform to generally accepted appraisal standards in USPAP.
  - — be subject to appropriate review for compliance with USPAP.
  - — be written and contain sufficient information and analysis to support the credit decision.
  - — analyze and report deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms and tract developments with unsold units.
  - — be based upon the definition of market value set forth in the definition section of the regulation.
  - — be performed by state-licensed or state-certified appraisers in accordance with the regulation.
- *Independence standards for staff appraisers and fee appraisers, section 225.65*
  - — Staff appraisers must be independent of the lending, investment, and collection functions of the institution and not involved, except as an appraiser, in the federally related transaction and have no direct or indirect interest, financial or otherwise, in the property.

   — Fee appraisers must be engaged directly by the institution or its agent and have no direct or indirect interest, financial or otherwise, in the property or the transaction.
   — The regulation allows an institution to accept an appraisal prepared by an appraiser engaged by another financial services institution if the appraiser has no direct or indirect interest, financial or otherwise, in the property or transaction, and the appraisal complies with the requirements of the regulation.
- *Exemptions from the regulation, section 225.63*
   — The regulation provides a list of transactions that do not require appraisals. These transactions do not require the services of an appraiser and are, therefore, not federally related transactions. Certain of these exceptions require an evaluation in lieu of an appraisal.
- *Standards for professional association membership and competency, section 225.66*
   — A state-certified or state-licensed appraiser may not be excluded from consideration of an assignment based on membership or lack of membership in a particular appraisal organization.
   — All staff and fee appraisers performing appraisals in connection with federally related transactions must be state-certified or state-licensed as appropriate. However, any determination of competency shall be based on the individual's experience and educational background as they relate to a particular appraisal assignment.
- *Enforcement actions, section 225.67*
   — Institutions and their affiliates, including staff and fee appraisers, may be subject to removal and/or prohibition orders, cease and desist orders, and the imposition of civil money penalties.

2231.0.4 SUPERVISORY EXPECTATIONS AND FINDINGS

In conjunction with assessing the overall adequacy of a supervised financial institution's appraisal and evaluation program to support safe and sound real estate lending, examiners may cite the appropriate supervised financial institution with the following possible findings.

1. Examiners may make a finding regarding the supervised financial institution's compliance with the Board's appraisal regulation. When citing a violation of the appraisal regulation for a state member bank, an examiner should note the matter as a violation of Regulation H (12 CFR part 208, subpart E) citing the provision as codified in Regulation Y.
2. In some instances, the finding may indicate that a state member bank has failed to comply with the Board's real estate lending standards regulation. Examiners may refer to 12 CFR part 208, appendix C, "Interagency Guidelines for Real Estate Lending Policies," for guidance related to the use of appraisals in developing loan-to-value estimates according to the real estate lending standards.
3. Examiners should consider the supervisory expectations in the Interagency Appraisal and Evaluation Guidelines for guidance on safe and sound valuation policies and practices. If the institution's valuation policies and practices pose safety-and-soundness concerns for the institution, examiners could refer to 12 CFR part 208, Appendix D-1, "Interagency Guidelines Establishing Standards for Safety and Soundness," for guidance on consideration of the value of underlying collateral.

The following provides examples of possible examination findings and references to the applicable provisions in the Board's regulations.

Examples of violations of the appraisal regulation, 12 CFR 208.50 as set forth in 12 CFR 225.61–67, include

- failure to obtain an appraisal (12 CFR 225.63);
   — not obtaining an appraisal as required by the regulation
   — using an outdated appraisal for an existing transaction without meeting the regulatory criteria
   — not obtaining an appraisal due to the misapplication of an exemption, or when the transaction does not meet the specific requirements of the exemption
   — **Remedy:** Examiners should require the supervised financial institution to obtain a new appraisal.
- appraisal fails to comply with the minimum appraisal standards in the appraisal regulation;
   — violation of 12 CFR 208.50, subpart E as set forth in 12 CFR 225.64 (minimum

appraisal standards) or 12 CFR 225.65 (appraiser independence)
  - **Remedy:** Examiners should require the supervised financial institution to obtain a new appraisal.
- failure to use a state-licensed or state-certified appraiser (12 CFR 225.63);
  - engaging an appraiser with an expired license or certification
  - engaging a state-licensed appraiser when a state-certified appraiser is required
  - **Remedy:** Examiners should require the supervised financial institution to obtain a new appraisal.
- failure to maintain appraiser independence (12 CFR 225.65);
  - using a staff appraiser that is not independent of the lending function
  - allowing the borrower to hire the appraiser (the regulation requires that fee appraisers be engaged directly by the institution or its agent)
  - using an appraisal prepared by an appraiser that has an interest in the real estate
  - **Remedy:** Examiners should require the bank to obtain a new appraisal.
- failure to obtain an evaluation for certain exempt transactions (12 CFR 225.63(b)).
  - not obtaining an evaluation for a renewed loan
  - not obtaining an evaluation for a commercial or residential transaction at or under the appropriate threshold
  - not obtaining an evaluation for a business loan at or under $1 million
  - For further background, refer to the Interagency Guidelines and the section on “Transactions That Require Evaluations” as well as Appendix A—Appraisal Exemptions.
  - **Remedy:** Examiners should require the supervised financial institution to obtain an evaluation.

Examples of violations of the real estate lending regulation 12 CFR part 208, subpart E that pertain to appraisals or evaluations:

- The bank does not have adequate procedures for monitoring market conditions for its commercial real estate lending.
  - A bank must monitor real estate market conditions in its lending area and have credit administration policies that address the type and frequency of collateral valuations. Violation of 12 CFR part 208, subpart E (real estate lending standards regulation).
- Bank does not have appropriate policies establishing loan-to-value limits for real estate collateral. Violation of 12 CFR part 208, subpart E (real estate lending standards regulation).
  - **Remedy:** Examiners should require the bank to implement policies and procedures to promote compliance with the real estate lending regulation.

Examples of possible safety and soundness violations:

- The supervised financial institution’s overall appraisal function is weak.
  - The supervised financial institution’s appraisal and evaluation programs are inconsistent with safe and sound practices. Guidance on developing appraisal and evaluation programs in a safe and sound manner is provided in the Interagency Appraisal and Evaluation Guidelines.
  - The supervised financial institution’s approach to monitoring collateral values raises safety-and-soundness concerns, as an institution needs to have sufficient information to assess the real estate collateral risk in its real estate loan portfolio.
- The evaluation is inadequate.
  - The supervised financial institution has failed to satisfy supervisory expectations for evaluations.
  - For further guidance, refer to the Interagency Guidelines, the “Evaluation Development” and “Evaluation Content” subsections, and Appendix B — Evaluations Based on Analytical Methods or Technological Tools.
  - **Remedy:** Depending upon the noted deficiencies, examiners should require the supervised financial institution to perform a new evaluation or, alternatively, the institution may obtain an appraisal.
- The supervised financial institution has failed to meet independence expectations for its appraisal and evaluation program. Guidance for meeting independence expectations is set forth in the section on the Independence of the Appraisal and Evaluation Program in the Interagency Guidelines.
  - Evaluations are prepared by persons who are not independent of loan production.
  - Reporting lines of valuation program staff are not independent of loan production.

2231.0.5 INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES

Over the years, the Board and the other federal banking regulatory agencies (the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the agencies)) have issued several appraisal-related guidance documents to assist institutions in implementing and complying with the appraisal regulation.[8] In December 2010, the agencies issued the Interagency Appraisal and Evaluation Guidelines (Interagency Guidelines) to clarify their appraisal regulations and to promote best practices in institutions' appraisal and evaluation programs. (See SR-10-16.) The Interagency Guidelines pertain to all real estate-related financial transactions originated or purchased by a regulated institution or its operating subsidiary for its own portfolio or as assets held for sale, including activities of commercial and residential real estate mortgage operations, capital markets groups, and asset securitization and sales units. The Interagency Guidelines provide a comprehensive discussion of the Board's supervisory expectations for a supervised financial institution's appraisal and evaluation program as well as background information on the technical aspects of appraisals.

The Interagency Guidelines more fully explain and clarify the requirements of the appraisal regulation. The Interagency Guidelines also contain supervisory guidance for developing and maintaining a safe and sound appraisal and evaluation program. Expectations for evaluations are addressed in the guidelines to clarify the requirement in the regulation that evaluations be performed in a safe and sound manner. For example, the appraisal regulation allows for the substitution of an "appropriate evaluation" for an appraisal under certain transactions; however, the regulation does not define what is an appropriate evaluation. The Interagency Guidelines provide guidance to assist regulated institutions in determining what an "appropriate evaluation" is. A violation of the appraisal regulation should be cited if the institution failed to obtain an evaluation, where one was required. The Interagency Guidelines may be used as guidance, for example, in determining the appropriate type of content in an evaluation. However, in making determinations about the adequacy of an institution's evaluation content, an assessment of the impact on the safety and soundness of the institution should be made and if it is determined that the evaluation was not conducted in a safe and sound manner, the evaluation requirement of the appraisal regulation should be cited. The Interagency Guidelines serve two main purposes:

1. Provides guidance regarding supervisory expectations for a supervised financial institution's appraisal and evaluation program including that
   - the institution's board of directors should provide for an effective appraisal and evaluation program;
   - the program should be independent;
   - the program should have a criteria for selection of appraisers and evaluators;
   - appraisals and evaluations should be appropriately reviewed;
   - there should be appropriate oversight of third-party arrangements;
   - the lender should have an appropriate compliance program; and
   - the lender should report appraisers that are involved in USPAP violations to state appraisal regulatory agencies.
2. Clarifies and provides guidance to assist firms in complying with the appraisal regulation, such as
   - the content expectations of an evaluation;
   - independence expectations for evaluations;
   - transactions that are exempt from the appraisal requirement;
   - situations where a real estate loan does not qualify for an exemption;
   - assessing the validity of existing appraisals and evaluations;
   - the importance of a scope of work and valuation approach in appraisal development; and
   - appraisal report options.

The Interagency Guidelines also discuss other uses for appraisals and evaluations. For example, a supervised financial institution's collateral-valuation program should consider when an appraisal or evaluation should be obtained to monitor ongoing collateral risk and to support credit analysis, including for purposes of updating risk ratings or classifying the credit. Also, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's cash flow and income to the expected proceeds from the sale of the real estate collateral. Therefore, it is important that supervised financial institutions have a sound

8. For more information, see the "Real Estate" supervisory policy and guidance topic page.

and independent basis for determining the ongoing value of the real estate collateral. (See SR-09-7, "Prudent Commercial Real Estate Loan Workouts.")

2231.0.5.1 Appendixes of Interagency Appraisal and Evaluation Guidelines

Below are summaries of the four appendixes included with the guidelines found in the attachment to SR-10-16.

Appendix A—Appraisal Exemptions. A commentary on the 12 exemptions from the agencies' appraisal regulations. The appendix provides an explanation of the agencies' statutory authority to provide for appraisal regulatory exemptions and the application of these exemptions. In addition to these exemptions, note that the appraisal regulation has been amended to exempt commercial real estate transactions below $500,000 and residential real estate transactions below $400,000.[9]

Appendix B—Evaluations Based on Analytical Methods and Technological Tools. A discussion of the agencies' expectations for evaluations that are based on analytical methods and technological tools, including the use of automated valuation models and tax assessment valuations.

Appendix C—Deductions and Discounts Minimum. A discussion on appraisal standards for determining the market value of a residential tract development, including an explanation of the requirement to analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.

9. In addition, the regulation was amended to cross reference a self-effectuating statutory exemption for rural residential real estate transactions under $400,000 that meet certain requirements, which was enacted by the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). Supervised financial institutions are unlikely to rely on this exemption because all transactions within its scope are also exempt under the broader residential threshold exemption, which does not require the institution to meet any other criteria. An evaluation is required regardless of whether the institution relies on the general residential threshold or rural exemption. For more information on the effective dates of this amendment, see 84 Fed. Reg. 53,579 (October 8, 2019).

Appendix D—Glossary. Definitions of terms related to real estate lending, appraisals, and regulations to aid in reading the guidelines.

2231.0.6 ASSESSING THE ADEQUACY OF AN APPRAISAL

When assessing the adequacy of an appraisal and its compliance with the minimum appraisal standards, examiners should assess whether the appraisal conforms to USPAP Standard Rule 1—Real Property Appraisal Development, and USPAP Standard Rule 2—Real Property Appraisal Reporting. The Interagency Guidelines discuss the importance of the appraiser developing an appropriate "scope of work" consistent with USPAP's Scope of Work rule. An appraisal's scope of work should be clearly developed and explained in the appraisal report. Further, the appraisal report should include a copy of the supervised financial institution's engagement letter with the appraiser for the appraisal assignment.

It is important to note that some of the USPAP standards differ from aspects of the appraisal regulation, and, in such cases, the appraisal regulation should be followed with respect to appraisals for federally related transactions. For example, USPAP does not require appraiser independence and allows for appraisals to address definitions of value other than market value.

In reviewing a real estate loan and the related appraisal, examiners should consider whether the type of appraisal report is acceptable, the valuation approach is appropriate for the transaction, and the appraisal contains an estimate based on the market value definition. The appraisal should contain a clear development of the market value of the collateral and should contain sufficient information to support the real estate's market value and the supervised financial institution's credit decision. The USPAP standards discuss all of the basic components of an appraisal. Residential appraisals are commonly completed in a report format that conforms to the Uniform Residential Appraisal Report, which was developed by Fannie Mae and Freddie Mac.

Examiners should also confirm that the bank has procedures for reviewing appraisals and evaluations to determine that an appraisal or evaluation complies with the appraisal regulation and provides sufficient information to support the supervised financial institution's credit decision. The Appraisal Regulation was amended to require supervised financial institutions to subject appraisals to appropriate review for compliance with USPAP. The Interagency Guidelines provide further guidance on appropriate reviews. Not all appraisal reviews need to include the content of a USPAP Standard 3—Appraisal Review, Development, and Reporting. The depth of the appraisal review performed by the bank should consider the complexity and risk of the transaction. If deficiencies are noted in the supervised financial institution's review process, a supervised financial institution should obtain a USPAP compliant review completed by an appraiser or obtain a new compliant appraisal. Supervised financial institutions are encouraged to report to the state appraiser regulatory agency any appraiser that violates USPAP standards.

2231.0.7 APPRAISAL VALUATION APPROACHES

An appraiser typically utilizes three market-value approaches to analyze the value of property:[10]

- cost approach
- sales comparison approach
- income approach

Appraisers should consider all three approaches to value when completing an appraisal assignment. All three approaches have particular merits depending upon the type of real estate being appraised. For example, for single-family residential property, the cost and comparable sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property were intended to be used as a rental property, the appraiser would have to consider the income approach as well. Commercial properties are typically valued using all three approaches to value, whereas the income approach is heavily favored for property whose primary source of income is derived from rents. The appraiser then correlates the results of the value considerations to determine a market value for the subject real estate. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and income approaches.

If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

2231.0.7.1 Cost Approach

The cost approach is commonly used to value construction or improvements to an existing building. In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any functional depreciation (disadvantages or deficiencies) of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

2231.0.7.2 Sales Comparison Approach

The essence of the sales comparison approach is to determine the price at which similar properties have recently sold on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The process used in determining the degree of comparability of two or more properties involves judgment about their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tends to set the range for the value of the subject property.

10. The standards and application of valuation approaches are contained in the USPAP published by the Appraisal Standards Board of the Appraisal Foundation.

2231.0.7.3 Income Approach

The income approach estimates the real estate project's expected income over time converted to an estimate of its present value. The income approach is typically used to determine the market value of income-producing properties that receive rent, such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can apply several different capitalization or discounted cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual method. Which method is used depends on whether there is project financing, whether there are long-term leases with fixed-level payments, and whether the value is being rendered for a component of the project, such as land or buildings.

The accuracy of the income-approach method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and discounted cash flow. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This provides gross rental data and shows the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
- Expense data, such as taxes, insurance, and operating costs paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined.
- A time frame for achieving stabilized, or normal, occupancy and rent levels (also referred to as a holding period).

Basically, the income approach converts all expected future net operating income into present-value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a capitalization rate or "cap rate." Stabilized income is generally defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated as a percentage of current income.

The use of this technique assumes that the use of either the stabilized income or the cap rate accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization should yield the same results. For special-use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a time frame for achieving a stabilized, or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions.

2231.0.7.4 Value Correlation

The three value estimates—cost, sales comparison, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that the examiner must exercise judgment in analyzing the results and determining the estimate of market value.

2231.0.7.5 Other Definitions of Value

While the Board's appraisal regulation requires that the appraisal contain the market value of the real estate collateral, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include the following:

Fair value. This is an accounting term that is generally defined as the amount in cash or cash-equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (the selling price), that is, other than in a forced or liquidation sale.[11] According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

Investment value. This is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different from participants' criteria and objectives in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

Liquidation value. This assumes that there is little or no current demand for the property but the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

Going-concern value. This is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record, with the assumption that the business will continue to operate.

Tax-assessed value. This represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

Net realizable value (NRV). This is recognized under generally accepted accounting principles as the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal. The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

11. See Accounting Standards Codification (ASC) Topic 820, "Fair Value Measurements and Disclosures" (formerly FASB Statement No. 157, "Fair Value Measurements"). It defines fair value and establishes a framework for measuring fair value. ASC Topic 820 should be applied when other accounting topics require or permit fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an "exit" price. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced liquidation or distressed sale.

These guidelines are designed to in ensure that troubled real estate loans receive consistent treatment nationwide. The guidelines are not intended to be a substitute for the examiner's judgment or for careful analysis of applicable credit and collateral factors. Use of the word "institution" in these guidelines refers to any lending source within the bank holding company organization, whether the lender is the parent company, a bank, thrift, or nonbanking subsidiary.

2240.0.1 EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

2240.0.1.1 Loan Policy and Administration Review

As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

2240.0.1.2 Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness

In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can affect a project's economic feasibility and may cause a real estate project and the loan to become troubled. Available indicators, such as permits for—and the value of—new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.[1]

2240.0.1.3 Examiner Review of Individual Loans, Including the Analysis of Collateral Value

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[2] However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.[3] Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.[4] Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.[5] This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on

1. As discussed more fully in Manual section 2240.0.2, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

2. The treatment of guarantees in the classification process is discussed in subsection 2240.0.3.

3. Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90–16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R–0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064–AB05); Department of the Treasury; Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90–1495).

4. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

5. The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization (''cap'') rates.

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and ''cap'' rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, ''cap'' rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and ''cap'' rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

2240.0.2 CLASSIFICATION GUIDELINES

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

2240.0.2.1 Classification of Troubled Project-Dependent Commercial Real Estate Loans[6]

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. The guidelines are not intended to address loans that must be treated as ''Other Real Estate Owned'' for bank and BHC reporting purposes.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified ''loss.''[7] The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than ''substandard.'' The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified ''doubtful'' when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a ''doubtful'' classification on the entire loan balance. However, this would occur infrequently.

6. The discussion in this section is not intended to address loans that must be treated as ''other real estate owned'' for bank regulatory reporting purposes or ''real estate owned'' for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

7. For purposes of this discussion, the ''value of the collateral'' is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

2240.0.2.2 Guidelines for Classifying Partially Charged-off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than ''substandard.''

A more severe classification than ''substandard'' for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

2240.0.2.3 Guidelines for Classifying Formally Restructured Loans

The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.[8] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

2240.0.3 TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.[9] The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a ''financially responsible guarantor,'' as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a ''financially responsible guarantor'' has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and[10]
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

2240.0.3.1 Considerations Relating to a Guarantor's Financial Capacity

The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

2240.0.3.2 Considerations Relating to a Guarantor's Willingness to Repay

Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the ''track record'' of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

8. An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a ''cash flow'' mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

9. Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

10. Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

2240.0.3.3 Other Considerations as to the Treatment of Guarantees in the Classification Process

In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

In June 2000, the Federal Financial Institutions Examination Council (FFIEC), on behalf of the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), collectively referred to as "the agencies," published revisions to the Uniform Retail Credit Classification and Account Management Policy.[1] The purpose of the 2000 revision was to clarify certain provisions, especially regarding the re-aging of open-end accounts and extensions, deferrals, renewals, and rewrites of closed-end loans. The revised policy provides supervisory guidance for residential and home equity loans; fraudulent loans; loans to deceased persons; loans to borrowers in bankruptcy; treatment of partial payments involving past-due loans; and re-aging, deferrals, renewals, or rewrites of open-end and closed-end credit. The agencies are to use this expanded supervisory guidance when applying the uniform classifications to retail-credit loans extended by depository institutions. See SR-00-8, "Revised Uniform Retail Credit Classification and Account Management Policy."

While the terms of the revised policy apply only to federally insured depository institutions, the Federal Reserve believes the guidance is broadly relevant to bank holding companies (BHCs) and their nonbank lending subsidiaries, as well as savings and loan holding companies (SLHCs).[2] Accordingly, examiners should consider the revised policy, as appropriate, in the inspection of consumer finance subsidiaries of BHCs and SLHCs.

The following subsection presents the Uniform Retail Credit Classification and Account Management Policy with minor clarifying edits and updated references. See 65 Fed. Reg. 36,903, (June 12, 2000) for the original statement issued by the FFIEC.

2241.0.1 UNIFORM RETAIL CREDIT CLASSIFICATION AND ACCOUNT MANAGEMENT POLICY

The Uniform Retail Credit Classification and Account Management Policy establishes standards for the classification and treatment of retail credit in financial institutions. The agencies' classifications used for retail credit are *Substandard, Doubtful,* and *Loss.*[3] These are defined as follows:

- **Substandard:** A *Substandard* asset is inadequately protected by the current sound worth and paying capacity of the obligor, or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful:** An asset classified *Doubtful* has all the weaknesses inherent in one classified *Substandard* with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
- **Loss:** Assets classified *Loss* are considered uncollectible, and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off this basically worthless asset, even though partial recovery may be effected in the future.

Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, including consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit port-

1. While the former Office of Thrift Supervision also adopted the Uniform Retail Credit Classification and Account Management Policy, the National Credit Union Administration, also a member of the FFIEC, did not.

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

3. Although the Federal Reserve, FDIC, and OCC do not require institutions to adopt identical classification definitions, institutions should classify their assets using a system that can be easily reconciled with the regulatory classification system.

folio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

1. Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified as *Substandard.*
2. Closed-end retail loans that become past due 120 cumulative days, and open-end retail loans that become past due 180 cumulative days, from the contractual due date should be classified as *Loss* and charged off.[4] In lieu of charging off the entire loan balance, a loan with non-real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
3. One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios greater than 60 percent should be classified as *Substandard.* Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more, should be classified as *Substandard,* even if the loan-to-value ratio is equal to or less than 60 percent.

   For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified as *Loss* and charged off.
4. Loans in bankruptcy should be classified as *Loss* and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified as *Substandard* until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
5. Fraudulent loans should be classified as *Loss* and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
6. Loans of deceased persons should be classified as *Loss* and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

4. For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate. Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

2241.0.1.1 Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. "In the process of collection" means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

2241.0.1.2 Partial Payments on Open- and Closed-End Credit

An institution should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, an institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is \$300 and the borrower makes payments of only \$150 per month for a six-month period, the institution could aggregate the payments received (\$150 × 6 payments, or \$900). The institution could then give credit for three full months (\$300 x 3 payments) and thus treat the loan as three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

2241.0.1.3 Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member.[5] A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

5. These terms are defined as follows. **Re-age:** Returning a delinquent, open-end account to current status without collecting (at the time of aging) the total amount of principal, interest, and fees that are contractually due. **Extension:** Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. **Deferral:** Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, (or the due date for subsequently scheduled payments,) of the loan. The account is shown current upon granting the deferral. **Renewal:** Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. **Rewrite:** Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

2241.0.1.4 Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

1. The borrower has demonstrated a renewed willingness and ability to repay the loan.
2. The account has existed for at least nine months.
3. The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any 12-month period and no more than twice within any 5-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a 5-year period and is in addition to the once-in-12-months/twice-in-5-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

2241.0.1.5 Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

1. The borrower should show a renewed willingness and ability to repay the loan.
2. The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
3. Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

2241.0.1.6 Examination Considerations

Examiners should assess whether an institution adheres to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail Credit Classification and Account Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient.

In addition to reviewing loan classifications, the examiner should assess whether the institution's allowance provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. A bank's internal controls should also confirm adherence to its retail-credit lending policies. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism as an unsafe and unsound practice.

In carrying out its regulatory and supervisory responsibilities, the Board requires the submission of various reports from bank holding companies. These reports are an integral part of the Board's supervision, monitoring, and surveillance functions. Information from these reports is used to evaluate the performance of bank holding companies, appraise their financial condition, and determine their compliance with applicable laws and regulations. The examiner must review the reports (submitted to the Federal Reserve System) for accuracy and timeliness and insist on their being amended if material errors are found. If inaccurate data are submitted, the resulting ratios could conceal deteriorating trends in the company's financial condition and performance. Bank holding companies should maintain sufficient internal systems and procedures to ensure that reporting is accomplished according to appropriate regulatory requirements. Clear, concise, and orderly workpapers should support the data presented and provide a logical tie between report data and the financial records. For detailed current information on who must submit reports and what the reporting requirements are, see the Board's public site on the Internet at the following address: www.federalreserve.gov/boarddocs/reportforms.

2250.0.1 PENALTIES FOR ERRORS IN REPORTS

Section 8 of the Bank Holding Company Act (the act) was amended to provide for the assessment of civil money penalties for the submission of late, false, or misleading reports filed by bank holding companies that are required by the act and Regulation Y and for the failure to file the required regulatory reports. Financial institutions that have adequate procedures to avoid any inadvertent errors but that unintentionally submit incorrect information or are minimally late in publishing or transmitting the reports can be fined up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent. If the error was not inadvertent, a penalty of up to $20,000 per day can be assessed. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or 1 percent of the institution's assets can be assessed for each day of the violation. Institution-affiliated parties who participate in any manner in the filing of an institution's false or misleading required regulatory report, or who cause the failure to file or a late filing of a required regulatory report, may be assessed a civil money penalty of up to $25,000 per day.

2250.0.2 APPROVAL OF DIRECTORS AND SENIOR OFFICERS OF DEPOSITORY INSTITUTIONS

The Federal Deposit Insurance Act (12 U.S.C. 1811) was amended to require each insured depository institution and depository institution holding company to give 30 days' prior notification to the federal banking authority of (1) the proposed addition of any individual to its board of directors or (2) the employment of any individual as a senior executive officer. This requirement applies to the following institutions:

1. institutions that have been chartered less than two years
2. institutions that have undergone a change in control within the preceding two years
3. institutions that are in a troubled condition or whose capital is below minimum standards

The agencies have the authority to issue a notice of disapproval to stop the appointment or employment of an individual if they feel that appointing or employing the person would not be in the interests of the public, taking into account that individual's competence, experience, character, and integrity.

2250.0.3 INSPECTION OBJECTIVES

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate and complete.
3. To recommend corrective and, if needed, formal enforcement action when official reporting practices, policies, or procedures are deficient.

2250.0.4 INSPECTION PROCEDURES

1. A bank holding company's historical record concerning the timely submission of reports should be ascertained by reviewing relevant

Reserve Bank files. The examiner should determine, from documentation in the files, which reports should have been filed because of the passage of time or the occurrence of an event. If a report is delinquent, the bank holding company should be instructed to prepare and submit the report expeditiously.

2. Copies of regulatory reports filed since the prior inspection should be reviewed and compared with company records on a random, line-by-line basis, using a significance test. In some cases, the review will necessarily extend to supporting schedules and workpapers that substantiate the data reflected in the reports. If the initial reports reviewed are found to be substantially correct, then the scope of subsequent reviews may be curtailed. If the reports are found to be incorrect, the overall review procedures should be intensified. When an error or misstatement is considered significant, the matter should be brought to management's attention and the bank holding company should be required to submit adjusted data. Improper methods used in preparing reports should be called to management's attention. The examiner should explain all changes carefully and assist bank holding company personnel in whatever way possible to ensure proper reporting in future reports.
3. At the conclusion of the review process, the examiner should discuss the following with management, when applicable:
   a. inaccuracies found in reports and the need for submission of amended pages or reports
   b. violations of law, rulings, or regulations
   c. recommended corrective action when policies or procedures have contributed to deficiencies noted in the reports or the untimely submission of report(s)
4. Details concerning the late or inaccurate preparation of reports should be listed in the inspection report on the Other Supervisory Issues report page. If the matter is considered significant, it should be noted on the Examiner's Comments and Matters Requiring Special Board Attention report page, as well. When the exceptions are considered minor and have been discussed with management and corrected, it will suffice to state this on the Other Supervisory Issues workpaper supporting page.
5. When it is determined that false, misleading, or inaccurate information is contained in financial statements or reports, consider whether formal enforcement action is needed to ensure that the offending bank holding company, financial institution, or other entity under the holding company structure will correct the statements and reports.

2250.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Submission of reports concerning compliance with the act, or regulations or orders under it	1844(c)			
Annual reports	1844(c)	225.5(b)		
Report on intercompany transactions	1844(c)	225.5(b)		
Reports emanating from inspection report recommendations	1844(c)	225.5(b)		
Reports emanating from cease-and-desist orders	1818(b), (c)			
Civil money penalties for errors on bank call and BHC Reports	324 1847			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2260.0.1 INTRODUCTION

Venture capital activities are usually conducted through one or more of the following types of entities: Small Business Investment Companies (SBIC); Minority Enterprise Small Business Investment Companies (MESBIC); Non-licensed Venture Capital Companies; and Partnerships or Venture Capital Funds. SBIC's and MESBIC's are licensed and regulated by the Small Business Administration (SBA); the other types are not. Both SBIC's and MESBIC's are limited by regulation to investing in and lending to small businesses; whereas, non-licensed venture capital companies and partnerships have greater latitude. The activities of MESBIC's (section 103d companies) are specifically limited to small firms owned by socially or economically disadvantaged persons. Most banks and bank holding companies engage in venture capital activities through an SBIC because of its broad ability to take equity positions in other companies. SBIC's are permitted to own up to 49.9 percent of the voting shares of a company. By contrast, a non-licensed venture capital company that is a subsidiary of a bank holding company may not own more than 4.9 percent of the voting shares of a business. To escape from this limitation some bank holding companies have formed partnerships or venture capital funds. However, a bank holding company can only participate as a limited partner with an ownership interest not to exceed 24.9 percent. Limited partnerships are preferred by those bank holding companies who do not possess the expertise for this type of activity but seek the potential opportunity for high returns.

Through the use of private capital and, in some cases, borrowed money, venture capital companies invest in and lend to new and growing business enterprises. They prefer to invest in and lend to companies that exhibit strong management talent and clearly defined strategies. Many of the companies are yet unknown to the public. Their products either have been introduced to the market or are due to arrive in the next few years. Venture capital companies do not favor pioneering research. Instead, they are interested in financing innovative products, i.e., those next in generation to existing ones, that have a wide market appeal and the potential for strong growth. Such products are preferred because of their shorter development time and possible faster realization of profits. One of the ways a venture capital company makes money is by purchasing the common stock of an emerging company and selling it when the company has grown and the stock has appreciated in value. It also generates earnings by making convertible preferred stock investments and by lending money in the form of subordinated debentures and term loans. Usually lending agreements contain provisions which enable a venture capital company to acquire shares or increase existing holdings through the exercise of warrants or stock options at a later date. Although in most cases some equity interest is taken, venture capital companies, generally, do not acquire a controlling interest in a business they finance.

Once financing commences, venture capital companies typically take an active role in the management of the companies. They usually receive representation on the company's board of directors, which enables them to review budgets and assist in structuring the company's long-range strategic plan. Guiding a company through its developing stages is considered essential for the achievement of equity appreciation and realization of the high returns sought by venture capital companies.

2260.0.2 LOANS AND INVESTMENTS

Investments and lending philosophy may differ among venture capital companies. Some choose to be equity-oriented; that is, they look for higher returns on investments through capital appreciation, while others favor lending in the form of loans or convertible debt securities which provide cash flow to fund operations and service debt. However, most companies will strive for a diversified portfolio in terms of the type of investment and industry mix. The range of financing possibilities associated with lending and/or investing is as follows:

First Step Financing	Funds needed for seed capital to help develop an idea.
Start-up Financing	Funds needed to cover the cost of preparing a business plan, conducting market studies and opening a business.
First Stage Financing	Funds needed to start manufacturing and selling the product(s).
Second Stage Financing	Funds needed for working capital to expand production and build inventories. Company is operating but not yet profitable.
Third Stage Financing	Funds needed to improve the product, build working capital and expand marketing and production facilities. At this point, the company should be generating a profit.
Fourth Stage Financing	Additional working capital funds needed prior to initial public offering which may be as much as a year later.

In addition to the above, venture capital companies will consider financing leveraged buyouts and turnaround situations.

The degree of risk assumed varies according to the stage of financing, i.e., lower stages contain greater risk because of the requirement for longer-term investment discipline than higher stages. Investments in start-up companies typically take five to seven years or more to mature. Because of the high risk involved, most bank-affiliated venture capital companies will avoid the earlier or lower stages of financing. Newly established venture capital companies and especially those that use leverage tend to focus on the intermediate and latter stages of financing. These stages are represented primarily by debenture financing, preferred stock investments, and straight term loans. In structuring a portfolio, a venture capitalist should consider both liquidity and capital protection. The ideal financing mix might entail a limited amount of money invested in common stock with the remainder distributed between debentures, loans, and preferred stock. These instruments will provide income to cover operating expenses and service debt as well as give some protection should the business start to decline. Limited holdings of common stock give the company the opportunity to enhance earnings through capital gains without adversely effecting cash flow. Regardless of the type of financing offered, the ability to exist from an investment or loan through either the issuance of public stock or a cash buyout by a larger company is the goal of a venture capital company.

2260.0.3 FUNDING

A venture capital company may use private capital, leverage, or a combination of both to fund its portfolio of loans and investments. Venture capital companies obtain private capital from their parent organization, either banks or bank holding companies. Generally, private capital is used to fund high-risk, lower-stage investments, although some companies may diversify their portfolio and deploy a portion of capital in loans, debentures and preferred stock. Leverage may be derived from internal and external borrowings. SBIC's that are banking subsidiaries may receive funding in the form of loans from their parent bank. For those companies that are a subsidiary of a bank holding company, internal funding may be provided by the bank holding company from internal cash flow or its external borrowing sources. A bank holding company might borrow from its available bank lines or other borrowing sources to fund venture capital operations. There is, however, one exception; that is, the use of commercial paper proceeds to fund venture capital investments and loans does not appear to qualify under the exemptive provisions of section 3(a)(3) of the Securities Act of 1933. SBIC's and MESBIC's can obtain external financing from the U.S. government and the private sector, while, non-licensed venture capital companies are limited to only private sources for their external financing. Under current SBA regulations, an SBIC can borrow up to $35 million from the federal financing bank with no limit as to the aggregate amount of private debt. Because of the investment restrictions on MESBIC's, the SBA allows them to incur higher leverage.

MESBIC's are permitted to borrow up to four times their capital base and issue preferred stock to the SBA up to two times their capital base. MESBIC's also have no limit on the aggregate amount of private debt. All government borrowings ings are through the federal financing bank and carry the guarantee of the SBA. Such borrowings are classified as senior debt.

2260.0.4 PROFITABILITY

Earnings of venture capital companies can fluctuate widely depending on the nature of their activities. Those companies that blend their portfolios with loans, debentures and preferred stock investments tend to be more predictable and less erratic in earnings performance than companies that are strictly equity-oriented. The difference being that loans, debentures and preferred stock provide income to cover operating expenses and debt service requirements, while common stock investments may not yield positive returns for several years. Portfolio diversification tends to smooth out earnings, although the potential for major fluctuations in earnings exists in the future should capital gains be realized on equity investments. In measuring earnings performance, one should consider the combination of net realized earnings (net investment income plus net realized gains (losses) on sale of investments) and net unrealized appreciation or depreciation on investment holdings found in the capital structure of the balance sheet. It is not uncommon to see aggregate returns on capital reach 50

or more. Typically, returns of this magnitude are influenced by either large gains realized on the sale of investments or a substantial amount of unrealized appreciation on investments held or a combination of both. Appreciation or depreciation in portfolio investments represents potential realized gains or losses and, therefore, should be considered in evaluating the company's earnings performance. Specifically, the change in year-to-year net unrealized appreciation or depreciation is a factor that should be considered in analyzing results. When measuring the company's contribution to consolidated earnings, net unrealized appreciation or depreciation should be ignored.

2260.0.5 CAPITALIZATION

In addition to the usual equity components of capital stock, surplus and retained earnings, the capital structure of a venture capital company includes a separate category for net unrealized appreciation (depreciation) on equity interests. Net unrealized appreciation (depreciation) on equity interests represents the gross amount reported under loans and investments less an appropriate provision for taxes. Since unrealized appreciation (depreciation) on equity interests represents future profits (losses) they are measured separately in the equity account rather than in earnings.

There are no industry norms with which to measure capital adequacy. What is known, however, is that the SBA requires a minimum capital investment of $1,000,000 to establish an SBIC. Moreover, regulations governing SBIC's limit the dollar amount of investments and/or loans to a single customer to 20 percent of an SBIC's capital base. Although banks are limited by statute to a maximum capital investment in an SBIC of 4.9 percent of their primary capital, statistics show that SBIC's have substantially less than this limit. By contrast, there are no restrictions as to the amount of capital that a bank holding company may invest in a nonbank affiliated venture capital company. Dependence on capital to fund portfolio loans and investments seems to be preferred as the cost of leverage, at present, cannot provide meaningful spreads. It can be assumed that the larger the capital position the higher the dollar amount available for investing and/or lending to a single customer.

Sustained profitability and satisfactory asset quality are required to maintain financial soundness and capital adequacy. The SBA will consider an SBIC's capital as impaired if net unrealized depreciation and/or operating losses equal 50 percent or more of its capital base. It would seem appropriate to use this guideline for measuring the adequacy of capital of non-licensed venture capital companies that are affiliated with a bank holding company.

2260.0.6 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.

2. To determine whether transactions with affiliates, especially banks, are in accordance with applicable statutes and regulations.

3. To determine the quality of the asset portfolios and whether the allowance for losses is

adequate in relation to portfolio risk and whether the nonaccrual policy is appropriate.

4. To determine the viability of the company as a going concern, and whether its affiliate status represents a potential or actual adverse influence upon the parent holding company and its affiliated bank and nonbank subsidiaries and the condition of the consolidated corporation.

5. To determine whether the company has formal written policies and procedures relating to lending and investing.

6. To determine if such policies and procedures are adequate and that management is operating in conformance with the established policies.

7. To assess management's ability to operate the company in a safe and sound manner.

8. To suggest corrective action when policies, practices or procedures are deficient, or when asset quality is weak, or when violations of laws or regulations have been noted.

2260.0.7 INSPECTION PROCEDURES

2260.0.7.1 Pre-Inspection

All SBIC's and MESBIC's are subject to comprehensive regulations and annual examinations administered by the SBA. Therefore, it is not necessary to conduct a full scope inspection of these subsidiaries. The bank holding company inspection should focus on the quality of assets, as disclosed in the annual director's valuation and financial statements submitted to the SBA on an annual basis, transactions with affiliates and an overall financial evaluation.

The decision whether the operations of a non-licensed venture capital company will be inspected "on-site" is based on the availability and adequacy of data from either the parent holding company or that which is obtained upon request from the subsidiary. The following information should be obtained and thoroughly reviewed prior to making a decision to go "on-site":

1. Minutes of the board and executive committee meetings since inception of company or the date of the previous inspection;

2. Comparative interim and fiscal financial statements containing value accounting adjustments, including the year-end filing with the SBA;

3. Listing of contingent liabilities, including any pending material litigation;

4. Latest director's valuation of loans and investments and results of latest internal loan or credit review;

5. Copies of the most recent internal and external audit reports;

6. Trial balance of all loans and investments, indicating the percent ownership of a company involving an equity interest;

7. Listing of loans, debentures and preferred stock on which scheduled payments are in arrears 30 days or more or on which payments are otherwise not being made according to original terms;

8. Details of internal and external borrowing arrangements; and

9. Any agreements, guarantees or pledges between the subsidiary and its parent holding company or affiliates.

After reviewing the above information, a decision whether or not to conduct an on-site inspection must be made. Some of the determinants of this decision would include: relative size; current level and trend of earnings; asset quality as indicated in the director's valuation of loans and investments; and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would warrant a visit even though a satisfactory condition had been determined during the previous inspection. All non-licensed venture capital companies should be inspected on-site at least once every three years.

2260.0.7.2 On-Site Inspection

If the decision was made to conduct an "on-site" inspection of the subsidiary, the examiner should expand the scope of the review to include these additional procedures:

1. Hold a brief meeting with the chief executive officer of the company to establish contact and present a brief indication of the scope of the inspection;

2. Review the company's policy statements for loans, investments, nonaccruals, and charge-offs;

3. Review the latest internal review by the company's directors or the loan review department of the bank affiliate or bank holding company;

4. Conduct an independent review of the portfolio;

a. Establish the minimum dollar of loans and investments to be reviewed to achieve at least 70 percent coverage of the portfolio;

b. Review loans and investments in sample, giving consideration to the following:

- Latest balance sheet and income data;
- Profitability projections;
- Product(s) being produced by customer and their market acceptance;
- Business plan;
- Extent of relationship with customer;
- Funding sources; and
- Ultimate source of repayment.

c. Discuss the more serious problem loans and investments with management;

d. Classify, if necessary, those loans and investments that exhibit serious weaknesses where collectibility is problematical or worse. Lower classification criteria must accompany these assets, which possess a higher degree of credit risk than found in other types of nonbank lending;

e. Determine the diversification of risk within the portfolio, i.e., the mix of loans and investments and the type of industries financed;

f. Review the adequacy of the allowance for loan losses and determine the reasonableness of the amount of unrealized appreciation or depreciation reported on the balance sheet in conjunction with the asset evaluation; and

g. Determine whether the board of directors or parent holding company has established credit limits for the maximum amount of loans and investments to be extended to a single customer. Verify adherence to the limits.

5. Review equity investments for compliance with the 4.9 percent maximum limitation to any one customer;

6. Verify office locations and activities with system approvals;

7. Compare company's general ledger with statements prepared for the latest FR Y–6;

8. Review the quality and liquidity of other investment holdings;

9. Review and classify, if necessary, assets acquired in liquidation of a customer's business due to default. Determine compliance of divestiture period with section 4(c)(2) of The Bank Holding Company Act;

10. Review the manner and frequency in which subsidiary management reports to the parent holding company;

11. Follow-up on matters criticized in the most recent audit reports and the previous inspection report on the subsidiary; and

12. Assess the expertise of subsidiary management and awareness of subsidiary directors.

2260.0.7.3 Matters Warranting Recommendation in Inspection Report

Deficiencies or concerns that warrant citation in the inspection report for the attention of management are:

1. Lack of policies and/or controls in the lending and investing functions;
2. Improper diversification of risk in the loan and investment portfolio;
3. Adverse tie-in arrangements with the affiliate bank(s):
4. Lack of management expertise;
5. Impairment of capital as a result of operating losses or high unrealized depreciation on equity interests or a combination of both; and
6. Lack of adequate reporting procedures to parent holding company management.

2260.0.8 LAWS, REGULATIONS, INTERPRETATIONS AND ORDERS

Subject	*Laws* [1]	*Regulations* [1]	*Interpretations* [3]	*Orders*
Acquisition of SBIC by a bank holding company	1843(c)(8) 1843(c)(5)	225.111	4–173 4–175 4–174	
Limitations of an SBIC's control over business enterprises		13 C.F.R. 107.901(a)		
Criteria for various types of business investments of an SBIC		13 C.F.R. 121.3–10 13 C.F.R. 121.3–11		
Acquisition of a non-licensed venture capital company by a bank holding company	1843(c)(8)	225.112		
Formation of joint ventures (limited partnerships) for purpose of conducting venture capital activities	1843(c)(6)			
Limitation on equity interests of a non-licensed venture capital company affiliated with a bank holding company	1843(c)(6)			
Loans to affiliates—Section 23A of FR Act	371c			
Restrictions on transactions with affiliates	371c			
Acquisition of shares acquired DPC	1843(c)(2)			
Acquisition of assets acquired DPC	1843(c)(2)	225.132	4–175.1	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2260.0.9 APPENDIX 1—VENTURE CAPITAL COMPANY SAMPLE BALANCE SHEET

	December 31, 19XX
ASSETS	
Cash	XXXX
Money Market investments	XXXX
Loans and investments	XXXX
Loans	XXXX
Debt securities	XXXX
Equity interests	XXXX
Total loans and investments	XXXX
Less: Allowance for losses on loans and investments	XXXX
Plus: Unrealized appreciation (depreciation) on equity interests	XXXX
Net loans and investments	XXXX
Interest and dividends receivable	XXXX
Assets acquired in liquidation of loans and investments	XXXX
Other assets	XXXX
Total assets	XXXX
LIABILITIES	
Notes payable—affiliates	XXXX
Notes payable—others	XXXX
Accrued taxes payable	XXXX
Deferred tax credits	XXXX
Other liabilities	XXXX
Total liabilities	XXXX
STOCKHOLDER'S EQUITY	
Common stock (par value XXX)	XXXX
Surplus	XXXX
Retained earnings	XXXX
Net unrealized appreciation (depreciation) of equity interests	XXXX
Total stockholder's equity	XXXX
Total liabilities and stockholder's equity	XXXX

2260.0.10 APPENDIX 2—VENTURE CAPITAL COMPANY—SAMPLE INCOME STATEMENT

	For Fiscal Year Ended December 31, 19XX
INTEREST INCOME	
Interest on loans and debt securities	XXX
Dividends on equity interests	XXX
Interest on money market investments	XXX
Total interest income	XXX
INTEREST EXPENSE	
Interest on notes payable to affiliates	XXX
Interest on notes payable to others	XXX
Total interest expense	XXX
NET INTEREST INCOME	XXX
PROVISION FOR LOAN LOSSES	XXX
Net interest after provision for loan losses	XXX
OTHER REVENUE	
Income from assets acquired in liquidation of loans and investments	XXX
Management Fees	XXX
Total other revenue	XXX
Net interest and other revenue	XXX
NONINTEREST EXPENSE	
Salaries and benefits	XXX
Management and service fees	XXX
Other expenses	XXX
Total noninterest expense	XXX
Income before taxes	XXX
Applicable taxes	XXX
Net investment income	XXX
Realized gain (loss) on sale of securities, net of tax	XXX
Net income	XXX

WHAT'S NEW IN THIS REVISED SECTION

Section 604(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, 124 Stat. 1601 (2010), (Dodd-Frank Act), added the "...risk to the stability of the United States banking or financial system..." to the example listing of possible adverse effects. The amendment is included below. See 12 U.S.C. 1843(j)(2)(A).

The Bank Holding Company Act of 1956 (BHC Act) was enacted to limit the expansion of banking institutions into nonbanking activities. A bank holding company was defined in the BHC Act as an entity that owned or controlled 25 percent or more of the voting shares of two or more banks; companies owning only one bank were exempted from regulation under the BHC Act.

During the 1960s, the number of commercial enterprises that purchased one bank, engaged in nonbanking activities, and remained exempt from regulation grew dramatically. As a result of this change in the structure of bank ownership, Congress enacted the Bank Holding Company Act Amendments of 1970. Of these amendments, the most significant is the extension of the act to grant to the Federal Reserve Board the authority to regulate the activities of one-bank holding companies.

In 1978, Congress passed the International Banking Act (IBA). Section 8 of the IBA expanded the nonbanking prohibitions of the BHC Act to foreign banks that engage in the business of banking in the United States directly through a branch or agency or indirectly through a subsidiary commercial lending company. This expanded the nonbanking restrictions beyond simply covering foreign banks that own or control U.S. banks or bank holding companies. However, section 2(h) of the BHC Act provides foreign organizations that are principally engaged in the business of banking outside the United States with exemptions from the nonbanking prohibitions of the BHC Act. Further exemptions have been granted by the Board's discretionary authority under section 4(c)(9) when such exemptions were in the public interest and were consistent with the purposes of the BHC Act.

Under section 4(c) of the BHC Act, Congress exempted a limited number of investments from the general prohibition against owning or controlling shares of nonbank concerns. Section 4(c)(8) permitted investment in shares of any company the activities of which the Board after due notice and opportunity for hearing has determined—pursuant to section 225.28 of Regulation Y or Board order issued prior to November 12, 1999—to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The act also provided that any bank holding company might apply to the Board for permission to engage in an activity that had not yet been determined to be permissible if the applicant was of the opinion that the activity in its particular circumstances was closely related to banking or managing or controlling banks. Section 225.28(b) of the Board's Regulation Y lists permissible nonbanking activities that the Board has deemed to meet these criteria. (See appendix 1.) The list of permissible nonbanking activities has been expanded at various times.

The Board also has permitted by order, on an individual basis, certain activities that it has considered to be closely related to banking under section 4(c)(8) of the BHC Act. In doing so, the Board did not expand the list of permissible activities under section 225.28(b) of Regulation Y. (For a list of such activities, see appendix 2.)

In determining whether the performance of a nonbank activity by a bank holding company or the acquisition of a nonbank firm by a bank holding company was a proper incident to banking, the Board applies a "public interest test." The Board must consider whether performance of a nonbank activity by a bank holding company or a subsidiary of such company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, or risk to the stability of the United States banking or financial system. (See 12 U.S.C. 1843(j)(2)(A).)

An interpretation of Regulation Y (12 C.F.R. 225.126) dated April 28, 1972, and amended September 20, 1972, listed activities that the Board determined do not satisfy the "so closely related" test under section 4(c)(8). The Board subsequently determined that a number of other activities do not satisfy the closely related test. (For a complete list of these impermissible activities, see appendix 3, and, for a brief description of a selected number of the activities denied by the Board, see section 3700.0 et seq.)

As the primary regulator for bank holding companies and their directly held nonbank subsidiaries, the Federal Reserve System conducts inspections of their operations, financial condition, and compliance with appropriate banking and other related statutes and regulations. Inspection personnel are called upon to evaluate the current condition of the organizations, as well as their future prospects.

On August 10, 1987, the Competitive Equality Banking Act of 1987 was signed into law. This act redefined the definition of "bank" in section 2 of the BHC Act so that an FDIC-insured institution is deemed a bank. An "insured bank" is defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)).

State-Authorized Activities of Savings Banks

A special rule was established for qualified savings banks (state-chartered, FDIC-insured institutions organized before March 5, 1987) that are subject to the BHC Act. (See section 2090.7.) In accordance with section 3 of the BHC Act, a qualified savings bank may engage in any nonbanking activity, except insurance activities, either directly or through a subsidiary, that it is permitted to conduct directly as a state-chartered savings bank, even if those activities are not otherwise permissible for bank holding companies. To engage in those activities, however, a qualified savings bank must remain a savings bank and a subsidiary of a savings bank holding company (a company that controls one or more qualified savings banks whose total aggregate assets, upon formation and at all times thereafter, constitute at least 70 percent of the assets of the holding company). With respect to insurance activities, qualified savings banks may engage in underwriting and selling savings bank life insurance if the savings bank is located in Connecticut, Massachusetts, or New York, and if certain other conditions are met.

BHCs Engaging in Nonbanking Activities in Foreign Countries

A bank holding company has greater leeway to perform nonbanking activities abroad than in the United States in that it may engage in nonbanking activities abroad that would not be permissible in the United States. However, activities abroad are subject to limitations. Section 211.8 of Regulation K requires a bank holding company to limit its direct and indirect activities abroad to those usual in connection with banking and financial activities and to necessary related activities. Section 211.10 also lists particular activities that are permissible abroad and provides rules regarding when a bank holding company must submit an application to engage in such activities directly or through investments.

Edge Act or Agreement Corporations

A bank holding company may own an Edge Act or agreement corporation. The Federal Reserve Act and Regulation K govern the permissible activities of Edge Act or agreement corporations. An Edge Act or agreement corporation is an international banking vehicle that may only engage in listed or approved activities that are incidental to international or foreign business. (See 12 C.F.R. 211.6) The restriction generally permits an Edge Act or agreement corporation to engage only in international banking or financial activities. (See 12 C.F.R. 211.8.)

Companies that own only an Edge Act or agreement corporation. Any company, other than a bank, that acquired an Edge Act or agreement corporation after March 5, 1987, must conform its activities to section 4 of the BHC Act.

Underwriting and Dealing in Debt and Equity Securities

Beginning in January 1989, certain nonbanking subsidiaries of bank holding companies were approved to underwrite and deal in debt or equity securities (excluding open-end investment companies), subject to the prohibition on affiliation with an organization dealing in securities under section 20 of the Glass-Steagall Act. (See 1989 FRB 192.) The Board delayed commencement of the activity by each applicant until it determined that the applicant had established the necessary managerial and operational infrastructure to commence the expanded underwriting and dealing activity and to comply with the Board order. The applicant's capital plan had to be determined to be adequate along with the necessary policies and procedures needed to comply with the Board's order. The Board's order requires that loans to and capital investments in the underwriting subsidiary be deducted from the bank holding company's capital, as provided for in the Board's capital adequacy guidelines. The Board further confirmed that the activities could not be conducted in any other subsidiary other than the Board-approved section 20 subsidiary. (See section 3600.21.4.)

As for underwriting and dealing in equity securities, the Board stated in the order that it would review within a year whether applicants could commence the activity. The first Board authorization to commence underwriting and dealing in equity securities was given on September 20, 1990, subject to the commitments given by the bank holding company in connection with its respective Board order, including its commitment to maintain the capital of its section 20 subsidiary at levels necessary to support its activities and commensurate with industry standards, and to increase the capital of the section 20 subsidiary accordingly as it grew.

Modifications to the Board's Orders Authorizing BHC Subsidiaries to Underwrite and Deal in Bank-Ineligible Securities Consistent with Section 20 of the Glass-Steagall Act

The Board announced its approval of modifications to its previous section 20 authorizations by order on September 21, 1989 (1989 FRB 751). The modifications (1) raised from 5 percent to 10 percent (currently 25 percent) the revenue limit on the amount of total revenues a section 20 subsidiary might derive from bank-ineligible securities underwriting and dealing activities, and (2) permitted underwriting and dealing in the securities of affiliates, consistent with section 20 of the Glass-Steagall Act, if the securities were rated by an unaffiliated, nationally recognized statistical rating organization or were issued or guaranteed by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC), or the Government National Mortgage Association (GNMA), or if they represented interests in such obligations.

Acting as Agent in the Private Placement of All Types of Securities and Acting as Riskless Principal in Buying and Selling Securities

In another Board order, the Board authorized a bank holding company to transfer its private-placement activities from its commercial bank subsidiary to its section 20 subsidiary. The section 20 subsidiary would act as agent in the private placement of all types of securities, including the provision of related advisory services, and would buy all types of securities on the order of investors as a "riskless principal." The Board concluded that the section 20 subsidiary's private placement of debt and equity securities within the limits proposed did not involve the underwriting or public sale of securities for the purposes of section 20 of the Glass-Steagall Act. The revenues derived therefrom should not be subject to the 25 percent revenue limitation placed on bank-ineligible securities activities. (See section 3230.4.)

Foreign Banks Authorized to Operate Section 20 Subsidiaries to Underwrite and Deal in Corporate Debt, Commercial Paper, and Other Securities

In a Board order (1990 FRB 158), the Board authorized a foreign bank to operate a section 20 subsidiary under the bank to underwrite and deal in corporate debt, commercial paper, and other securities. (Securities issued by open-end investment companies are not included.) The foreign bank operated outside the United States but owned a subsidiary bank in the United States. To achieve equality between the domestic and foreign banking operations in the United States and in an effort to negate any advantages that a foreign bank might have over a domestic bank, the Board considered the foreign bank as a bank holding company even though the bank was not part of a bank holding company structure. In so doing, the Board imposed restrictions on the section 20 subsidiary. The foreign bank might fund the section 20 subsidiary, but that action required prior Board approval. In addition, the section 20 subsidiary might not borrow from its parent bank. Any loans to, transfers of assets to, or investments in the section 20 subsidiary also required Board approval. (See 1990 FRB 158, 455, 554, 568, 573, 652, and 683.)

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

FIRREA became law on August 9, 1989. The law revised section 4(c)(8) of the BHC Act and authorized the Board to approve applications from bank holding companies for the acquisitions of savings associations. The Board thus revised section 225.28(b)(4)(i) of Regulation Y to include as a permissible nonbanking activity the owning, controlling, or operating of a savings association, if the savings association engaged only in deposit-taking, lending, and other activities permissible for bank holding companies. The legislation required the Board to remove tandem restrictions found in previous Board orders that were not prohibited by FIRREA and, in approving applications, to confine limitations on transactions between the savings association and its bank holding company affiliates to those required by sections 23A and 23B of the Federal Reserve Act. FIRREA made sections 23A and 23B applicable to savings associations as though they were member banks. Two exceptions apply: (1) no extensions of credit may be granted by a savings association to an affiliate unless the affiliate is engaged only in activities permissible for bank holding companies under the BHC Act, and (2) savings associations may not purchase or invest in securities of an affiliate other than shares of a subsidiary. The legislation also provided for a "sister-bank" exemption from the provisions of sections 23A and 23B of the Federal Reserve Act. (See sections 2020.1.1.6 and 2090.8.1.)

1992 Revisions to the Regulation Y List of Nonbanking Activities—the "Laundry List"

During 1992, the Board initiated several actions that affected certain nonbanking activities. The first action, effective May 18, 1992, amended section 225.28(b) of Regulation Y with regard to tangible personal property leases. Subject to the stated limitations, a bank holding company can rely on estimated residual values of up to 100 percent of the acquisition costs of the leased property in order to recover the bank holding company's leasing costs. Previously, the nonbanking activity had only been approved by Board order. (See the initial Board order at 1990 FRB 462 and the subsequent Board orders at 1990 FRB 960 and 1991 FRB 187 and 490.)

The Board issued a revised interpretive rule, effective August 10, 1992, regarding investment advisory activities of bank holding companies to expressly provide that a bank holding company or its nonbank subsidiary may act as agent for customers in the brokerage of shares of an investment company advised by the holding company or any of its subsidiaries. In addition, the revision provided that a bank holding company or its nonbank subsidiary may provide investment advice to customers regarding the purchase or sale of shares of an investment company advised by an affiliate. In both instances, the Board requires certain disclosures to be made to address potential conflicts of interest or adverse effects. (See 12 C.F.R. 225.125(h) of Regulation Y.)

Effective September 10, 1992, the Board added two nonbanking activities to Regulation Y that were previously approved by Board order. The two activities dealt with full brokerage services and financial advisory services. (See 12 C.F.R. 225.28(b)(6) and (7).)

Comprehensive Revision of Regulation Y

In August 1996, the Board proposed comprehensive revisions to Regulation Y that were designed to significantly reduce regulatory burden, improve efficiency, and eliminate unwarranted constraints on credit availability. The proposal followed a Board review of its regulations that was required by the Riegle Community Development and Regulatory Improvement Act of 1994. The changes (1) removed a number of restrictions on the permissible nonbanking activities of BHCs, (2) expanded and reorganized the regulatory list of permissible nonbanking activities to include numerous nonbanking activities that had been previously approved only by Board order,[1] (3) streamlined the application/notice process for BHCs and the procedures governing change in bank control notices, and (4) revised the tying rules to enhance banking organizations' ability to provide customer discounts on services. Included were changes that streamlined the procedures for well-run BHCs to seek Federal Reserve System approval to acquire additional banks within certain limits. The Board approved these revisions to Regulation Y, effective April 21, 1997.

1. See subsection 3000.0.2, appendix 1. See also section 225.28(b) of Regulation Y. In addition to these activities, other activities have been approved by Board order. For a list of those activities, see subsection 3000.0.3, appendix 2.

Limitation on Board-Approved Nonbanking Activities

The Gramm-Leach-Bliley Act (the GLB Act) amended the BHC Act to limit bank holding companies that are not financial holding companies to engaging only in "activities which had been determined by the Board by regulation or order under section 4(c)(8) of the BHC Act and section 225.28 of Regulation Y before November 12, 1999 (the approval date of the GLB Act), to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board)" (12 U.S.C. 1843(c)(8)). Prior to November 12, 1999, the Board had determined that "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board" is closely related to banking. Accordingly, the Board retains authority after the GLB Act to define the scope of this section 4(c)(8) activity and to modify the terms and conditions that apply to the activity.

Financial Holding Companies

The GLB Act, approved in November 1999, amended section 4 of the BHC Act and expanded the powers of qualifying BHCs and foreign banks that elect to become financial holding companies (FHCs). An FHC is defined in the GLB Act as a BHC that meets certain eligibility requirements. The law repealed those provisions of the Glass-Steagall Act and the BHC Act that restricted the ability of BHCs to affiliate with securities firms and insurance companies. For a bank holding company to become an FHC and be eligible to engage in new activities authorized under the GLB Act, the GLB Act requires that all depository institutions controlled by the BHC be well capitalized and well managed. With regard to a foreign bank that operates a branch or agency or that owns or controls a commercial lending company in the United States, the GLB Act requires the Board to apply comparable capital and management standards that give due regard to the principle of national treatment and equality of competitive opportunity.

Qualifying BHCs that elect to become FHCs can engage in a broad array of financially related activities, including (1) securities underwriting and dealing, (2) insurance agency and insurance underwriting activities, and (3) merchant banking activities. With respect to merchant banking, the GLB Act (1) permits an FHC to retain a merchant banking investment only as long as necessary to dispose of the investment on a reasonable basis consistent with the financial viability of its merchant banking activities, and (2) provides that an FHC may not routinely manage or operate a company held as a merchant banking investment except as necessary to obtain a reasonable return on the investment.

The statute also sets forth parameters for the relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with regulators of depository institutions and functional regulators, such as those for nonbanking or nonfinancial activities such as insurance, securities, and commodities activities.

An FHC may engage in any other activities that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities. An FHC may also engage in any nonfinancial activity that the Board determines (1) is complementary to a financial activity and (2) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The activities of BHCs and foreign banks that are not FHCs continue to be limited to activities currently authorized under section 4(c) of the BHC Act to be closely related to banking and permissible for BHCs. No additional activities may be found to be so closely related to banking as to be a proper incident thereto after November 11, 1999, thus limiting the ability of BHCs and foreign banks that are not FHCs to expand their activities.

In this manual, the sections in the 3900 series have been designated for FHCs. Those sections discuss FHC qualification requirements (domestic and foreign); permissible nonbanking FHC activities designated by statute (for example, merchant banking activities) or regulation, including activities jointly approved by the Board and the Secretary of the Treasury; and the supervisory approach and guidance for FHCs.

To implement the provisions of the GLB Act that govern FHCs, the Board amended Regulation Y by adding subpart I for FHCs. The provisions of an interim rule became effective March 11, 2000, and the Board approved a final rule effective December 21, 2000. Key provisions of the final rule are discussed within the 3900 sections of this manual. With respect to permissible activities of FHCs, the rule includes activities that previously were determined to be closely related to banking under section 225.28 of Regulation Y, activities that are usual in connection with transactions of banking abroad (including those in section 211.10 of Regulation K), and other activities defined as financial in nature by the GLB Act.

3000.0.1 CATEGORIES OF NONBANKING ACTIVITIES

Section 4(c)(8) of the BHC Act authorizes bank holding companies to engage directly or through a subsidiary in activities that the Board determined before November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board and the courts established the following guidelines for determining whether a nonbanking activity is closely related to banking:[2]

1. whether banks have generally provided the service
2. whether banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed service
3. whether banks generally provide services that are so integrally related to the proposed service as to require their provision in specialized form

In addition, before November 12, 1999, the Board considered other factors in deciding what activities were closely related to banking.[3] For those activities found to be closely related to banking or to managing or controlling banks, the Board also must find that the proposed activity is a "proper incident" to banking and that performance of an activity by a bank holding company could reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices). The following describes three categories of bank holding company nonbanking activities:

1. those that have been found to be permissible and are listed in Regulation Y, the so-called laundry list activities (see appendix 1)
2. those that are permissible by Board order only (see appendix 2)
3. those that have been denied by the Board (see appendix 3)

2. *National Courier Association v. Board of Governors,* 516 F. 2d 1229 (D.C. Cir. 1975).

3. *Alabama Association of Insurance Agents v. Board of Governors,* 533 F.2d 224 (5th Cir. 1976), *cert. denied,* 435 U.S. 904 (1978).

3000.0.2 APPENDIX 1—Activities Approved by the Board as Being Considered "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act (Section 225.28(b) of Regulation Y)

Permitted by Regulation[1]	*Year Added to Regulation Y*
Note: The bulleted items in this appendix are provided for historical reference only. The narrative before the bulleted items reflects the current Regulation Y authorization.	
1. Extending credit and servicing loans	1971
Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit, and accepting drafts) for the company's account or the account of others.	
2. Activities related to extending credit[2]	
a. Appraising	
(1) Real estate appraising	1980
(2) Personal property appraising	1986
b. Arranging commercial real estate equity financing	1983
c. Check-guaranty services	1986
d. Collection agency services	1986
e. Credit bureau services	1986
f. Asset management, servicing, and collection activities	1997
g. Acquiring debt in default	1995
h. Real estate settlement servicing	1997
3. Leasing personal or real property or acting as agent, broker, or adviser in leasing such property	
• Personal property leasing[3]	1971
• Real property leasing	1974
4. Operating nonbank depository institutions	
a. Owning, controlling, or operating an industrial bank, Morris Plan bank, or industrial loan company so long as the institution is not a bank	1971
b. Owning, controlling, or operating a savings association, if the savings association engages in deposit-taking activities, lending, and other activities that are permissible for bank holding companies	1989
5. Trust company functions or activities	1971
6. Financial and investment advisory activities: acting as an investment adviser or financial adviser to any person, including (without limiting these activities in any way)—	1971

Permitted by Regulation[1]	*Year Added to Regulation Y*
a. Serving as an investment adviser to an investment company registered under the Investment Company Act of 1940, including sponsoring, organizing, and managing a closed-end investment company	1972
• Investment or financial advising	1971
• Advisory services to open-end (mutual fund) investment companies	1972
b. Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies	1984
c. Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, reorganizations, recapitalizations, capital structurings, financing transactions, and similar transactions,[4] and conducting financial feasibility studies[5]	1992
• Financial futures and options on futures	1986
d. Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments	1992
• Financial futures and options on futures	1986
• Providing financial advice to—	
— state and local governments and	1973
— foreign governments, including foreign municipalities and agencies of foreign governments, such as with respect to the issuance of their securities	1992
• Inclusion of any investment or financial advisory activity without restriction	1997
• Discretionary investment advice to be provided to any person (includes investment advice regarding derivative transactions to institutional or retail customers as an investment, commodity trading, or other adviser) regarding contracts related to financial or nonfinancial assets (such advice is no longer restricted to institutional customers)	1997
• Financial and investment advice (or any permissible nonbanking activity) can be provided in any combination of permissible nonbanking activities listed in Regulation Y	1997
e. Providing educational courses and instructional materials to consumers on individual financial-management matters	1986
f. Providing tax-planning and tax-preparation services	1986
7. Agency transactional services for customer investments (principal positions)	
a. Securities brokerage services (including securities clearing and/or securities execution services on an exchange) for the account of customers and does not include securities underwriting or dealing	
(1) Securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or	1982
(2) In combination with advisory services and incidental activities (including related securities credit activities and custodial services)	1992
b. Riskless-principal transactions	1997
c. Private-placement services	1997
d. Futures commission merchant activities	1984
• A nonbanking subsidiary may act as an FCM with respect to any exchange-traded futures contract and options on a futures contract based on a financial or nonfinancial commodity	1997

Permitted by Regulation[1]	Year Added to Regulation Y
e. Other transactional services such as providing to customers as agent transactional services with respect to the following:	1997
(1) Swaps and similar transactions	
(2) Investment transactions as principal[6]	
(3) Transactions permissible for a state member bank	
(4) Any other transaction involving a forward contract, an option, futures, an option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange	
8. Investment transactions as principal	
a. Underwriting and dealing in government obligations and money market instruments	1984
b. Investing and trading activities. Engaging as principal in the following:	
(1) Foreign exchange	1984
(2) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security, if the transaction meets certain requirements (A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.)	1997
(3) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement	1997
9. Management consulting and counseling activities	
a. Providing management consulting advice on any matter (financial, economic, accounting, or audit) to any other company[7]	
• Unaffiliated banks (depository institutions)	1974
• Nonbank depository institutions	1982
• Other unaffiliated depository institutions	1997
• Any financial, economic, account, or audit matter to any other company	1997
b. Employee benefits consulting services	1997
c. Career counseling services	1997
10. Support services	
a. Courier services	1973
b. Printing and selling MICR-encoded checks and related documents	1997
11. Insurance agency and underwriting	
a. Credit insurance: acting as principal, agent, or broker for insurance (including home mortgage redemption insurance)	
• Acting as insurance agent or broker primarily in connection with credit extensions[8]	1971
• Underwriting credit life and credit accident and health insurance related to an extension of credit	1972

Permitted by Regulation[1]	*Year Added to Regulation Y*
b. Finance company subsidiary: insurance agent or broker for extension of credit by finance company subsidiary	1982
c. Insurance agency activities in small towns	1984
d. Insurance agency activities conducted on May 1, 1982	1984
e. Supervision of retail insurance agents	1984
f. Insurance agency activities by small bank holding companies	1984
g. Insurance agency activities conducted before 1971	1984
12. Community development	
a. Financing and investment in community development activities	1971
b. Advisory and related services designed to promote community welfare	1997
13. Issuance and sale of payment instruments	
a. Issuance and sale of retail money orders	1984
b. Sale of savings bonds	1979
c. Issuance and sale of traveler's checks	1981
14. Data processing	
a. Providing data processing and data transmission services; facilities (including data processing and data transmission hardware,[9] software, documentation, or operating personnel); databases; advice; and access to services, facilities, or databases by any technological means	
• Providing bookkeeping and data processing	1971
• Data processing and transmission services	1982
• Providing data processing and transmission advice to anyone on processing and transmitting banking, financial, and economic data	1997
b. Conducting data processing and data transmission activities not described in "a." that are *not* financial, banking, or economic[10]	1997

1. See section 225.28(b) of Regulation Y for the details of the regulatory authorizations.
2. A Board staff opinion, issued July 9, 2002, concluded that a BHC's certain proposed flood zone–determination services are usual in connection with making mortgage loans and that these activities are within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y.
3. The provision of higher residual value leasing for tangible personal property was added to Regulation Y in 1992, including acting as agent, broker, or adviser in leasing such property.
4. The words "and similar transactions" were added in 1997.
5. Feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice.
6. Transactions described in section 225.28(b)(8) of Regulation Y.
7. Management consulting services may be provided to other customers not described in section 225.28(b)(9) of the rule, but the revenues derived therefrom are subject to a 30 percent annual revenue limitation.
8. Scope narrowed to conform to court decisions in 1979 and 1981; in 1982, it was further narrowed by title VI of the Garn–St Germain Depository Institutions Act.
9. Beginning in April 1997, the general-purpose hardware may not constitute more than 30 percent (previously 10 percent) of the cost of any package offering.
10. The total revenue may not exceed 30 percent (increased to 49 percent, effective January 8, 2004) of the company's total annual revenues derived from data processing, data storage, and data transmission activities.

3000.0.3 APPENDIX 2—Activities Considered "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act

	Permitted by Order on an Individual Basis	*Year Approved*	*Manual Section 3600.*
1.	Operating a "pool-reserve plan" for the pooling of loss reserves of banks with respect to loans to small businesses	1971	1
2.	Operating an article XII New York investment company	1977	5.1
3.	Underwriting and dealing in commercial paper to a limited extent	1987	21.1
4.	Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage-related securities, and commercial paper	1987	21.2
5.	Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage-related securities, consumer receivable–related securities, and commercial paper	1987	21.3
6.	Issuing and selling mortgage-related securities backed by the guarantees of the Government National Mortgage Association	1988	23
7.	Engaging in title insurance agency activities (approved under exemption G of the Garn–St Germain Depository Institutions Act of 1982)	1988	17.1
8.	Underwriting and dealing in, to a limited extent, corporate debt and equity securities	1989	21.4
9.	Acting as a sales-tax refund agent	1990	24.1
10.	Providing real estate settlement activities through a permissible title insurance agency (exemption G companies only)	1990	26
11.	Providing administrative and certain other services to mutual funds	1993	27
12.	Acting as a dealer-manager in connection with cash-tender and exchange-offer transactions	1993	21.5
13.	Privately placing limited partnership interests	1994	8
14.	Engaging in real estate title abstracting	1995	30
15.	Providing employment histories to third parties	1995	29
16.	Underwriting "private ownership" industrial development bonds by a section 20 company	1995	21.6
17.	Serving as a commodity pool operator of investment funds engaged in purchasing and selling futures and options on futures on certain financial and nonfinancial commodities	1996	13.1

Permitted by Order on an Individual Basis	*Year Approved*	*Manual Section 3600.*
18. Development of broader marketing plans and advertising, sales literature, and marketing materials for mutual funds (see 1997 FRB 678)	1997	28
19. Sale of government services involving (see 1998 FRB 481)—	1998	25
a. postage stamps and postage-paid envelopes b. public transportation tickets and tokens c. vehicle registration services (including the sale and distribution of license plates and license tags for motor vehicles) d. notary public services		
20. Operating a securities exchange	1999	6
21. Acting as a certification authority for digital signatures	1999	7

3000.0.4 APPENDIX 3—Activities Considered Not to Be "Closely Related to Banking" Under Section 4(c)(8) of the Bank Holding Company Act

Activities Denied by the Board	*Year Denied*
1. Insurance premium funding ("equity funding") (combined sales of mutual funds and insurance)	1971
2. Underwriting general life insurance not related to credit extension	1971
3. Real estate brokerage	1972
4. Land investment and development	1972
5. Real estate syndication	1972
6. General management consulting	1972
7. Property management	1972
8. Trading in platinum and palladium coin and bullion[1]	1973
9. Armored car service[2]	1973
10. Sale of level term credit life insurance	1974
11. Underwriting mortgage guarantee insurance	1974
12. Computer output microfilm services[3]	1975
13. Operating a travel agency	1976
14. Underwriting property and casualty insurance	1978
15. Real estate advisory activities	1980
16. Certain contract key entry services	1980
17. Offering investment notes with transactional features	1982
18. Engaging in "pit arbitrage" spread transactions on commodities exchanges to generate trading profits	1982
19. Engaging in the publication and sale of personnel tests and related materials	1984
20. Providing credit ratings on bonds, preferred stock, and commercial paper	1984
21. Providing independent expert actuarial opinions of a general nature for purposes such as divorce action and personal injury litigation	1984
22. Acting as a specialist in foreign-currency options on a securities exchange	1985

Activities Denied by the Board	*Year Denied*
23. Title insurance activities (See the Board letter dated March 17, 1986, re: Independence Bancorp, Inc. and the Board order at 1989 FRB 31)	
24. Acting as a broker for customers in the purchase and sale of forward contracts based on certain financial and nonfinancial commodities, and acting as the primary clearing firm for professional floor traders[4]	1991

1. Authorized by the Board in 1995 FRB 190 (platinum) and 1996 FRB 571 (palladium).

2. On June 18, 1990, the Board determined that the activity of providing armored car services to the general public is closely related to banking (see 1990 FRB 676). In order for the Board to approve a nonbank activity for a bank holding company, the Board must also find that the activity is a "proper incident thereto." On February 10, 1993, the Board denied the application (1993 FRB 352), finding that the proposed transactions posed potential violations of section 23B of the Federal Reserve Act and that the applicant had failed to prove that the activity is a proper incident to banking.

3. The Board's interpretation of Regulation Y at 12 C.F.R. 225.123 was amended on November 25, 1987, by deleting item (e)(4) relating to the impermissibility of the activity (see 52 *Federal Register* 45160–45161 and 1987 FRB 933).

4. The Board subsequently approved this activity by Board order. (See 1997 FRB 138.)

Section 2(c) of the BHC Act (Savings Bank Subsidiaries of BHCs Engaging in Nonbanking Activities) Section 3001.0

As an FDIC insured institution, a savings bank qualifies as a "bank" under section 2(c) of the BHC Act, as amended by section 101(a) of the Competitive Equality Banking Act of 1987 ("CEBA"). CEBA amended the BHC Act, in section 3(f), stating that any qualified savings bank, which is a subsidiary of a bank holding company, could engage directly, or through a subsidiary, in any nonbanking activity, except for certain insurance activities, that it is permitted to engage in by State law—including activities which are not otherwise permitted for bank holding companies under section 4(c)(8) of the BHC Act. In order for a qualified savings bank, that is a subsidiary of a bank holding company, to engage in such activities, however, the bank holding company must be a savings bank holding company as defined in section 2(1) of the BHC Act, in other words, 70 percent of the assets of the bank holding company must consist of one or more savings banks at the time of formation.

Insurance activities of any qualified savings bank which is a subsidiary of a bank holding company are limited to the insurance activities allowed under section 4(c)(8) of the BHC Act. A qualified savings bank that was authorized to engage in the sale or underwriting of savings bank life insurance, as of March 5, 1987, can sell or underwrite such insurance directly, provided that it is permitted to underwrite and engage in the sale of savings bank life insurance as that activity is authorized for savings banks by state law, and is located in Massachusetts, Connecticut, or New York. Should the bank holding company parent of the qualified savings bank cease to be a savings bank holding company, the savings bank must cease engaging in these activities within two years.

In a separate application a nonoperating company, which was formed for the purpose of acquiring a savings bank, insured by the Federal Deposit Insurance Corporation, applied for the Board's approval to become a bank holding company pursuant to section 3(a)(1) of the Bank Holding Company Act, acquiring all of the voting shares of the savings bank. The savings bank engages through subsidiaries in real estate investment and development activities authorized pursuant to State law.

As part of the Board's analysis in this case, including its evaluation of the capital and financial resources of the bank holding company and the bank involved, the Board considered the risk to the Applicant and to the savings bank of the real estate development activities to be conducted by the savings bank through its nonbank subsidiaries. The Board expressed serious reservations with regard to this application and similar applications by bank holding companies to acquire savings banks engaged directly or through subsidiaries in real estate development activities. In the Board's view the conduct of real estate development activities through a holding company subsidiary rather than a bank subsidiary would provide more effective corporate separateness.

The Board approved the application by Order on October 30, 1987 (1987 FRB 925), relying on the Applicant's commitments.

WHAT'S NEW IN THIS SECTION

Effective January 2006, this section has been revised to incorporate a table of Laws, Regulations, Interpretations, and Orders concerning a credit card bank exemption found in section 2(c)(2)(F) of the Bank Holding Company Act. (See the discussion below of the Board staff legal interpretation dated February 18, 2005.)

3005.0.1 SECTION 2(c)(2)

Section 2(c)(2) of the Bank Holding Company Act (the BHC Act) provides 10 exemptions from the definition of a bank for purposes of the BHC Act. Section 2(c)(2)(F) sets forth the criteria that an institution must meet in order to qualify for the so-called credit card bank exemption. The credit card bank exemption applies to any "institution, including an institution that accepts collateral for extensions of credit by holding deposits under $100,000, and by other means which—

1. engages only in credit card operations;
2. does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others;
3. does not accept any savings or time deposit of less than $100,000;
4. maintains only one office that accepts deposits; and
5. does not engage in the business of making commercial loans."[1]

3005.0.2 SECTION 2(c)(2)(F)

On February 18, 2005, Board staff issued an interpretation in response to a bank's (MB Bank's) legal counsel, who had requested a determination that (1) MB Bank would qualify for the "credit card bank exemption" from the definition of bank in section 2(c)(2)(F) of the BHC Act and that (2) no application to the Board would be required under the BHC Act either for the proposed acquisition of control of MB Bank (the acquisition) by Financial Group (a joint venture), or for the proposed redemption of shares of common stock of MB Bank's parent, MB BHC—a bank holding company for the purposes of the BHC Act—in connection with the acquisition.

1. 12 U.S.C. 1841(c)(2)(F).

Financial Group proposed to acquire substantially all of the outstanding stock of MB BHC and, indirectly, MB Bank. Prior to the acquisition, MB Bank planned to convert itself to a depository institution that would qualify for the credit card bank exemption under the BHC Act. Before the acquisition, but after MB Bank's conversion to a credit card bank, MB BHC also proposed to redeem approximately 50 percent of its common stock.

To comply with the provisions of the credit card bank exemption under the BHC Act, other representations and commitments were made by and on behalf of MB Bank and MB BHC. Under these commitments, MB Bank would—

1. engage only in credit card operations[2] as of and after the acquisition, including selling advertising space in monthly statements mailed to account holders ("statement stuffers");
2. provide, as agent, limited debt-protection services to its credit card customers—services in which, for a fee, customers can receive debt relief from MB Bank during certain unexpected hardships (the limited debt-protection coverage provides for the payment of MB Bank's outstanding credit card balance in the event of the borrower's death, disability, or involuntary unemployment); and
3. not engage in the business of making commercial loans as of and after the acquisition.

MB Bank also agreed to cease providing certain ancillary services within three months of the acquisition by (1) selling a credit report–monitoring service offered by an unaffiliated third party and (2) selling a membership-based roadside-assistance product offered by an unaffiliated third party. In addition, MB Bank committed to restricting the scope of its deposit operations as of, and after, the acquisition to comply with the credit card bank exemption provisions of the BHC Act. MB Bank agreed to not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others.

2. The Senate report accompanying S. 790 states that the "engage only in credit card operations" language was intended to limit a qualifying institution to engage "only in the business of issuing and processing credit cards for individuals and in transactions that are necessary and incident to that business."

Moreover, except for deposits that serve as collateral for MB Bank's credit card loans (collateral deposits), MB Bank will not accept savings or time deposits of less than $100,000. MB Bank also represented that each collateral deposit held by MB Bank will be no greater than the amount of the relevant customer's line of credit with the bank. Any deposit not conforming to the credit card bank exemption requirements or the representations and commitments within the letter of interpretation and not transferred to an unaffiliated third party prior to the acquisition would be liquidated by MB Bank prior to the acquisition through a wire transfer to the relevant depositor. MB Bank would maintain only one office that accepts deposits.

At the time of the determination request, MB Bank was issuing debit cards and holding related deposits that were not permissible for a depository institution that qualifies for the credit card bank exemption under the BHC Act. Therefore, to qualify for the credit card bank exemption, MB Bank committed to transferring, before the acquisition, its current debit card accounts and related deposits to another bank (the issuing bank), which would issue new debit cards under the issuing bank's name to the current holders of MB Bank's debit card accounts. MB Bank also committed that it would cease all debit card–related activity, including origination, servicing, and marketing services provided to the issuing bank, within three months of the acquisition. MB Bank would also cease engaging in any account-servicing activities for debit card or credit card accounts of affiliated or unaffiliated banks within three months of the acquisition (except on a temporary basis in connection with acquisitions of credit card accounts by MB Bank from other credit card lenders).

Various other specific representations and commitments regarding MB Bank's investment activity were also made, including a commitment to divest within two years of the acquisition certain reverse-mortgage-loan participations. Based on all the facts of record and subject to the commitments and representations stated in the Board staff's February 18, 2005, interpretation and in letters to the Board's Legal Division, the Board's Legal Division informed MB Bank's legal counsel that it would not recommend that the Board find MB Bank to be a bank for purposes of the BHC Act as of and after the acquisition, or that the Board require Financial Group or its parent companies to file an application with the Board under section 3 of the BHC Act for the acquisition. Because MB Bank would cease to be a bank, the Board also determined that it would not require MB BHC to provide notice to the Board to redeem MB Bank shares pursuant to 12 C.F.R. 225(4)(b).

3005.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Credit card bank exemption under section 2(c)(2)(F) of the BHC Act	1841(c)(2)(F)	225.104	Staff interpretation dated February 18 2005	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3010.0.1 INTRODUCTION

The prohibitions against a bank holding company having or acquiring nonbank interests do not apply to bank holding companies meeting the requirements of section 4(c)(i) and (ii) of the Act.

3010.0.2 LABOR, AGRICULTURAL OR HORTICULTURAL ORGANIZATIONS

Section 4(c)(i)—"Any company that was on January 4, 1977, both a bank holding company and a labor, agricultural or horticultural organization exempt from taxation under section 501 of the Internal Revenue Code of 1954, or . . . any labor, agricultural or horticultural organization to which all or substantially all of the assets of such company are hereafter transferred."

Exemption under this section was amended when the Financial Institutions Regulatory and Interest Rate Control Act of 1978 became effective early in 1979. The effect of the amendment was to repeal exemption under this section for labor, agricultural or horticultural organizations becoming BHCs after *January 4, 1977,* except for those organizations becoming BHCs by means of acquiring all or substantially all of the assets of a company that was both a BHC and a labor, agricultural or horticultural oganization exempt from taxation on January 4, 1977. In order for a holding company to be entitled to this exemption, net income derived from the organization cannot inure to the benefit of any individual. Organizations must be formed primarily for the betterment of the working conditions of the labor organization's members, or improvement in the grade of agricultural or horticultural products for an agricultural or horticultural organization. The growing of products for profit by agricultural or horticultural organizations would disqualify them for exemption. Thus the phrase "any labor, agricultural or horticultural organization" is intended to include only such organizations that are also exempt from taxation under section 501 of the Internal Revenue Code of 1954.

In order for a labor, agricultural or horticultural organization to receive exemption from taxation under section 501(c)(5) of the Internal Revenue Code of 1954, it must file an application (form 1024) with the IRS. In response to the application, the organization receives a determination letter which should be reviewed to assure that exemption was allowed and to verify the date the company became exempt under section 501. The date of exemption is determined as follows. A company which files for exemption within 18 months after its organization is considered exempt as of the date of its organization. The date of IRS approval is the date of exemption if application for exemption is filed more than 18 months after organization. The date of exemption must be no later than January 4, 1977, for the company to be entitled to exemption from section 4 of the Act. The fact that an organization pays income taxes annually does not disallow its exemption under section 501 of the tax code. Despite its tax exemption, an organization is subject to tax on its unrelated business income.

3010.0.3 FAMILY-OWNED COMPANIES

Section 4(c)(ii)—"A company covered in 1970 more than 85 percentum of the voting stock of which was collectively owned on June 30, 1968, and continuously thereafter, directly or indirectly, by or for members of the same family, or their spouses, who are lineal descendants of common ancestors."

The phrase "voting stock" does not limit the form of an organization to an incorporated entity. Exemption under this section extends to other forms of business associations which meet the definition of a company. For example, for a partnership, the 85 percent rule applies to "general partnership interest" and for a trust which meets the definition of a company, the 85 percent rule applies to "beneficial ownership." A company must continue to control the same subsidiary bank that it controlled on June 30, 1968, to retain its exemption under this section. Lineal descendants of common ancestors include descendants by half as well as full blood and legally adopted children.

In January 1980, the Board approved an application of a one-bank holding company covered by the exemption in 4(c)(ii) to acquire an additional bank, but stated that the holding company could no longer rely on that section for conducting its nonbanking activities. Based upon its review of the legislative intent of Congress in providing this exemption, it was the Board's judgment that the exceptionally broad exemption afforded by section 4(c)(ii) must be limited to family-owned one-bank holding companies that are not engaged in the management of banks. Moreover, in the Board's view, upon the acquisition of an additional bank, a one-bank holding company that is exempt under section 4(c)(ii) of the Act, would become engaged in the management of banks, and would thereby terminate its eligibility for the exemption. In addition, the Board believed that to permit unsupervised nonbank expansion by a multibank holding company would constitute an evasion of the Act, which the Board is authorized to prevent pursuant to section 5(b) of the Act.

3010.0.4 INSPECTION OBJECTIVES

1. To verify that a holding company qualifies for exemption from the prohibitions of section 4 by virtue of either section 4(c)(i) or 4(c)(ii).
2. Review the activities conducted by a company qualifying for an exemption under section 4(c)(ii) of the BHC Act, which may be faced with revocation of the exemption, and determine if there may be eligibility for permanent grandfathering under section 4(a)(2) of the BHC Act.

3010.0.5 INSPECTION PROCEDURES

1. Although bank holding companies qualifying for a section 4(c)(i) or 4(c)(ii) exemption are not routinely inspected on a periodic basis, when inspected their exempt status should be verified. All nonbank activities of exempt organizations should be examined in the inspection. The nature of all such activities and the dates they were commenced should be documented in the work papers to establish their current permissibility in the event the organization should lose its exemption from section 4.
2. For BHCs exempt under section 4(c)(i), the examiner should ascertain the date the company became exempt under section 501 of the tax code. Also, the stock books of the subsidiary bank or other pertinent documents should be reviewed to assure that the company was a BHC on January 4, 1977.
3. When verifying a company's exemption under section 4(c)(ii), the stock records of the subsidiary bank and the stock records, partnership agreements, trust agreements and other records of the bank holding company should be reviewed to assure that the following conditions have been satisfied:
    a. 25 percent or more of the voting stock of the subsidiary bank has been continuously owned by the BHC since June 30, 1968;
    b. Members of the same family have continuously held an 85 percent or more interest in the holding company since June 30, 1968.

3010.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Acquisition of an additional bank by a company exempt under 4(c)(ii)				1980 FRB 165
"Successor" to a Company Exempt under 4(c)(ii)				1980 FRB 349

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3020.0.1 INTRODUCTION

By virtue of section 4(c)(1) of the Act, a bank holding company may invest, without supervisory approval, in the shares of companies engaged in activities that Congress felt were incidental to the business of banking. The following activities are permissible investments for bank holding companies under this section.

3020.0.2 PROVIDING BANKING QUARTERS

Section 4(c)(1)(A) provides that a BHC may invest in a company engaged in holding or operating properties used wholly or substantially by any banking subsidiary of such bank holding company in the operations of such banking subsidiary or acquired for such future use.

Normally, bank utilization of 50 percent or more of the property would meet the requirements of this section. Investments in property where usage of such property by subsidiary banks is less than 50 percent will be reviewed on an *ad hoc* basis to determine its permissibility under this section. Future needs of the bank holding company and its bank subsidiaries will be considered when reviewing these cases.

In acquiring property, a bank holding company must have definite plans for use of the property as a subsidiary bank's premises within a reasonable period of time. Property may not be acquired and indefinitely warehoused until a need develops for the property.

This section of the BHC Act does not provide the authority for a BHC to invest in the shares of a company engaged in holding or operating properties used by nonbank subsidiaries. Directly holding or operating properties used by a nonbank subsidiary is considered an incidental activity necessary to carry on the main business activity of the subsidiary and thus is exempt under section 4(a)(2)(A) of the Act and section 225.22(a)(2)(vi) of Regulation Y.

3020.0.3 SAFE DEPOSIT BUSINESS

Section 4(c)(1)(B) of the Act provides that a holding company may invest in the shares of a company whose activities are limited to conducting a safe deposit business. Refer to Section 225.22(b) of Regulation Y.

3020.0.4 FURNISHING SERVICES TO BANKING SUBSIDIARIES

Section 4(c)(1)(C) of the BHC Act provides that a BHC may invest in a company which furnishes services to or performs services for the bank holding company or its banking subsidiaries. Section 225.22(a) of Regulation Y provides that a bank holding company may, without the Board's prior approval, furnish services to or perform services for its banking and nonbanking subsidiaries either directly or indirectly through a subsidiary. Generally, a BHC may only provide services related to the internal operations of the BHC or its subsidiaries. A bank holding company or its subsidiaries may not rely on the servicing exemption to deal with the public as principal, but may deal with outside parties provided they are acting only as agent for the holding company or its subsidiaries.

The term ''services'' implies servicing operations a bank may carry on itself, but which the BHC chooses to have done through a nonbank subsidiary. Section 225.22(a)(2) states that services for the internal operations of the bank holding company or its subsidiaries include: accounting, auditing, appraising, advertising, public relations, data processing, data transmission services, data bases or facilities, personnel services, courier services, holding or operating property used wholly or substantially by a subsidiary in its operations or for its future use, and selling, purchasing or underwriting insurance such as blanket bond insurance, group insurance for employees, and property and casualty insurance. For the later insurance activities, bank holding companies are permitted under the servicing exemption to act as agent or to underwrite insurance on their own risks (e.g. blanket bond insurance or employee group insurance plans). Refer to section 225.22(a)(2) of Regulation Y for other services permissible for the internal operations of the BHC or its subsidiaries.

The servicing exemption extends to services that are normally performed by a bank for its customers or correspondent banks. These activities generally include computerized billing, payroll, accounting, financial records maintenance and other similar data processing services as long as the subsidiary bank is permitted under applicable State or federal law to provide the service. These services may be provided only upon request by the customers to the subsidiary bank. Furthermore, the contractual arrangements must be made between the customer and the bank. The company can service existing service contracts the bank has originated but is prohibited from purchasing the contracts or entering into contracts to provide services directly to the public.

The purchasing of participations by the parent in loans from subsidiary banks generally is not considered an exempt activity under the authority of sections 4(a)(2) or 4(c)(1). Holding companies that engage in the purchase of participations from their subsidiary banks should file an application pursuant to Section 4(c)(8) of the BHC Act. Purchasing participations in loans for the purpose of providing liquidity or acquiring a portion of a line of credit to facilitate the needs of the bank's customers (overlines) provides a service or benefit to the bank and is considered an acceptable purchase under the services exemption. In all cases where a participation in a loan is purchased, the loan must be made in the name of the bank and serviced by the respective bank. The purchasing of a loan for reasons other than those set forth above may be viewed as a direct lending activity.

3020.0.5 FURNISHING SERVICES TO NONBANK SUBSIDIARIES

The Bank Holding Company Act of 1956 prohibited a BHC itself from engaging in any business except (1) banking, (2) managing or controlling banks, and (3) furnishing services to its bank subsidiaries. In 1970, Congress amended section 4 of the BHC Act to expressly authorize a BHC to furnish services to or perform services for its nonbank subsidiaries as well as its bank subsidiaries under exemption A of section 4(a)(2). While section 4(c)(1) authorizes a BHC to invest in shares of a company engaged in certain activities, exemption A provides the authority for a BHC to engage in those activities directly.

The Board issued an interpretation (12 C.F.R. 225.141), effective August 1980, which stated that it will permit, without any regulatory approval, a bank holding company to form a wholly-owned subsidiary to perform servicing activities for both banking and nonbanking subsidiaries that the holding company itself could perform directly or through a department or a division under section 4(a)(2)(A) of the BHC Act. In addition, an approved section 4(c)(8) company may form a wholly-owned subsidiary to engage in activities that such company could itself engage in.

3020.0.6 LIQUIDATING ASSETS

Section 4(c)(1)(D) provides that a BHC may own shares of a company which engages in liquidating assets acquired from such BHC (not including its nonbank subsidiaries) or its banking subsidiaries or which were acquired from any other source prior to May 9, 1956, or the date on which such company became a BHC, whichever is later.

Assets acquired for liquidation by a section 4(c)(1)(D) subsidiary are subject to the same time limitations as shares acquired D.P.C. pursuant to section 4(c)(2) of the Act.

BHCs seeking to hold the shares of a liquidating or nominee subsidiary organized to dispose of assets acquired D.P.C. by a BHC nonbank subsidiary, can rely on the Board's August 1980 interpretation permitting, without prior regulatory approval, a BHC to form a subsidiary to perform activities which itself could perform under exemption A of section 4(a)(2).

3020.0.7 INSPECTION OBJECTIVES

1. To determine whether the activities conducted by companies in which the BHC has a greater than 5 percent investment in the company and for which the BHC claims exemption under section 4(c)(1) of the BHC Act, are the types of permissible activities contemplated by that section—activities claimed under the premises exemption under 4(c)(1)(A), the safe deposit business exemption under 4(c)(1)(B), the services exemption under (4)(c)(1)(C), or the liquidating subsidiary exemption (4)(c)(1)(D).

3020.0.8 INSPECTION PROCEDURES

The inspection of a nonbank subsidiary exempt under section 4(c)(1) of the Act should center on a review of the activities to assure that those activities are the types permissible under section 4(c)(1) subsections A, B, C and D.

3020.0.8.1 Section 4(c)(1)(A)—Bank Premises

The following procedural steps should be performed in connection with an inspection of a bank premises company.

1. Obtain a list of all real estate held by the company including the following information:

a. Property description and location;

b. Date acquired;

c. Current utilization;

d. Extent of utilization by banking subsidiaries and others indicating percentage of square feet leased to subsidiaries.

2. When use of the property by a subsidiary bank(s) is less than 50 percent, discuss future plans for the use of the property with management. Note any related discussion contained in the minutes of directors' and committee meetings, and action taken to date to implement these plans. Lease agreements with other tenants should be reviewed to determine the term of a lease including options to renew.

3. Evaluate the permissibility of holding each property under the premises exemption.

4. Review and evaluate other activities engaged in and assets held by the company to establish their permissibility under the premises exemption. Such activities could include leasing property and providing a general maintenance service to other tenants.

3020.0.8.2 Section 4(c)(1)(B)—Safe Deposit Business

Activities exempt under this section are restricted to conducting a safe deposit business. All activities engaged in and assets held by companies for which the BHC is claiming exemption under this section should be reviewed and evaluated to determine their permissibility under this exception.

3020.0.8.3 Section 4(c)(1)(C)—Services

The following procedural steps should be performed when inspecting service companies.

1. List and describe all services provided to subsidiaries in the inspection report.

2. Review and evaluate the types of services provided to the banking and nonbanking subsidiaries to determine their permissibility.

3. Obtain from management any written bank holding company policies concerning the provision of services and the assessment of fees or discuss with management the basis on which service fees are established.

4. Comment on the reasonableness of fees relative to the fair market value, cost, volume, or quality of such services rendered.

5. Indicate if all service contracts have been approved by each subsidiary's board of directors.

6. When reviewing services provided to banking subsidiaries for their customers:

a. List and describe all services provided;

b. Determine that the company is operating as an adjunct to its affiliated banks for the purpose of facilitating the bank's operations, and not as a separate, self-contained organization;

c. Review contractual arrangements to assure that the company has not purchased any service contracts from a subsidiary bank and has not entered directly into agreements to provide services to any party other than the bank;

d. Review and evaluate all services to determine whether they are services that the subsidiary bank is permitted to provide under applicable State or federal law.

3020.0.8.4 Section 4(c)(1)(D)—Liquidating Subsidiary

The following procedural steps should be followed in connection with an inspection of a liquidation company in which the BHC holds an investment.

1. Obtain a list of all assets acquired by the company for the purpose of liquidation including the following information:

a. Asset description and location;

b. Date acquired;

c. Source of acquisition;

d. Liquidation plans, including timetable and selling price;

e. Cost of assets and book value, including detail on any improvements.

2. Verify that assets acquired from sources other than the parent or its subsidiary banks were acquired prior to May 9, 1956, or the date on which the holding company became a BHC, whichever is later.

3. Verify that assets acquired for liquidation did not originate in a nonbank subsidiary. If a section 4(c)(1)(D) liquidating subsidiary is holding a material amount of assets acquired from a nonbank subsidiary, discuss the propriety of these holdings with the Reserve Bank office staff and, if necessary, Board staff in the Division of Banking Supervision and Regulation or the Legal Division.

4. Review the bank holding company's policies, practices and procedures concerning the liquidation of assets and determine if the subsidiary is in compliance with the time limits indicated above.

5. Discuss with management and note the

liquidation plans and progress to date in liquidating assets that have been held in excess of 12 months. Note any related discussion found in the minutes of directors' and committee meetings.

6. Comment on whether management is making a *bona fide* effort to dispose of all assets for fair value.

7. Check improvements made to property by the company to assure that the nature and use of the asset has not substantially changed. The investment of funds to change substantially the nature of the asset (such as undeveloped real estate) to increase its value would generally be viewed as engaging in real estate development, an activity which is not permissible.

3020.0.9 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Purchase of instalment paper for subsidiary banks as furnishing of services		225.104	4–192	
Furnishing insurance not "services"		225.109	4–193	
Services for banks that are not subsidiaries		225.113	4–194	
Computer services for customers of subsidiary banks		225.118	4–195	
Applicability of Bank Service Corp. Act in certain BHC situations		225.115	4–174.1	
Mortgage company services		225.122	4–196	
Insurance and sale of short-term debt obligations by BHCs		250.221, 225.130	4–867	
Operations subsidiaries of a BHC		225.141		
Shares held by a subsidiary bank in a bank premises company and the applicability of section 4(c)(1)(A)		225.101(g) 225.141	4–185	
Investment in an asset liquidation subsidiary	1843(c)(1)(D)			
Providing services to bank and nonbank subsidiaries	1843(a)(2)(A)	225.22(a)		
BHC dealing for a BHC's own account in futures, and options on futures, on gold and silver bullion to limit price risks in trading				1987 FRB 61
BHC subsidiaries performing services that BHC could itself perform				1980 FRB 774

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Approved 4(c)(8) subsidiary forming an operations subsidiary to perform activities it could itself perform				1979 FRB 566 footnote 1

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(2) of the Bank Holding Company Act permits a bank holding company or any of its subsidiaries to acquire shares in satisfaction of debts previously contracted (DPC) in good faith. The shares must be disposed of within two years from the date they were acquired, except that the Board is authorized upon application of a company to grant additional exemptions if, in its judgment, the extension would not be detrimental to the public interest and either the bank holding company has made a good faith attempt to dispose of those shares during the five-year period, or the disposal of the shares would have been detrimental to the company. The aggregate duration of the extensions cannot extend beyond 10 years.

Even though the statute refers specifically to shares, the Board has taken the position, in section 225.22(d) of its Regulation Y and in an interpretation (12 C.F.R. 225.140), that the congressional policy evidenced by section 4(c)(2) should apply to DPC acquisitions of other assets, other than shares (assets), and real estate by bank holding companies and their nonbanking subsidiaries. Section 225.22(d)(1) provides the same holding periods (including provision for extensions) for other DPC assets or real estate as are provided by statute for DPC shares.

Regulation Y, section 225.22(d), addresses nonbanking acquisitions that do not require prior Board approval. With respect to DPC acquisitions, voting securities, or other assets or real estate acquired by foreclosure or otherwise, in the ordinary course of collection of a debt previously contracted (DPC property) in good faith, Regulation Y does not require the Board's prior approval if the DPC property is divested within two years of acquisition. Regulation Y further states that the Board may, upon request, extend the two-year period for up to three additional years. Further, the Board may permit additional extensions for up to five years (for a total of 10 years). This provision applies to shares, real estate, or other assets in which the holding company demonstrates that each extension would not be detrimental to the public interest and either the bank holding company has made good faith attempts to dispose of such shares, real estate, or other assets, or the disposal of the shares, real estate, or others assets during the initial period would have been detrimental to the company. Transfers within the bank holding company system do not extend any period for divestiture of the property.

Under the Board's delegated authority, the Reserve Banks may approve a BHC's requests for extensions beyond the two-year divestiture period.[1] In accordance with a Board interpretation (12 C.F.R. 225.138), extensions should not be granted except under compelling circumstances, and periodic progress reports on divestiture plans are generally required. When these permissible extension periods expire, the Board no longer has discretion to grant further extensions. A BHC would be in violation of the act if shares, other assets, or real estate acquired DPC is not disposed of within the prescribed time frame.

In July 1980, the Board issued an interpretation of Regulation Y (12 C.F.R. 225.140) that provided for a possible approval for an additional five-year period for the divestiture of real estate acquired DPC. With respect to DPC real estate, this interpretation requires that (1) the value of the real estate on the books of the company be written down to fair market value, (2) the carrying costs cannot be significant in relation to the overall financial position of the company, and (3) the company must make good faith efforts to effect divestiture. Fair market value should be derived from appraisals, comparable sales, or some other reasonable method. Companies holding real estate for this extended period are expected to make active efforts to dispose of it, and they should advise the Reserve Bank regularly concerning their ongoing efforts.

In accordance with the Board's interpretation (12 C.F.R. 225.140), after two years from the date of acquisition of DPC assets, the holding company is to report annually to the Federal Reserve on its efforts to accomplish divestiture of the assets. The Reserve Bank will monitor the efforts of the company to effect an orderly divestiture. Divestiture may be ordered before the end of the authorized holding period (beyond the initial two-year period that requires no Board authorization) if supervisory concerns warrant such action.

Section 4(c)(1)(D) allows a bank holding company to establish a subsidiary to hold real estate acquired by itself or by any of its banking subsidiaries for debts previously contracted, for the purpose of disposing of the real estate in an orderly manner. Permissible activities of this

1. Each Federal Reserve Bank has been delegated the authority (12 C.F.R. 265.2(f)(12)) to extend the time within which a bank holding company or any of its subsidiaries must divest itself of interests acquired in satisfaction of a debt previously contracted.

liquidating subsidiary include completion of a real estate development project and other activities necessary to make the real estate saleable. The "date of acquisition" is the date the bank holding company (or subsidiary of the bank holding company) acquired the DPC asset. Section 4(c)(1)(D) may not be used to extend the time under which a bank holding company may indirectly hold DPC property under section 4(c)(2). In most cases where a subsidiary bank has held property for the statutory holding period, a BHC may not shift the property to another subsidiary or to the parent to avoid disposing of the property. However, due to the complexity and potential impact on the organization of a forced divestment at the end of the holding period, inspection personnel and Reserve Bank staff are encouraged to discuss the situation with Board staff to tailor the supervisory response to the particular situation.

With respect to the transfer by a subsidiary of other DPC shares, other assets, or real estate to another company in the holding company system, including a section 4(c)(1)(D) liquidating subsidiary, or to the holding company itself, such transfers would not alter the original divestiture period applicable to such shares or assets at the time of their acquisition. Moreover, to ensure that assets are not carried at inflated values for extended periods of time, the Board expects, in the case of all such intercompany transfers, that the shares or assets will be transferred at a value no greater than the fair market value at the time of transfer and that the transfer will be made in a normal arm's-length transaction. With regard to DPC assets (except for DPC shares as described above) acquired by a banking subsidiary of a holding company, as long as the assets continue to be held by the bank itself, the Board will regard them as being solely within the authority of the primary supervisor of the bank.

Section 4(c)(3) of the Bank Holding Company Act permits a bank holding company to acquire shares or real estate from any of its subsidiaries if a subsidiary had been requested to dispose of the shares by any federal or state authority having power to examine the respective subsidiary. The Board does not have authority to extend the two-year disposition period under section 4(c)(3) of the act. Section 4(c)(3) may not be used to extend the statutory period in which a bank must dispose of DPC assets (10 years in the case of DPC real estate assets, five years for all other).

3030.0.1 EXEMPTION TO SECTION 4(c)(2) DISPOSITION REQUIREMENTS OF DPC SHARES

Section 4(c)(5) of the Bank Holding Company Act allows a bank to own shares in certain nonbanking companies, specifically, the kinds and amounts eligible for investment by national banking associations under the provisions of section 5136 of the Revised Statutes (see section 3050.0 for a detailed explanation of section 4(c)(5)). The exemption provided by section 4(c)(5) covers any shares, including shares acquired DPC, that meet the conditions set forth in that exemption. Therefore, DPC shares held by a banking subsidiary of a bank holding company which meet section 4(c)(5) conditions are not subject to the disposition requirement prescribed in section 4(c)(2); however, such shares would continue to be subject to requirements for disposition as may be prescribed by provisions of any other applicable banking laws or by the appropriate bank supervisory authorities.

Section 4(c)(6) of the act allows a bank holding company to own shares, including those acquired DPC, of any nonbank company that does not exceed 5 percent of the outstanding voting shares of such company. The Board has expressed an opinion (12 C.F.R. 225.101(f)) that any shares acquired DPC under this section, whether by a holding company or a bank subsidiary, are not subject to the disposition requirements of section 4(c)(2) of the act.

Real property is often shown on an entity's books as other real estate (ORE). Possession of ORE usually results from a distressed loan collateralized by a lien on real estate. In addition, in attempting to salvage other types of credit, an entity may have obtained title to real property through process of law or by voluntary deed. Acquisition costs for other real estate acquired for debts previously contracted usually consist of the principal amount that was due on the defaulted loan at the time the entity took possession, unpaid interest, legal fees and other foreclosure costs, accrued and unpaid taxes, and mechanic's liens. Property acquired DPC may be recorded on the company's books by capitalizing the loan amount and acquisition costs. Advances to complete the project can be included in the capitalized investment if the ORE is an unfinished project. The fact that the additional investment is being used to improve the property and make the property more saleable should be evident.

A company owning a DPC asset should maintain records documenting its efforts to dispose of the asset. Because an ORE asset is normally a nonliquid, nonproductive asset of uncertain value, a company should attempt to dispose of the asset at the earliest date possible. Unless special circumstances are present, a company should sell the ORE asset when a price offer sufficient to cover the acquisition, investment, and carrying costs is obtained.

3030.0.2 INSPECTION OBJECTIVES

1. To determine compliance with applicable laws, rulings, and regulations, and to initiate corrective action when violations appear in these areas.
2. To determine whether policies, practices, and internal controls regarding DPC shares, other assets, or real estate are adequate and to recommend correction when deficiencies are noted.
3. To evaluate the quality of DPC shares, other assets, or real estate and the progress toward their disposition.
4. To determine whether the DPC shares, other assets, or real estate acquired are recorded at fair market value.

3030.0.3 INSPECTION PROCEDURES

1. During the preinspection review, compile a list of shares, other assets, and real estate known to have been acquired DPC by the bank holding company and its nonbank subsidiaries, as well as a list of shares known to have been acquired DPC by the BHC's bank subsidiaries. Information on this list should include—
   a. a description of the shares or asset(s);
   b. the fair market value of the shares and asset(s), and the method of valuation, if available;
   c. the name of the company owning the shares and asset(s); and
   d. the date the shares and asset(s) were acquired.
2. If the shares or asset has been held longer than the initial holding period, determine whether the BHC has requested an extension of time.
3. In the Officer's Questionnaire, request a list of DPC shares, other assets, or real estate owned by the holding company and its nonbanking subsidiaries, and a list of DPC shares owned by the holding company's bank subsidiaries, including a detailed description of the shares or asset, the value of the shares or asset on the entity's books, the date the shares or asset was acquired, and plans for disposal of the shares or asset. In addition, a list of DPC shares, other assets, or real estate which has been disposed of since the previous inspection or within the past year should be obtained. Compare these lists with the list compiled during the preinspection review.
4. Review other real estate owned accounts to evaluate—
   a. the fair market value of the property (A qualified appraiser should appraise the property at the time of acquisition, and subsequent timely appraisals should be conducted to determine the current fair market value of the property.);
   b. the carrying costs of the property; and
   c. the company's efforts to dispose of the property (Information on file should include documentation showing a record of offers made by potential buyers and other information reflecting efforts to sell the property (i.e., advertisement brochures)).
5. Determine whether additional advances have been made on an unfinished project and whether evidence supports that the advances are making the property more saleable.
6. Determine whether a first-lien status exists and whether there are any tax liens or other encumbrances against the property.
7. Discuss DPC shares, other assets, or real estate and their values with management who is familiar with the history and current status of the shares or asset and assign classification, if warranted. A substandard classification may be applied when a company is sustaining losses in maintaining the property, and prospects for sale are not evident or encouraging. A company's acquisition of property through foreclosure often indicates a lack of demand and, as time elapses, the value of the real estate may become more questionable if the lack of demand persists. If the carrying amount of the investment exceeds the estimated value of the property, an adequate allowance reserve for any difference should be established and maintained. Property that is in the process of being sold for an amount in excess of the carrying value should not be classified if it appears that ultimate payment will be forthcoming.
8. List shares, other assets, and real estate acquired DPC under "other assets" in the inspection report. For significant shares and assets, the examiner may choose to present in the inspection report or in the workpapers, whichever is deemed appropriate, the following information:

a. a brief description sufficient to identify the property, the manner in which the property was acquired, and the reasons for its acquisition

b. the value of the shares or assets on the books of the company, the method used to determine the booked value, and whether it is the fair market value

c. a brief statement as to management's efforts to sell the property, its opinion of the likelihood of sale, and the anticipated sales price

d. a summary of the carrying costs subsequent to assumption and income generated from the property

e. the date when the holding company or its subsidiary must dispose of the property or request an extension to continue to hold the DPC shares or asset

f. the amount classified, if appropriate

g. any apparent discrepancies with rules or regulations

3030.0.4 Laws, Regulations, Interpretations, and Orders

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Transactions not requiring Board approval:				
1. Acquisition of securities by a BHC with majority control	1843(c)(2)	225.12(b)		
2. Acquisition of securities by a BHC with majority control		225.12(c)	4–020	1980 FRB 654
Required disposal by Regulatory Agency	1843(c)(3)			
Section 4(c)(5) and 4(c)(6) shares with respect to Section 4(c)(2)		225.101	4–187	
Delegation of Authority to extend time to dispose of DPC shares and assets		265.2(f)(12)		
Policy statement concerning divestitures by BHCs		225.138		
Disposition of property acquired in satisfaction of debts previously contracted		225.22, 225.140		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Federal Reserve issued a policy statement on April 5, 2012, indicating that banking organizations[1] may rent one- to four-family residential "Other Real Estate Owned" (OREO) properties without having to demonstrate continuous active marketing of the properties, provided that suitable policies and procedures are followed.[2] Key risk-management considerations are described for banking organizations that engage in the rental of residential OREO, including compliance with holding-period requirements for OREO, compliance with landlord-tenant and associated requirements, and accounting according to generally accepted accounting principles (GAAP). Rental OREO properties with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return should generally not be classified.

The statement establishes specific supervisory expectations for banking organizations that undertake large-scale residential OREO rentals (generally, 50 properties or more available for rent). Such organizations should have formal policies and procedures governing the operation and administration of OREO rental activities, including property-specific rental plans, policies and procedures for compliance with applicable laws and regulations, a risk-management framework, and oversight of third-party property managers. (See SR-12-5/CA-12-3 and their attachments.)

3032.0.1 POLICY STATEMENT ON RENTAL OF RESIDENTIAL OTHER REAL ESTATE OWNED PROPERTIES

In light of the large volume of distressed residential properties and the indications of higher demand for rental housing in many markets, some banking organizations may choose to make greater use of rental activities in their disposition strategies than in the past. This policy statement reminds banking organizations and examiners that the Federal Reserve's regulations and policies permit the rental of residential OREO properties to third-party tenants as part of an orderly disposition strategy within statutory and regulatory limits.[3]

The general policy of the Federal Reserve is that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date. Consistent with this policy, in light of the extraordinary market conditions that currently prevail, banking organizations may rent residential OREO properties (within statutory and regulatory holding-period limits) without having to demonstrate continuous active marketing of the property, provided that suitable policies and procedures are followed. Under these conditions and circumstances, banking organizations would not contravene supervisory expectations that they show "good-faith efforts" to dispose of OREO by renting the property within the applicable holding period. Moreover, to the extent that OREO rental properties meet the definition of community development under the Community Reinvestment Act (CRA) regulations, they would receive favorable CRA consideration.[4] In all respects, banking organizations that rent OREO properties are expected to comply with all applicable federal, state, and local statutes and regulations.

Home prices have been under considerable downward pressure since the financial crisis began, in part due to the large volume of houses for sale by creditors, whether acquired through foreclosure or voluntary surrender of the property by a seriously delinquent borrower (distressed sales). Creditors, in turn, often seek to liquidate their inventories of such properties quickly. Since 2008, it is estimated that millions of residential properties have passed through lender inventories. These distressed sales represent a significant proportion of all home sales transactions, despite some ebb and flow, and thus are a contributing element to the downward pressure on home prices. With mortgage delinquency rates remaining stubbornly high, the continued inflow of new real estate owned prop-

1. The policy statement applies to state member banks, BHCs, nonbank subsidiaries of BHCs, savings and loan holding companies, non-thrift subsidiaries of savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations (collectively, banking organizations).

2. This policy statement supplements other relevant Federal Reserve guidance, including the Board's policy statement on the disposition of property acquired in satisfaction of debts previously contracted. See 12 CFR 225.140. Also see sections 3020.0.6, 3030.0, and 3090.2.4.6 of this manual and section 2200.0 of the *Commercial Bank Examination Manual.*

3. The term "residential properties" in this policy statement encompasses all one-to-four family properties and does not include multi-family residential or commercial properties.

4. The Federal Reserve's CRA regulations define community development to include activities that provide affordable housing to low- and moderate-income individuals as well as those activities that revitalize or stabilize low- and moderate-income areas (see 12 CFR 228.12(g)(1) and (4)).

erties to the market—expected to be millions more over the coming years—will continue to weigh on house prices for some time.[5]

Banking organizations include their holdings of such properties in OREO on regulatory reports and other financial statements.[6] Existing federal and state laws and regulations limit the amount of time banking organizations may hold OREO property.[7] In addition, there are established supervisory expectations for management of OREO properties and the nature of the efforts banking organizations should make to dispose of these properties during that period.

3032.0.1.1 Risk-Management Considerations for Residential OREO Property Rentals

In all circumstances, the Federal Reserve expects a banking organization considering such rentals to evaluate the overall costs, benefits, and risks of renting. The banking organization's decision to rent OREO might depend significantly on the condition of individual properties, local market conditions for rental and owner-occupied housing, and its capacity to engage in rental activity in a safe and sound manner and consistent with applicable laws and regulations.

Banking organizations should have an operational framework for their residential OREO rental activities that is appropriate to the extent to which they rent OREO properties. In general, banking organizations with relatively small holdings of residential OREO properties—fewer than 50 individual properties rented or available for rent—should use a framework that appropriately records the organizations' rental decisions and transactions as they take place, preserves key documents, and is otherwise sufficient to safeguard and manage the individual OREO assets.[8] In contrast, banking organizations with large inventories of residential OREO properties[9]—50 or more individual properties available for rent or rented—should utilize a framework that systematically documents how they meet the supervisory expectations described in the next section. All banking organizations that rent OREO properties, irrespective of the size of their holdings, should adhere to the guidance set forth in this section.

3032.0.1.1.1 Compliance with Maximum OREO Holding-Period Requirements

Banking organizations should pursue a clear and credible approach for ultimate sale of the rental OREO property within the applicable holding-period limitations. Exit strategies in some cases may include special transaction features to facilitate the sale of OREO, potentially including prudent use of seller-assisted financing or rent-to-own arrangements with tenants.

3032.0.1.1.2 Compliance with Landlord-Tenant and Other Associated Requirements

Banking organizations' residential property rental activities are expected to comply with all applicable federal, state, and local laws and regulations, including landlord-tenant laws; landlord licensing or registration requirements; property maintenance standards; eviction protections (such as under the Protecting Tenants at Foreclosure Act); protections under the Servicemembers Civil Relief Act;[10] and anti-discrimination laws, including the applicable provisions of the Fair Housing Act and the Americans with Disabilities Act. Prior to undertaking the rental of OREO properties,

5. For further discussion of housing market conditions and the obstacles to conversions of OREO properties to rental, see "The U.S. Housing Market: Current Conditions and Policy Considerations," Federal Reserve staff white paper, January 4, 2012 (housing white paper).

6. "Other real estate owned" is comprised of all real estate other than (1) bank premises owned or controlled by the bank and its consolidated subsidiaries and (2) direct and indirect investments in real estate ventures.

7. Generally, the Federal Reserve allows BHCs to hold OREO property for up to five years, with an additional five-year extension subject to certain circumstances (see 12 CFR 225.140). National banks are subject to similar restrictions. State member banks and licensed branches of foreign banks are subject to the holding periods and other limitations on OREO activity established by their respective licensing authorities, which vary. Savings and loan holding companies generally may acquire real estate for rental (see 12 USC 1467a(c)(2) and 12 CFR 238.53(b)).

8. A preliminary analysis of the Consolidated Reports of Condition and Income (Call Report) data suggests that roughly 98 percent of community banks held 50 or fewer residential OREO properties.

9. For purposes of this guidance, the supervisory expectations for OREO rentals and the number of properties available for rent should include those properties for which tenants were already in place at the time of foreclosure or transfer of ownership, and for which tenants are afforded certain protections under the Protecting Tenants at Foreclosure Act of 2009. See the Federal Reserve's *Consumer Compliance Handbook*, section IV, for further information.

10. See CA-09-5, "Information and Examination Procedures for the 'Protecting Tenants at Foreclosure Act of 2009,'" July 30, 2009, and CA-05-3, "Servicemembers Civil Relief Act of 2003," May 6, 2005.

banking organizations should determine whether such activities are legally permissible under applicable laws, including state laws. When applicable, banking organizations should review homeowner and condominium association bylaws and local zoning laws for prohibitions on renting a property. Banking organizations may use third-party vendors to manage properties but should provide necessary oversight to ensure that property managers fully understand and comply with these federal, state, and local requirements.

3032.0.1.1.3 Other Considerations

Banking organizations should account for OREO assets in accordance with GAAP and applicable regulatory reporting instructions.[11] Banking organizations should also provide the appropriate classification treatment for their residential OREO holdings. Residential OREO is typically treated as a substandard asset, as defined by the interagency classification guidelines. (See section 5010.10.1 which discusses the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts, as revised June 15, 2004.) It sets forth the definitions of the classification categories and the specific examination procedures and information that are to be used for classifying bank assets, including securities. (See SR-04-9.) See also section 2060.1 of the *Commercial Bank Examination Manual*. Residential properties, however, with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return[12] should generally not be classified.

3032.0.1.2 Specific Expectations for Large-Scale Residential OREO Rentals

Banking organizations with large inventories of residential OREO properties that decide to engage in rental activities should have in place a documented rental strategy, including formal policies and procedures for OREO rental activities, and a documented operational framework. Policies and procedures should clearly describe how the banking organization will comply with all applicable laws and regulations. Policies and procedures should include processes for determining whether the properties meet local building code requirements and are otherwise habitable, and whether improvements to the properties are needed in order to market them for rent. In addition, policies and procedures should establish operational standards for the banking organization's rental activities, including that adequate insurance policies are in place, that property and other tax obligations are met on a timely basis, and that expenditures on improvements are appropriate to the value of the property and to prevailing norms in the local market.

Policies and procedures should also require plans for rental of residential OREO properties, down to the individual property level, that cover the full holding period from the time the bank received title to ultimate sale by the bank. Plans should identify which properties would be eligible for rental. Plans also should establish criteria by which properties are chosen for marketing as rental properties, and the process by which rental decisions should be made and implemented. Plans should describe the general conditions under which the organization believes a rental approach is likely to be successful, including appropriate consideration of rental market and economic conditions in respective local markets.

Finally, policies and procedures should address all risk-management issues that arise in renting residential OREO properties. Some risk elements parallel those found in other banking activities, for example, the credit risk associated with tenants' potential failure to make timely

11. See the instructions for the Call Report as to the reporting of OREO transactions and to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C). See more generally this manual's section 2200.1, "Other Real Estate Owned."

12. Whether a rate of return is reasonable depends on a number of considerations including local market conditions, the time horizon of the rental, and the nature of the property. Commonly used measures include a capitalization rate (known as a "cap rate," which generally is the expected annual cash flows from renting the property relative to the price at which the property holder could expect to sell it in the owner-occupied market), as discussed in the housing white paper, or other measures of internal rate of return. Depending on the circumstances and risks associated with the property, valid indications that a level of return is reasonable could include (but would not be limited to) comparisons with normal returns for single-family rentals in the relevant local market; rates of return on other similar local real estate investments; or cap rates or other measures of internal rate of return on investments with similar risk profiles. For example, in many markets a cap rate above 8 percent would likely represent a reasonable rate of return. Large one-time expenditures that are idiosyncratic to a given year but are normal to residential properties over their lifetime, such as replacement cost for worn-out appliances, should generally not be the reason that a property would be classified. Costs of improvement should be treated as capital expenditures with a corresponding effect on properties' carrying value to the extent the improvements improve the properties' values.

rent payments, or potential conflict of interest issues such as the use of a firm by a banking organization to both provide information on a property's value and list that property for sale on behalf of the banking organization. Other risks unique to such rental include

- dealing with vacancy, marketing, and re-rental of previously occupied properties;[13]
- liability risk arising from rental activities, along with the use and management of liability insurance or other approaches to mitigate that liability and risk; and
- legal requirements arising from the potential need to take action against tenants for rent delinquency, potentially including eviction. Such requirements may include notice periods.

Banking organizations may need to develop new policies and risk-management processes to address properly these categories of risk.

In many cases, banking organizations will use third-party vendors (for example, real estate agents or professional property managers) to manage their OREO properties. Policies and procedures should provide that such individuals or organizations have appropriate expertise in property management, be in sound financial condition, and have a good track record in managing similar properties. Policies and procedures should also call for contracts with such vendors to carry appropriate terms and provide, among other key elements, for adequate management information systems and reporting to the banking organization, including rent rolls (along with actual lease agreements), maintenance logs, and security deposits and charges to these deposits. Banking organizations should provide for adequate oversight of vendors.[14]

3032.0.1.3 Additional Materials for Reference

- Accounting Standards Codification (ASC) 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings").
- ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets").
- ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement.
- The disposition of other real estate is addressed in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within FAS 66, "Accounting for Sales of Real Estate"), which includes specific criteria for the recognition of profit.
- SR-10-16, "Interagency Appraisal and Evaluation Guidelines," December 2, 2010 and this manual's section 4140.1. For the sale of OREO property with a value of $250,000 or less, a BHC or state member bank may obtain an evaluation in lieu of an appraisal.
- SR-95-16, "Real Estate Appraisal Requirements for Other Real Estate Owned (OREO)," March 28, 1995.

13. Various jurisdictions may apply specific requirements to landlords in their marketing and re-rental activities (for example, an obligation to offer potential tenants an initial lease term of two years).

14. See Federal Financial Institutions Examination Council statement on *Risk Management of Outsourced Technology Services* (November 28, 2000, SR-00-17 and the appendix of section 4060.1 of the *Commercial Bank Examination Manual*), which provides illustrative guidance on constructing outsourcing risk assessments, due diligence in selecting a service provider, contract review, and monitoring of a third party that provides services to a regulated institution.

Section 4(c)(4) of the Bank Holding Company Act (the act) provides that nonbank shares held or acquired by a bank in good faith in a fiduciary capacity are exempt from the general prohibitions of section 4 of the act. This exemption is provided to allow banks to continue their normal fiduciary operations without significant interference and without being subject to the limitations of the Bank Holding Company Act. Without this exemption, a subsidiary bank could act as trustee for up to only 5 percent of a nonbank company's shares, as provided by section 4(c)(6) of the act.

Certain exceptions were included within the body of the section 4(c)(4) exemption to prevent use of the trust vehicle to circumvent the intent of the act. The section 4(c)(4) exemption is not applicable when shares acquired are held by a trust that is considered a "company" under section 2(b) of the act. Under section 2(b), a trust is defined as a company if it does not terminate within 25 years or within 21 years and 10 months after the death of individuals living on the effective date of the trust. Such trusts are generally referred to as perpetual trusts and include employee benefits and charitable trusts that can operate in perpetuity.

Another exception to the exemption implies that no more than 5 percent of the shares of a nonbank company may be held by a subsidiary bank as trustee under a trust established for the benefit of the bank itself; the bank's parent company or any of its subsidiaries; or the shareholders or employees of the bank, the parent company, or its subsidiaries, as indicated in section 2(g)(2) of the act. Employee benefit trusts have become a principal source of banks' trust assets. As strictly applied, section 4(c)(4) would limit acquisition of stock of a nonbank company to 5 percent of its shares for employee trust accounts of banks that are subsidiaries of bank holding companies.

3040.0.1 TRANSFER OF SHARES TO A TRUSTEE

Under section 4(c)(4), if a bank holding company transfers nonbank shares to a trustee and the trustee has one or more directors in common with the bank holding company, the nonbank shares are deemed to be controlled by the bank holding company until the Board determines otherwise.

3040.0.2 TRUST COMPANY SUBSIDIARIES

Even though section 4(c)(4) refers to shares held or acquired by a bank in good faith in a fiduciary capacity, the exemption also applies to shares held or acquired in a fiduciary capacity by a trust company subsidiary of a bank holding company.

3040.0.3 QUALIFYING FOREIGN BANKING ORGANIZATION OWNING OR CONTROLLING SHARES OF A COMPANY IN A FIDUCIARY CAPACITY

A foreign bank that maintains branches in the United States is subject to the provisions of the BHC Act in the same manner and to the same extent as a U.S. bank holding company.[1] Section 4 of the BHC Act prohibits a bank holding company and its subsidiaries from owning or controlling nonbanking assets or shares or engaging in any nonbanking activity unless it qualifies for an exemption.[2] Accordingly, such a foreign bank may not own nonbanking assets or shares (such as real estate), directly or through any company it controls, unless it qualifies for an exemption from the nonbanking prohibitions of section 4 of the BHC Act.

Under section 211.23(f)(4) of Regulation K, a qualifying foreign banking organization may "[o]wn or control voting shares of any company in a fiduciary capacity under circumstances that would entitle such shareholding to an exemption under section 4(c)(4) of the [BHC Act] . . ."[3] Section 225.22(d)(3) of the Board's Regulation Y (which implements section 4(c)(4) of the BHC Act) provides that the BHC Act's nonbanking prohibitions shall not apply to "voting securities or assets acquired by a bank or other company (other than a trust that is a company) in good faith in a fiduciary capacity, if the voting securities or assets are . . . held in the ordinary course of business and not acquired for the benefit of the company or its shareholders, employees, or subsidiaries."[4]

1. 12 U.S.C. 3106(a).
2. 12 U.S.C. 1843.
3. 12 C.F.R. 211.23(f)(4).
4. 12 C.F.R. 225.22(d)(3).

Two subsidiaries of the foreign bank CMB AG (the foreign bank) that are located in Germany currently invest in non-U.S. real estate for the benefit of third-party investors. One of the subsidiaries, IGC, manages only retail investment trusts (beneficial interests in which are typically sold widely to retail investors); the other subsidiary, SGC, manages only institutional investment trusts (beneficial interests in which are sold to 30 or fewer institutional investors). Through its legal counsel, the foreign bank requested an interpretation of section 4 of the BHC Act (12 U.S.C. 1843) and section 211.23(f)(4) of the Board's Regulation K (12 C.F.R. 211.23(f)(4)) that would permit its two asset-management subsidiaries, IGC and SGC, to sponsor and manage German-based investment trusts that invest in U.S. real estate.

The powers and duties of the asset-management services provided by IGC and SGC to their investment trusts are governed by the German Investment Law and a trust agreement entered into between IGC or SGC, on the one hand, and the investor, on the other hand (the trust agreement). IGC and SGC are subject to the supervision and regulation of the German bank supervisory authority (BaFin). Compliance by IGC and SGC with the German Investment Law and the trust agreement would be monitored and enforced by BaFin. Amendments in 2002 to the German Investment Law liberalized the ability of companies to sponsor, manage, and serve as distributor for one or more retail or institutional investment trusts, allowing investment in real estate outside the European Economic Area, including in the United States.

In light of the 2002 changes in German law, IGC established a retail investment trust (the retail trust) to invest in real estate located in the United States, Europe, and Asia. In addition, SGC is established as an investment trust for institutional investors (the institutional trust, and, together with the retail trust, the trusts) to invest in U.S. real estate. The trusts proposed to invest in existing commercial real estate properties in major U.S. cities (the properties), but not in undeveloped U.S. real estate. As required by the German Investment Law, title to each of the properties would be held either directly by IGC or SGC or by a special-purpose entity established and controlled by IGC or SGC.

Interests in the trusts would be sold only to non-U.S. persons. All property management, leasing, real estate brokerage, and refurbishment services obtained by the properties would be obtained from parties that are unaffiliated with the foreign bank or any of its subsidiaries. For their services to the trusts, IGC and CGS would receive an annual management fee based primarily on the net asset value of the trusts. The foreign bank's legal counsel contended that the proposed ownership of U.S. real estate by IGC and SGC for the account of the trusts would qualify for the fiduciary exemptions available in Regulation K and Regulation Y.

Under the arrangement, the two subsidiaries are subject to fiduciary duties that closely resemble those of a trustee in the United States. Under the German Investment Law, the investment trusts would not be legal entities separate from the two subsidiaries, IGC and SGC. The foreign bank made several representations and commitments in support of its inquirer's interpretation that the proposed ownership of U.S. real estate by IGC and SGC for the account of the trusts would qualify for the fiduciary exemptions under section 211.23(f)(4) of Regulation K and section 225.22(d)(3) of Regulation Y. In particular, the foreign bank committed that neither it nor its subsidiaries or employee benefit plans would own any beneficial interests in the investment trusts.

Based on all the facts, including all the representations and commitments made by or on behalf of the foreign bank, IGC, and SGC, Board legal staff stated that it would not recommend that the Board disagree with the inquirer's interpretation of the availability of the fiduciary exemptions in section 211.23(f)(4) of Regulation K and section 225.22(d)(3) of Regulation Y to the foreign bank. The fiduciary exemptions in the Board's Regulations K and Y (12 CFR 211.23(f)(4) and 225.22(d)(3)) would, therefore, permit the two subsidiaries of the foreign bank to take title to U.S. real estate on behalf of the investment trusts and for the benefit of the investors in the trusts. (See the Board staff's legal interpretation dated November 24, 2004. See also the summary of the interpretation in the *Federal Reserve Regulatory Service* at 3-744.13 and 4-305.2.)

3040.0.4 OTHER REPORTING REQUIREMENTS

In certain circumstances, holdings in fiduciary capacities of nonbank stock over 5 percent may also trigger reporting requirements under the federal securities laws.

3040.0.5 INSPECTION OBJECTIVES

To determine that nonbank shares held by a bank in a fiduciary capacity are in compliance with section 4(c)(4).

3040.0.6 INSPECTION PROCEDURES

Review the holding company's internal reporting procedures to establish that bank trust departments report 5 percent holdings in nonbank companies. In multibank companies, determine that controls are in place to aggregate nonbank shares held by each bank so that if an aggregate of 5 percent is held, it is reported in the Y-6.

3040.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interests in nonbanking organizations	1843 1843(c)(4)	225.12(a) 225.22(d)(3)	3–744.13	
A qualifying foreign banking organization may own or control voting shares of any company in a fiduciary capacity		211.23(f)(4)	4–305.2	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Section 4(c)(5) of the Bank Holding Company Act permits (without prior approval) investments by a bank holding company in shares of the kinds and amounts eligible for investment by national banks under the provisions of section 5136 of the Revised Statutes (12 U.S.C. 24(7)).

National banks are prohibited by section 5136 of the Revised Statutes from purchasing and holding shares of any corporation except those corporations whose shares are specifically made eligible by federal statute. This prohibition is made applicable to State member banks by section 9, paragraph 20 of the Federal Reserve Act (12 U.S.C. 335).

In 1968, the Board interpreted section 5136 as permitting a member bank to purchase shares of a corporation engaging in business (at locations the bank is authorized to engage in business) and carrying out functions the bank is empowered to perform directly. Section 5136 is a broad statute with types of permissible activities both explicitly defined and implied indirectly without express definition. Therefore, to limit the need for constant Board interpretation regarding the implied areas of section 5136, the Board curtailed the authority of a bank holding company to acquire shares on the basis of section 4(c)(5) through section 225.22(d) of Regulation Y. As a result, effective June 30, 1971, permissible shares for bank holding company acquisition under section 4(c)(5) are limited to those *explicitly* authorized by any federal statute. Additional reasons for limiting the scope of activities to those explicitly defined by statute, are that section 4(c)(5) acquisitions require neither prior Board approval, nor the opportunity for interested parties to express their views, nor any prior regulatory consideration of anti-trust and related matters.

3050.0.1 COMPANIES IN WHICH BHC'S MAY INVEST

The following is a list of permissible companies expressly authorized by federal statute. The list includes the companies most frequently encountered.

1. Small business investment companies ("SBICs").
2. Agriculture credit companies.
3. Edge and agreement corporations.
4. Bank premises companies (usually exempt under section 4(c)(1)(A)).
5. Bank service corporations (usually exempt under section 4(c)(1)(C)).
6. Safe deposit companies.
7. Obligations of student loan marketing associations.
8. State housing corporations.

3050.0.2 LIMITATIONS

On most 5136 authorizations, share investments are limited in some form, usually based on a percentage of the bank's capital and surplus. Under section 4(c)(5), a holding company's investment in such shares is also limited by amount and type to those permitted for a national bank to prevent avoidance of these limitations by a bank holding company.

3050.0.3 INSPECTION OBJECTIVES

1. To determine the permissibility of each activity encountered during the inspection which claims a section 4(c)(5) exemption.
2. To determine if the operations and financing of the section 4(c)(5) activity is not to the detriment of the bank(s).

3050.0.4 INSPECTION PROCEDURES

1. Review compliance with section 5136 of the Revised Statutes to determine if the activity is expressly permitted by any federal statute.
2. Determine the financial condition of the activity and its impact on the bank affiliate.

3050.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible investments for a national bank	(Section 5136 of the Revised Statutes)			
Investment in bank premise corporation	371d	250.200	4–185	
Investment in bank service corporation	1861–65	250.301	1–329	
Investment in small business investment corporation (SBIC)	15 USC 682b	225.107 225.111 225.112	4–173 4–175 4–174	
Operating subsidiaries/ loan production offices		250.141	3–415.4	
Section 23A Section 23B	371c 371c	250.240	3–1133 1–206.1	
Mortgage company		225.122	4–196	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3060.0.1 SECTION 4(c)(6)

This section provides an exemption for ownership of shares of any nonbank company that do not exceed 5 percent of the outstanding voting shares of such company. The exemption is designed to permit diversification of investments by a bank holding company and its subsidiaries which do not result in control of a nonbanking organization. The Board has indicated through an interpretation of 12 U.S.C. 225.101, that in its opinion, the 5 percent limitation applies to the aggregate amount of voting stock in a particular nonbank company held by the entire bank holding company organization including the parent company and all of its direct and indirect bank and nonbank subsidiaries. This is to prevent a holding company from acquiring a controlling interest in a nonbank company through ownership of small blocks of stock by numerous subsidiaries in circumvention of the provisions of section 4 of the BHC Act.

3060.0.1.1 D.P.C. Shares

The same interpretation (12 C.F.R. 225.101) also addresses the question of the applicability of section 4(c)(6) to nonbank shares acquired in satisfaction of debts previously contracted (D.P.C.) by a subsidiary bank, any nonbank subsidiaries, or the parent company. In this instance, the Board expressed the opinion that the 5 percent exemption provided by section 4(c)(6) covers any nonbank shares, including those acquired D.P.C. Consequently, shares which meet such conditions are not subject to the disposition requirements of section 4(c)(2) of the Act. It is important to remember that the exemption provided by section 4(c)(6) applies only to shares of any nonbank company. Acquisitions of any bank shares are subject to the provisions contained in section 3(a) of the Act.

Although the 5 percent limitation of this section applies, by its language, to ''voting shares'' rather than ''any class of voting shares'' as used elsewhere in the Act, the Board has indicated in 12 C.F.R. 225.137 that it applies to ''any class of voting shares'' rather than to the aggregate of all classes of voting shares held. Thus section 4(c)(6) is not available to a group of BHCs each owning a ''class of voting securities'' even if each BHC owns less than 5 percent of all shares outstanding. Further, section 4(c)(6) must be viewed as permitting ownership of 5 percent of a company's voting stock only when that ownership does not constitute ''control'' as otherwise defined in section 2 of the Act.

Note that section 4 prohibits engaging in nonbank activities other than those permitted by section 4(c)(8). Thus, if a BHC may be deemed to be ''engaging in an activity'' through the medium of a company in which it owns less than 5 percent of the voting stock it may nevertheless require Board approval, despite the section 4(c)(6) exemption.

3060.0.1.2 Acquisition of Nonbank Interests—Royalties as Compensation

A bank holding company requested an opinion on the permissibility of its subsidiary's receiving limited overriding royalty interests in oil, gas, and other hydrocarbon leasehold interests as partial compensation for investment advisory services in connection with those properties. The bank holding company was not acquiring more than 5 percent interest in any project. The subsidiary was to place the assigned royalties in a compensation plan for assignment to certain professional employees. Neither the subsidiary nor any affiliate were to acquire, hold, locate, sponsor, develop, organize, or manage any other energy property investment or in any other manner control the investment. The subsidiary was to hold interest in energy properties only if the interest had not yet been reassigned to an employee, or if an employee terminates service with the subsidiary and is required to reassign his or her energy properties to the subsidiary. The bank holding company's proposal was consistent with section 4(c)(6) of the Bank Holding Company Act, which exempts passive investments of 5 percent or less from the prohibitions of section 4 of the Bank Holding Company Act.

3060.0.2 SECTION 4(c)(7)

This section provides bank holding companies the opportunity to own, directly or indirectly, shares of an investment company (any amount up to 100 percent of outstanding shares) provided that each of the following conditions is met:

1. The investment company is not itself a bank holding company;
2. The investment company is not engaged in

any business other than investing in securities; and

3. Securities in which the investment company invests do not include more than 5 percent of the outstanding voting securities of any company.

4. As in section 4(c)(6), the 5 percent limitation applies, by its language, to ''voting shares'' rather than ''any class of voting shares,'' as used elsewhere in the Act. However, the criterion applies to ''any class of voting shares'' for purposes of this section.

The 5 percent restriction does not prevent an investment company from having direct or indirect subsidiaries of its own, provided that ownership of such subsidiaries is permitted under another provision of the Act. Rather, the limitation is intended to apply only to securities purchased in the ordinary course of investing by the investment company.

The legislative history of this provision of the Act does not provide a clear indication as to the type of institutions encompassed under the term ''investment company'' as used in this section. It appears, however, that any company primarily engaged in the purchasing and ownership of securities may be regarded as an investment company for purposes of this section. Section 4(c)(7) can be viewed, more or less, as an extension of section 4(c)(6) which permits a bank holding company to directly or indirectly through subsidiaries own up to 5 percent of the voting stock of any nonbank company. In fact, until the Amendments of 1966, the Bank Holding Company Act incorporated both section 4(c)(6) and section 4(c)(7) under one section. From a practical standpoint, the parent company is allowed, under section 4(c)(6), to directly engage in the same activities as an investment company. Accordingly, most holding companies conduct these activities through the parent company, rather than through an investment company subsidiary. Such an arrangement prevents duplicate payment of certain taxes and provides more flexibility for utilizing funds in other areas of the organization.

3060.0.3 INSPECTION OBJECTIVES

3060.0.3.1 Section 4(c)(6)

1. To determine that the investments held pursuant to section 4(c)(6) comply with the Act and 12 C.F.R. 225.101 and 225.137.

2. To determine that no more than 5 percent of the voting shares of any nonbank company (other than those owned pursuant to other provisions of the Act) is held by the bank holding company and its subsidiaries.

3060.0.3.2 Section 4(c)(7)

1. To determine the overall quality of the investments held.

2. To determine the financial impact of the ownership of such shares upon the bank holding company and its subsidiaries.

3. To determine if policies, practices and procedures regarding investments are adequate.

4. To suggest corrective action where necessary in the areas of policies, procedures, or laws and regulations.

3060.0.4 INSPECTION PROCEDURES

3060.0.4.1 Section 4(c)(6)

1. Review investments held to determine that the BHC has a total interest of no more than 5 percent.

2. Determine that 5 percent does not constitute control.

3. Determine that the BHC is not ''engaged'' in any nonbank activity through its 5 percent ownership.

3060.0.4.2 Section 4(c)(7)

1. Where section 4(c)(7) applies, compare the investment company's general ledgers with statements prepared for the latest FR Y–6.

2. Obtain schedules of investments in voting shares of any companies. Review quality of such shares (utilizing rating service publications, etc.) and check for ownership interests exceeding 5 percent.

3. Review policies (written or oral) regarding purchase and sale of stocks.

4. Obtain and evaluate documentation relating to credit review for securities held. Determine adequacy of procedures to maintain credit updates.

5. Compare carrying value of stocks to current market value to determine market depreciation, if any and determine adequacy of any established reserves.

6. Perform verification procedures, including physical review of stock held in safekeeping, where practical.

7. Determine that purchases and sales of stocks are appropriately approved by directors or designated officers.

8. Review minutes of the board of directors meetings (where an investment company subsidiary is involved).

3060.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
4(c)(6)				
Applicability to shares acquired D.P.C.		225.101	4–187	
Aggregating shares owned by subsidiaries		225.101	4–187	
Five percent limit on ''any class of voting securities''		225.137	4–189	
Control with less than 5 percent		225.137	4–189	
4(c)(7)				
Indirect ownership of shares of investment company		225.102	4–188	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2014, this section was revised to include a brief discussion of the December 13, 2013, "Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans" that was issued to clarify the safety and soundness expectations and Community Reinvestment Act (CRA) considerations for regulated institutions engaged in residential mortgage lending. The section references the Consumer Financial Protection Bureau's (CFPB) Ability-to-Repay and Qualified Mortgage Standards Rule that was issued on January 10, 2013 (effective on January 10, 2014). Institutions may issue qualified mortgages or non-qualified mortgages, based on their business strategies and risk appetites. Refer to SR-13-20 and its attachment.

A mortgage banker specializes in the origination, acquisition, and sale of residential real estate loans to permanent investors (the secondary mortgage market). Most mortgage banking firms that are affiliated with banks and bank holding companies primarily originate residential real estate loans, although some firms may engage in interim and other lending secured by real estate. Unlike their nonbank competitors, the vast majority of the loans mortgage banks originate are sold to permanent investors in the secondary mortgage market.

Mortgage banks can retain or sell their loans and sell or retain the servicing of their mortgages. The mortgage banking industry currently offers a wide variety of products, market mechanisms, financing vehicles, and financial strategies due to competitive pressures within the mortgage banking industry and rapid growth in the demand for loans and related securities within the secondary mortgage market. Mortgage bankers use these marketing and financing strategies to differentiate themselves from the competition in terms of interest rates, maturities, down-payment requirements, and product offerings.

The earnings stream, cash flow, and capital needs of a mortgage banking company are all highly influenced by management's decision whether to retain or sell the mortgage loans as well as the related mortgage-servicing rights. The majority of loans that are sold in the secondary market are originated under government-sponsored programs. Such loans are either sold directly or are converted into securities that are collateralized by the underlying mortgages (mortgage-backed securities). The pools of collateralized mortgage loans backing mortgage-backed securities provide a form of risk diversification for the investor.

Originations, secondary market sales, and servicing constitute the primary functional business lines within a typical mortgage company. As an originator of mortgages, the company is responsible for the initial phase of the mortgage, from original contacts with the borrowers to the closing of the loans. At closing, the company disburses its funds and becomes the lender of record. Mortgage loans can also be acquired through a network of correspondent companies. Most mortgage banking companies use a combination of origination and acquisition strategies. The decision about whether to originate or purchase loans also varies over time due to fluctuations in demand and pricing discrepancies.

The secondary marketing department is responsible for selling loans in the secondary market and managing the interest-rate risk associated with loans during the interim period. In most cases, the mortgage company retains the loans until it can find a permanent investor to purchase the loans. The mortgage banker obtains purchase commitments from permanent investors and submits completed loan documentation packages to the investors for their approvals in satisfaction of the commitments.

As part of the overall process, the mortgage banker maintains a relationship with a variety of other permanent investors to whom the originated mortgages are sold. These investors are generally institutional investors such as securities dealers, commercial banks, life insurance companies, pension funds, and other financial and nonfinancial institutions. Some of these investors are restricted by state law, charter, or bylaws as to the type of mortgages and the locations of the property in which they can invest. Accordingly, their purchase commitments should incorporate these limits as well as the price and/or required yield of the mortgage loans or mortgage-backed securities. When these commitments are filled and the mortgages sold to the investors, the mortgage banker may retain the servicing rights to the mortgages it sells to permanent investors or sell the servicing rights in the secondary market.

The servicing department manages the loans that were retained in permanent loan portfolio or those that were sold to another permanent investor. Fees paid for services rendered in administering the mortgage portfolios of investors are a principal source of revenue for most mortgage bankers. In general, the company receives a fee that is usually based on a percent of the unpaid balance of the administered mortgages. In return for the fee, the servicer is responsible for collecting and remitting payments, managing the tax and insurance escrow accounts, inspecting the properties when required, pursuing delinquent borrowers, foreclosing on the mortgages when necessary, and providing accounting support. Considering the services rendered and the generally low fees involved, the servicing portfolio must be sizable for the company to be profitable. The servicing portfolio may represent very little credit risk to the servicer and can be a valuable source of residual income to the company.

The mortgage banking industry is experiencing significant consolidation. To be competitive, participants must maximize economies of scale and efficiencies. Emphasis has been placed on using more efficient systems and technologies that enhance loan processing, underwriting, servicing, and the management of pipeline risk (the interest-rate risk associated with the holding period for the mortgages). Existing mortgage banking firms are larger and operate more efficiently (faster, cheaper, and with higher quality) than they did in the past. Operating efficiencies are achieved through the use of sophisticated information systems, such as electronic data interchange, imaging, optical character recognition, expert systems, and other forms of artificial intelligence.

Within a bank holding company, mortgage banking subsidiaries generally focus on residential mortgage lending. As discussed initially, these mortgage bankers may also engage in other forms of lending. On an industry basis, they extend loans to real estate brokers who buy properties for resale, engage in second mortgage and home improvement lending (usually through dealer agreements), and extend interim loans. Interim loans represent a means of funding a project through one or more phases, with the property and improvements as collateral for the loan. The size of interim loans may range from a single residence under construction to large industrial, commercial, or residential projects. Construction lending and other forms of lending may be provided by other such real estate lending subsidiaries located elsewhere within the bank holding company's organizational structure.

The mortgage banker, as a lender, has the flexibility to fund any and all phases of a project including land acquisition, development, and construction. Land acquisition credit may be extended for the acquisition of more than one parcel of land, which may not necessarily be identified with a specific project. More frequently, acquisition credit is tied into a specific project for which the lender expects to fund more than one phase. In development-phase lending, funds are advanced to "improve" the property, bring utilities on-site, cut roadways, and prepare the site for its intended use. Many residential and industrial park projects are funded through this phase, with the sale of individual parcels providing the repayment of the loan. Construction lending funds the project from the foundation to completion. For those loans that fund two or more phases, there may be no clear distinction between the phases as certain elements of each may be underway concurrently.

On large projects funded through completion, such as apartment and office buildings where the construction is to be repaid from a permanent mortgage, the lender will usually require the borrower to obtain a permanent mortgage commitment from a third party. While this "takeout" commitment may or may not be arranged through the lender's network of investors, this commitment provides the lender with some assurance of repayment. In some cases, particularly in unsettled market environments, these takeouts are not available, and the lender may issue a "standby" commitment. On occasion, no permanent financing will be available upon completion and the lender will extend a "bridge" loan for the interim period between project completion and the placement of a permanent mortgage. Making construction loans without takeout commitments from responsible term lenders could expose the construction lender to adverse interest-rate movements as well as the market acceptability of the project. The absence of a takeout can represent a weakness in a loan. The general lack of takeouts in a portfolio should be a criticizable management practice (unless mitigating circumstances prevail) and should be discussed with management.

This section provides inspection guidance and procedures for mortgage banking nonbank subsidiaries of bank holding companies. Except for the limited guidance that pertains only to bank holding companies, they may also serve as examination guidance and procedures for mortgage banking subsidiaries of state member banks. The way in which these procedures are used should be determined on a case-by-case basis depending on the size of a particular company and its business activities. The information in "Board Oversight and Management," "Financial Analysis," and "Intercompany Transactions" presented in this section is applicable to all mortgage banking reviews. The subsection "Mortgage-Servicing Rights" is recommended for use in companies that have significant risk exposure. The examiner should also target functional areas such as production, marketing, and servicing/loan administration.

3070.0.1 BOARD OVERSIGHT AND MANAGEMENT

The examiner should assess the quality and effectiveness of a mortgage banking company's board of directors (board) and executive management team, the appropriateness of its organizational structure, the nature of its internal control environment, and the effectiveness of internal control programs.[1] Such internal control programs may include internal and external audits, loan review, quality control over mortgage loans originated and/or serviced for investors, compliance, fraud detection, and related employee training programs.

The board and executive management team must be evaluated within the context of the particular circumstances surrounding each mortgage banking company. Since business complexities and operating problems vary according to the institution's size, organizational structure, and business orientation, directors and managers who are competent to effectively discharge their responsibilities under one set of conditions may be less competent as these conditions change.

Board oversight and management should be rated satisfactory, fair, or unsatisfactory based on both objective operating results and more subjective criteria. Performance must be evaluated against virtually all the factors necessary to operate the mortgage banking company's activities in a safe, sound, and prudent manner, including the ability to anticipate and plan for future events that may have a material impact on the company's financial condition. Such a rating should also be considered when assigning a consolidated rating of risk management (see sections 4070.1 (SR-95-51) and 4071.0 (SR-16-11)).

3070.0.1.1 Board Oversight

The mortgage banking company's board provides oversight, governance, and guidance to the executive management team. The board may include executives of the mortgage banking company, executives of the bank holding company and other affiliated companies, and outside directors.

The examiner should determine whether a separate board exists, as well as the identity and qualifications of the members. Minutes of board meetings should be reviewed to determine whether directors are fulfilling their fiduciary responsibilities. At a minimum, directors should—

- select and retain a competent executive management team;
- establish, with management, the company's short- and long-term business objectives and adopt operating policies to achieve those objectives in a safe and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the mortgage banking company's business performance; and
- ensure that the mortgage banking company meets the community's residential mortgage credit needs.

The examiner should assess whether directors exercise independent judgment in evaluating management's actions and competence, attend board and committee meetings regularly, remain well informed regarding the company's activities and the mortgage banking industry overall, and are knowledgeable regarding all applicable state and federal laws and regulations. The examiner should also review the quality of board reporting. Board reports must provide accurate and timely information to directors with respect to operating results, asset-quality trends, liquidity and capital needs, and relevant industry and peer-group performance statistics for each

1. See section 1010.1 of the *Commercial Bank Examination Manual* and a report, "Internal Control—Integrated Framework," which was issued in September 1992 by the Committee of Sponsoring Organizations of the Treadway Commission, for a more detailed discussion of internal controls. The Treadway Commission report broadly defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

operational area. Directors should also receive information regarding exceptions to established policies and operating procedures, volume-related processing backlogs, and the effectiveness of the internal control programs. Information on hedging products and strategies should be routinely provided to the board and to holding company management. In connection with this portion of the review, examiners should also request and review information regarding all loans to insiders and their related interests to ensure that no preferential transactions have been extended to these parties.

3070.0.1.2 Management

The executive management team generally consists of a president and chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), and senior executives in charge of production, marketing, and servicing/loan administration. Management formulates operating policies and procedures and oversees the day-to-day administration of mortgage banking activities. Management should be evaluated in terms of its technical competence, leadership skills, administrative capabilities, and knowledge of relevant state and federal laws and regulations. The management assessment should evaluate management's attitude toward risk, as evidenced by the type of products that are offered; the existence of effective hedging programs; and/or the degree of reliance that is placed on the resources of affiliate banks, nonbanks, and other entities to support mortgage banking company activities.

Prudent operating policies and procedures that are consistent with the business needs and risk-management practices of the parent bank holding company should be in place for each functional area. An effective risk-management program should also be in place. Without adequate management oversight, excessive errors can occur, fraud or other violations of law may go undetected, and financial information may be reported incorrectly. Any of these events can damage the company's image, impair its access to external funding sources, and jeopardize its ability to originate and sell mortgage loans in the secondary market.

It is management's responsibility to develop and maintain management information systems (MIS), which should be dedicated to obtaining, formatting, manipulating, and presenting data to managers when needed. Such systems should generate accurate financial statements; identify the need for financial, human, technological, and physical resources; and produce timely and useful management exception reports.

Management should also be evaluated on its ability to plan effectively. Effective planning entails the annual approval of an operating budget and the development of a long-term strategic plan that helps management anticipate changes in the internal and external environment and respond to changing circumstances. Because losses on the origination of mortgage loans are common in the mortgage banking industry, management should assess the servicing time necessary to recapture costs and achieve required returns. This information is critical to decisions to purchase mortgage-servicing assets, and it should be incorporated into hedging strategies.

The strategic plan should identify the company's strengths and weaknesses, growth targets, and other strategic initiatives (including management's philosophy toward the business, the extent of financial risk-taking, commitments to maintaining procedures and controls in managing the business, and management's commitment to staff development) over a one- to three-year time horizon. Planning efforts should also address system deficiencies and technological advancements within the industry. Without appropriate planning, the company can only react to external events and market forces.

Management should be results-oriented, but not at the expense of sound risk-management practices. Goals and objectives should be specific and measurable. Management should develop a performance measurement system that tracks progress toward achieving both financial and nonfinancial goals.

3070.0.1.3 Organizational Structure

The organizational structure should be reviewed to determine, on a legal-entity basis, the relationship between the mortgage banking company, the bank holding company, and any other bank or nonbank subsidiaries. The structure should also be reviewed to determine whether the lines of authority are clearly defined, the responsibilities are allocated logically, and management depth is sufficient within each division, department, or functional area.

The president and CEO usually reports directly to the mortgage banking company's board of directors, as well as to an executive management committee at the affiliate bank or the bank holding company level. Other reporting lines may exist between functional area executives and their counterparts at either a bank affiliate or the holding company level.

3070.0.1.4 Control Environment

Management's attitude toward risk is communicated to employees through the company's corporate culture. In general, the CEO should establish and communicate a corporate culture that promotes safe, sound, and prudent business practices. The corporate culture should provide a positive control environment, set high standards, and reward ethical, desirable behavior.

Management's failure to communicate acceptable standards of behavior may encourage impermissible or high-risk business practices. For instance, compensation programs that are incentive-based may generate poor-quality loans. Below-market pricing strategies or overly aggressive growth targets may further exacerbate asset-quality problems or generate loans in excess of processing and servicing capabilities.

3070.0.1.5 Control Programs

Management controls in a mortgage banking company consist of an internal audit, an external audit, loan review, compliance, quality control over loans originated and/or serviced for investors, fraud detection procedures and related employee training programs, insurance coverage, and legal review. The examiner should review recent reports conducted by internal loan review, state and federal agencies, and private investors to determine the scope of the review, the nature of any problems noted, and the adequacy of management's response.

3070.0.1.5.1 Internal Audit

The internal audit function in a mortgage banking company is responsible for detecting irregularities; determining compliance with applicable laws and regulations; and appraising the soundness and adequacy of accounting, operating, and administrative control systems. Accounting, operating, and administrative control systems are designed to ensure the prompt and accurate recording of transactions and a proper safeguarding of assets.

Internal audit activities may be conducted through a separate department located on-site or through the internal audit department of the bank holding company. Very small financial institutions that do not maintain a separate audit function may rely solely on their external auditor to perform these functions.

Regardless of the organizational structure, internal auditors must be independent of the line areas being reviewed, have access to all company records, and maintain sufficient status and authority within the company. The internal auditors' findings should be reported directly to the board or a designated committee thereof.

The scope, frequency, and coverage provided through the internal audit program should reflect the size and complexity of the institution. The audit schedule should cover underwriting practices and other high-risk areas of mortgage banking, including the most significant balance-sheet accounts, income statement accounts, and internal control systems.

To yield meaningful results, the department must be adequately staffed with individuals who are experienced and knowledgeable about mortgage banking. Audit staff should receive ongoing training and be encouraged to hold professional industry certifications. Internal audit reports should be issued and responded to by line management in a timely fashion. Follow-up procedures should be in place to ensure that corrective measures are taken.

3070.0.1.5.2 External Audit

External auditors generally review and assess the mortgage company's financial condition and the adequacy of internal controls. The engagement letter sets forth the external auditor's responsibilities, scope, and extent of reliance that is placed on the internal audit department with respect to the type of engagement. When an external audit is to be performed, the audit is an examination that is conducted to determine that the present financial condition of the company and the results of operations are fairly stated and are in conformity with generally accepted accounting principles.

Examiners should review the most recent external audit report to determine whether the opinion regarding the company's financial statements and their disclosures was qualified in any manner. If applicable, examiners should note any significant concerns or weaknesses in the company's internal control structure. Examiners should also review management's written response to the audit to determine whether corrective measures were appropriate, complete, and timely and whether the response reveals any internal control weaknesses.

The reason behind any changes in external audit firms used should be investigated. Unusual items and areas of potential concern should be discussed with management and/or the external auditor. If questions arise during the safety-and-soundness review, the examiner should determine whether the area of concern was considered to be a material item by external auditors, the nature of audit work performed, and the outcome of that review. If questions persist, the examiner may want to request access to specific external audit workpapers.

3070.0.1.5.3 Loan Review

Loan review activities may be conducted at the mortgage banking company or in conjunction with the loan review activities of either an affiliate or the parent bank holding company. In any event, loan review should determine whether mortgage loans that are originated and/or purchased meet underwriting standards as defined in the internal loan policy. Loan review may also sample loans to determine whether they meet underwriting criteria established by investors. The scope of the loan review program should be evaluated. The examiner should also review a copy of the most recent loan review to determine whether problems are identified and addressed in a timely manner.

3070.0.1.5.4 Quality Control

Mortgage banking companies that service loans for investors must also maintain a separate quality control department to test the quality of loans produced and serviced for investors. Investors such as the Government National Mortgage Association (GNMA or Ginnie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and FannieMae issue very specific guidelines that must be met with respect to the scope and frequency of such reviews.

At a minimum, these investors require that the mortgage banking company sample at least 10 percent of all closed loans each month and conduct a quality control review to determine the extent of accuracy, completeness, and adherence to agency underwriting standards. Random samples should include loans originated through the company's own production network, purchased loans, loans for which work was performed by a third party (outsourced), and loans with various product characteristics, such as a high loan-to-value or a convertible feature.

Quality control personnel reverify loan documentation, including the appraisal, down payment, employment, and income information. After each review, the department should issue a comprehensive report detailing specific quality control findings and recommendations. Quality control reviews must be completed within 90 days of closing. Exceptions to company policy or investor underwriting standards should be documented and communicated to executive management. Corrective measures should be initiated promptly.

The quality control function should serve as an early warning system that alerts management to situations that may jeopardize the financial strength, image, or origination and sale capacity of the company. To function as an effective management control, the quality control department should operate independently from the production and servicing/loan administration departments. Quality control should complement, not substitute, work performed by the internal audit and loan review functions.

3070.0.1.5.5 Insurance Program

The insurance program should be reviewed to determine whether coverage adequately protects the mortgage banking company and its affiliates against exposure to undue financial risk. Insurance policies should be reviewed and approved by the board at least annually.

3070.0.1.5.6 Litigation

The legal department should be contacted to determine whether existing or pending litigation exposes the mortgage banking company or its affiliates to undue financial risk. Particular attention should be paid to the status of any actual or pending class action lawsuits of a material nature.

Examiners should also determine whether procedures exist to detect and investigate suspected fraud, either internal or external. In many instances, the legal department coordinates fraud training and investigations, as well as the submission of criminal referral or suspicious activities reports and the initiation of legal action. If a separate fraud division or unit does not exist, examiners should determine whether procedures governing the detection, investigation, and referral of potentially fraudulent situations exist and function effectively. Examiners should also determine whether management reports adequately detail and track potential exposure.

3070.0.1.5.7 Supervisory Approach for Qualified and Non-Qualified Mortgage Loans

An "Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans," dated December 13, 2013, was issued to clarify the safety-and-soundness expectations and Community Reinvestment Act (CRA) considerations for regulated institutions engaged in residential mortgage lending. The Consumer Financial Protection Bureau's (CFPB) Ability-to-Repay and Qualified Mortgage Standards Rule[1a] was issued on January 10, 2013 (effective on January 10, 2014). Institutions may issue qualified mortgages or non-qualified mortgages, based on their business strategies and risk appetites. Residential mortgage loans will not be subject to safety-and-soundness criticism based on their status as either qualified mortgages or non-qualified mortgages. As for safety-and-soundness expectations, the agencies[1b] continue to expect institutions to underwrite residential mortgage loans in a prudent fashion and to address key risk areas in their residential mortgage lending, including loan terms, borrower qualification standards, loan-to-value limits, documentation requirements, and appropriate portfolio and risk-management practices. Refer to SR-13-20 and its attachment.

3070.0.1.6 Inspection Objectives—Board Management and Oversight

1. To assess the composition, qualifications, and degree of oversight provided by the mortgage company's board and executive management team.
2. To determine whether the organizational structure is appropriate given the nature and scope of the mortgage banking company's operations.
3. To evaluate the reasonableness of the operating budget, long-term business planning, performance measurement systems, and MIS and related management and board reports.
4. To determine the nature of the company's internal control environment and the effectiveness of its system of internal controls, including internal and external audits, loan review, quality control, suspicious activities and fraud detection (including criminal referral and suspicious activities reporting) and related employee training programs, insurance coverage, and pending litigation.

3070.0.1.7 Inspection Procedures—Board Management and Oversight

Board Oversight

1. Review biographies of the board of directors and minutes from board and committee meetings to determine whether directors are qualified and fulfilling their fiduciary responsibilities.
2. Review the most recent package of information that was provided to directors. Do they receive sufficient detail regarding the financial condition, internal controls, and risk-management techniques employed within the company?

Management

1. Review biographies of members of the executive management team to determine their level of experience, technical knowledge, leadership skills, and administrative capabilities. Discuss whether salaries are commensurate with management's experience level and expertise.
2. Evaluate the quality of operating policies and procedures within each division or functional area and the extent to which compliance with such policies and procedures is monitored and reported.
3. Evaluate the output from the planning process, including the most recent operating budget, business plan, and related performance measurement system reports. Determine whether objectives, goals, and growth targets are reasonable.

1a. See the Ability-to-Repay and Qualified Mortgage Standards Rule (the Ability-to-Repay Rule)_ under the Truth in Lending Act (Regulation Z), 78 *Fed. Reg.* 6408 (January 30, 2013), as amended. The Ability-to-Repay Rule requires institutions to make reasonable, good faith determinations that consumers have the ability to repay mortgage loans before extending such loans. In accordance with the rule, a "qualified mortgage" may not have certain features, such as negative amortization, interest-only payments, or certain balloon structures, and must meet limits on points and fees and other underwriting requirements.

1b. The federal banking financial institutions regulatory agencies (the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency).

Organizational Structure

1. Review the organization chart to determine whether the organizational structure is appropriate, as well as the appropriateness of the division of functional responsibilities and the degree of management depth within each division or functional area.

Internal Control Environment

1. Evaluate the nature of the internal control environment and how risk parameters are communicated to employees.

Internal Control Programs

1. Assess the effectiveness of internal controls in identifying and controlling risks. Internal controls include internal and external audits, quality control for mortgage loans, insurance coverage, and fraud detection procedures and related employee training programs.

Internal Audit

1. Determine whether a separate internal audit function exists and, if so, its degree of independence.
2. Review the qualifications of the internal audit manager and his or her staff for mortgage banking and accounting and auditing expertise. Consider the size of the department and its ongoing training programs, as well as the experience levels, educational backgrounds, and professional certifications of the department's staff.
3. Determine the scope and frequency of the internal audit program to ensure that all high-risk areas are reviewed regularly.
4. Review all internal audit reports, management responses to them, and follow-up audit reports for work conducted since the previous inspection.
5. Select a significant sample of internal audit reports and respective workpapers and conduct an intensive review of the internal audit program. Determine that all issues and exceptions were brought forward to the final audit report, the report was presented to the board or a committee thereof, and that any detected and disclosed problems or control weaknesses received appropriate management attention.
6. Evaluate the internal audit department's system for following up on issues and exceptions. Determine whether prompt, satisfactory resolution of issues was effected.

External Audit

1. Review the engagement letter for the most recent external audit to determine the external auditor's scope, responsibilities, and extent of reliance on the internal audit department.
2. Review the most recent external audit report to determine whether the opinion regarding the company's financial condition was qualified in any way and whether any internal control weaknesses were noted. Review the notes to the financial statements for appropriate disclosures.
3. Discuss any unusual items and areas of potential concern with management and/or the external auditor. Determine whether any areas of concern were considered to be material items by the external auditors, based on the nature of audit work performed, management's representations in the management letter, and the outcome of that review. If questions persist, consider the need to request and review specific external audit workpapers.
4. Discuss the reasons for any recent changes in external auditors with management.

Compliance and Disaster Recovery

1. Review the methods used to ensure compliance with state and federal laws and regulations by—
   a. interviewing the person who is responsible for compliance to determine the nature of outstanding problems and the adequacy of corrective measures that have been taken, and
   b. reviewing the system for logging, tracking, and responding to customer complaints.
2. Determine whether the disaster recovery plan is adequate.

Quality Control

1. Review the quality control department's policies and procedures to determine whether the quality control program meets minimum investor requirements.
2. Review a sample of reports issued by the quality control unit to determine whether they were issued in a timely manner and conclusions were adequately documented.
3. Determine whether quality control results

are relayed to executive management and whether follow-up procedures are adequate.

4. Determine whether the quality control unit is sufficiently staffed and independent.

5. Determine whether quality control outsources work to outside parties. If so, are adequate controls in place to ensure that such outsourcing meets the company's own quality standards?

Insurance

1. Review insurance policies maintained for the mortgage banking company to determine whether coverage is adequate and whether the majority of insurable risks is included, giving consideration to a cost versus benefits analysis.

2. Review board minutes to ascertain the date the board last reviewed and approved the insurance program.

Litigation

1. Review all current and pending litigation of a material nature and determine whether adequate reserves are maintained to cover anticipated financial exposure.

Fraud Detection and Training

1. Determine whether a separate fraud unit exists and whether procedures are in place regarding the detection and investigation of suspected fraudulent activity and the issuance of related management reports.

2. Evaluate the company's early warning system for detecting potential fraud. Is the level of training adequate?

3. Review any criminal referral or suspicious activities forms filed since the prior inspection and discuss their status with management.

3070.0.2 PRODUCTION ACTIVITIES

Loan production covers the process of originating or acquiring loans. Production begins with the initial loan application and ends when a loan has been underwritten and processed, closed, and reviewed by post-closing.

3070.0.2.1 Types of Loans

Loans are categorized as either government or conventional loans. *Government loans* generally carry a below-market interest rate and are either insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). Both agencies protect investors holding such securities against losses in the event of a borrower default, thereby slightly reducing investors' required yields. To be insured or guaranteed, a loan must meet agency standards regarding the size, interest rate, and terms. The lender can obtain a certificate of insurance or guaranty to give support to a loan for securitization. A certificate of insurance or guaranty may not be needed for a loan to be securitized.[2]

Loans that are not FHA-insured or VA-guaranteed are referred to as *conventional loans*. Conventional loans are generally originated for larger loan amounts and made to stronger borrowers. Conventional loans typically require higher down payments and bear market interest rates. Most lenders that offer programs with smaller down-payment terms require that the borrower purchase private mortgage insurance for the top 5 to 20 percent of the loan principal balance so that a proportionate share of the credit risk is borne by a private mortgage insurance (PMI) company.

The extent of credit risk associated with a loan often depends on the marketing program under which the loan is originated. Marketing programs and participants are described briefly here; for a more detailed description, see "Marketing Activities" later in this section.

The market for residential real estate loans is dominated by three government-sponsored entities: the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FannieMae). GNMA is a government agency that guarantees the timely payment of principal and interest on pass-through securities that are backed by pools of FHA-insured or VA-guaranteed mortgages. These guaranties are backed by the full faith and credit of the U.S. government. Although investors will get paid in full, servicers may retain some risk of loss, particularly with respect to VA loans (see subsection 3070.0.4.5 for addi-

2. See the appropriate agency seller/servicer guide for standards and requirements regarding certificates of insurance or guaranty.

tional information on "VA no-bids").

Pass-through securities provide for monthly installments of interest at the stated certificate rate plus scheduled principal amortization on specific dates, despite the delinquency status of the underlying loans, as well as any prepayments and additional principal reduction. The issuer collects the mortgage payments and, after retaining servicing and any other specified fees, remits monthly payments to the certificate holders.

Although FHLMC and FannieMae are not extensions of the U.S. government, the market believes that there is an implicit guaranty that their securities will be repaid. FHLMC and FannieMae securitization involves the purchase of conventional loans from lenders and the selling of mortgage-participation certificates, which are similar to GNMA pass-through securities. Participation certificates represent an ownership interest in pools of conventional loans. FHLMC and FannieMae guarantee the monthly pass-through of interest, the scheduled amortization of principal, and the ultimate repayment of principal. Unlike GNMA pass-throughs, however, participation certificates are not backed by the full faith and credit of the U.S. government.

Conventional loans are classified as either conforming or nonconforming. *Conforming* loans must comply with FannieMae's and/or FHLMC's underwriting and documentation guidelines in order to be sold in the secondary market. Conforming mortgages may be sold to FannieMae or FHLMC on either a recourse or nonrecourse basis.

Private pools of *nonconforming* loans that do not meet FannieMae or FHLMC guidelines may be sold in the secondary market under a private label structure. Nonconforming loans are often "nontraditional" products such as loans with teaser rates, limited documentation, and graduated payment schedules, as well as "jumbo" loans that exceed maximum agency size requirements. To improve salability, pools of nonconforming loans may be insured through third-party credit enhancements (for example, letters of credit) or various senior/subordinate structures. Since the underlying mortgages generally already carry private mortgage insurance, such pools are, in effect, doubly insured.

3070.0.2.2 Production Channels

Mortgage loan applications are generated through either *retail* (internal) or *wholesale* (external) production channels. Retail loans are originated through the company's own branch network. A branch network is relatively costly, since origination costs often exceed the origination fees received from the borrowers.

Wholesale production channels (where contact with the borrower is made by another party) take several forms. Whole loans can be purchased either individually or by using bulk commitments. Bulk commitments either require the correspondent to deliver a set amount of loans (mandatory) or deliver all registered loans that close (best effort or optional).

Loans may be closed in the buyer's own name using its own funds, closed in the seller's name using the buyer's own funds, or closed and funded by the seller with delivery to the buyer within a certain number of days. If the seller closes in its own name, the mortgage and note are generally assigned to the buyer simultaneously upon closing.

Three hybrid production channels are worth mentioning here. Examiners should note that terminology within the industry varies greatly. Under the first method, *table funding*, a mortgage banking company funds loans at closing that have been originated by a correspondent or broker according to the company's own specifications. Historically, the company's ability to record mortgage-servicing rights depended on the degree of independence that was maintained and the extent of risk borne by the originator. See subsection 3070.0.6, on "Mortgage-Servicing Assets and Liabilities."

The second hybrid method, *assignment of trade*, involves the bulk purchase of loans and investor commitments to sell the loans in the secondary market. The purchaser bears virtually no market risk under this production method. The third hybrid method, *co-issue*, entails the acquisition of servicing rights only, at the time a security is issued.

Most mortgage originators operate on a nonrecourse basis. For purchasers of correspondent production, credit risk increases to the extent that the lender relies on other parties to correctly process and underwrite the loan. Contracts with correspondents should include representations and warranties from the correspondent that loans delivered meet the underwriting requirements of the agency or investor program for which the loan was originated. Approved correspondent lenders should be continually monitored for the quality of the product delivered and the financial ability to repurchase mortgages that do not meet the standard representations and warranties under which the mortgages are sold.

3070.0.2.3 Production Strategies

A successful production strategy combines high credit-quality standards with cost containment and effective marketing. In contrast, an overly aggressive or inappropriate strategy leads to heightened production risk. High-risk production strategies can be evidenced by relaxed credit standards, low documentation requirements, an executive officer's compensation based on volume, an emphasis on high-risk product types or geographic areas, and/or dependence on a limited number of production channels. Examiners are responsible for recognizing and reaching agreement with management to better control such high-risk production strategies where appropriate.

3070.0.2.4 Production Process

There are five principal steps in the retail production process: (1) pipeline entry, (2) processing, (3) underwriting, (4) closing and funding, and (5) post-closing. Each of these functions should be independent from one another and separately supervised to ensure the quality of the loans produced. Each step is briefly discussed below.

1. *Pipeline entry.* A loan has entered the pipeline when a prospective borrower completes a loan application. The applicant authorizes the lender to verify his or her employment, credit history, bank deposits, and other information that evidences repayment capacity.

2. *Processing*. The application is then processed to qualify the applicant and the property for the loan. Processing personnel verify the applicant's employment history and credit information and order an appraisal on the property. Processing activities should be controlled through standardized procedures, checklists, and systems.

3. *Underwriting*. The underwriting unit approves or disapproves applications based on underwriting criteria that are established by the FHA, VA, FannieMae, and FHLMC and by private mortgage insurers and institutional investors. To ensure objectivity, the underwriting unit should not report to management of the production function.

4. *Closing and funding*. After an application has been approved, the lender generally issues a commitment letter to the borrower, which states the interest rate and terms of the loan. At closing, the lender or its agent obtains all the legal and related documents executed by the parties to the sale, disburses the proceeds of the loan, and collects certain funds from the borrower.

5. *Post-closing*. After closing, a post-closing review is performed to ensure that documents were properly executed and underwriting instructions were followed. The post-closing review also identifies any trailing or missing documents that must be tracked and obtained to meet investors' pool certification requirements. Specific agency requirements are detailed in the agency seller/servicer guides. Before the loan is transferred to the delivery or shipping department, processing begins for the final mortgage insurance (from the private mortgage insurer or from the FHA/VA guaranty certificate). Receipt of the actual certificate may take 45 to 60 days or longer. Pool custodians and investors will allow the lender to complete the sale if final documentation, including the insurance certificate, is expected to be received within a reasonable timeframe.

3070.0.2.5 Production Risks

The production process can present risks of both a short- and potentially long-term impact. Operational inefficiencies can result in high management and staff turnover, an inability to meet investor documentation requirements, an increasing number of pools that have not received final certification, or an unusually high production cost structure. Operations risk often increases during peak volume periods. If additional resources (which can include independent service providers) are not allocated to the processing, underwriting, closing, and post-closing areas, delinquency levels may increase and workloads may exceed existing capacity.

Management should be prepared to quickly respond to interest-rate cycles and related volume increases or declines, since failure to act promptly can affect earnings and capital. During the pooling and securitization process, for example, if the number of pools that lack final certification exceed a certain limit, the company may be required to seek financial support in the form of a letter of credit from an affiliate bank or bank holding company to ensure that all required loan documentation is secured in a timely manner. Credit risk and operational inefficiencies may also create liquidity problems and additional interest-rate risk if the company is unable to sell its loans in the secondary market.

To the extent a company retains servicing on either its retail or correspondent production, long-term credit risk issues may develop. These include exposure to the pools being serviced through recourse arrangements, potential non-reimbursable foreclosure costs, or costs associated with VA "no-bid" options.

3070.0.2.6 Overages

In certain instances, originators and loan brokers may have the ability to deviate from mortgage loan prices that are established by the marketing department. An overage exists when a lender permits an originator or broker to impose a higher number of points (or a higher interest rate) on a loan to certain borrowers than is imposed for the same product offered to other borrowers at a given point in time. (See CA-94-6.)

Overages are often used as an incentive to compensate originators or brokers. The amount that is received over the expected price is often shared by the mortgage banking company and the originator or broker. The practice of permitting overages may contribute to or result in lending discrimination under the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHAct).

Examiners should review the mortgage banking company's lending policy and determine whether overages are permitted and whether the practice has resulted in lending discrimination. If a more detailed review of overages is deemed necessary, such review should be performed in conjunction with the appropriate Federal Reserve System's legal and consumer compliance staff.

3070.0.2.7 Inspection Objectives—Production Activities

1. To determine the types of loans offered to borrowers and any significant changes in product mix.
2. To determine whether mortgage loans are securitized; if so, to determine whether mortgage-backed securities are insured or otherwise guaranteed by government-sponsored agencies or private entities.
3. To determine what channels are used to originate loans.
4. To determine if production processes are consistent with operational risk controls and efforts to minimize risk.
5. To determine whether production processes can handle cyclical changes in volume.
6. To determine whether overages are permitted and to assess whether the practice has resulted in lending discrimination.

3070.0.2.8 Inspection Procedures—-Production Activities

General

1. Review organization charts to determine the structure of the production function and its status within the company. Verify that functional units such as underwriting and quality control are independently managed.
2. Determine the types of mortgage products offered and the company's target markets. Evaluate portfolio trends for overreliance on one product type and undue concentrations in one geographic area.
3. Discuss the company's credit culture, compensation methods, and growth targets to determine whether income and loan volume are emphasized over credit quality.
4. Determine whether the level of nonconforming or unsalable loans being originated present undue risk and whether the quality and delinquency trends for such loans are adequately monitored.

Originations

1. Review policies and procedures for retail branch originations. How are originators compensated? Determine whether originators have the authority to alter loan pricing parameters set by the marketing unit.
2. Determine the size of the branch network and its cost structure. Is the network growing or shrinking? How does management plan for anticipated changes in loan volume?
3. Determine if the mortgage banking company is involved in overage activities. If so—
   a. determine whether management has developed comprehensive policies and procedures, detailed documentation and tracking reports, accurate financial reporting systems and controls, and comprehensive customer complaint tracking systems to adequately monitor and supervise overage activities;
   b. review whether overages are an essential component of the mortgage banking company's earnings and origination activities, and review the percentage of mortgages originated

since the previous inspection that resulted in overages and the average overage per loan;

c. determine if management reviews overage activity for disparate treatment and disparate impact; and

d. determine if overages are a major component of loan officer and/or broker compensation.

4. Review policies and procedures for wholesale purchases. Which production channels are used and how do they work? Channels may include whole loan purchases (production flow), table funding, assignment of trade, or co-issuances (bulk purchases of servicing rights only). For each production channel, review how brokers and correspondents are compensated.

5. Review the method for reviewing and approving brokers and correspondents and specific programs under which wholesale loans are purchased. Is there an approved list of correspondents? How is it updated and how frequently? Determine whether exceptions to this list are made and by whom, and whether controls are in place to prevent unauthorized purchases.

6. Evaluate the process for conducting financial reviews on correspondents. How often are financial statements obtained, and who analyzes them?

7. Determine whether adequate controls are in place to detect changes in the financial condition of a correspondent, test and monitor the quality of loans purchased, and evaluate the correspondent's financial capacity to perform under contractual repurchase obligations.

8. Select a sample of contracts for the largest correspondents for additional review. Do contracts clearly state pricing structures, maximum dollar volumes, recourse arrangements, and whether loans are purchased on a mandatory delivery or a standby basis? Have any legal issues arisen as a result of the contract language? How frequently does management put back loans to its largest correspondents?

9. Determine whether management information systems adequately track approvals and denials by loan type and production channel. Are exceptions to policy adequately tracked and monitored?

Processing

1. Determine whether processing is performed in-house or by another party (a third-party contractor or the originator). Review checklists and procedures for the processing unit and determine whether loan tracking systems are adequate.

2. Review steps that have been taken to address any audit or quality control findings. Determine whether additional corrective actions are necessary.

Underwriting

1. Determine whether underwriting is performed in-house, by third-party underwriters, or by the originator. Is management planning for peak volume periods and are controls over the underwriting process adequate?

2. Review policies and procedures to gain a reasonable assurance that underwriting standards are prudent and comply with investor guidelines. If individual underwriters perform this function, determine whether management has established approval limits, developed exception procedures for loans that are rejected or suspended, and receives reports that track loan quality for each underwriter. If a committee performs the underwriting function, review its charter, composition, and minutes. If a scoring system is used, review credit scoring methodology. Can the system be overridden? If so, by whom?

3. Review a representative sample (preferably a statistical sample) of current loans to test the underwriting policies and procedures and also determine the validity and adequacy of documentation supporting loans held for sale or investment.

4. If an unusual increase in unmarketable loan inventory has been noted, select a small sample of loans in current production for additional review. Does underwriting comply with established guidelines? If a credit scoring system is used, focus on loans that are of the lowest acceptable grade. If deficiencies are noted, consider expanding the review sample.

5. Review loans that were rejected and then approved. Did the proper authority approve such loans, and was management's rationale adequately documented?

Closing/Post-Closing

1. Evaluate procedures, checklists, and systems for closing loans. Are all required documents obtained from the borrower before funds are disbursed? If not, evaluate the appropriateness of suspense items.

2. Determine if a post-closing documentation review process exists to differentiate, track, and

obtain both trailing and missing documents. Assess its effectiveness.

3. Determine if wholesale loans are re-underwritten at delivery. If not, how does management ensure that loans are re-underwritten in accordance with secondary marketing program requirements?

4. Determine the number of pools that lack final pool certification. Has this number exceeded the maximum allowable limit since the previous review? Why has this problem occurred, and what steps are being taken to secure the necessary documentation? Has a letter of credit been posted? Does the situation pose undue financial risk for the company or any of its affiliates?

3070.0.3 MARKETING ACTIVITIES

The marketing department is typically responsible for the development of mortgage products, determination of products to be offered, and the establishment of daily mortgage prices. The marketing department, which is also referred to as secondary marketing, is also responsible for the sale of mortgage loans to investors. Given these roles, the marketing department acts as an intermediary between the borrower and the investor. All of these activities require close coordination to be effective and are appropriately placed within one department.

3070.0.3.1 Oversight

Marketing activities are generally supervised by a marketing committee, which may consist of the chief executive officer, chief operating officer, chief financial officer, and the executive officers responsible for marketing, production, and servicing/loan administration. The marketing committee is responsible for the formulation of marketing policies, departmental operating procedures, pricing strategies, and parameters governing the use of various mortgage-related products and strategies used to hedge the interest-rate risk associated with certain mortgage loans.

3070.0.3.2 Securitization

The marketing department's primary tool in performing its activities involves securitization outlets. Securitization activities are discussed in SR-90-16, which transmitted the following documents: (1) the Examination Guidelines, (2) An Introduction to Asset Securitization, and (3) Accounting Issues Relating to Asset Securitization. There is also a discussion of these activities in the *Commercial Bank Examination Manual*, section 4030.1. A review of the securitization process can provide a clearer understanding as to the value the marketplace assigns to a mortgage banker's production. Mortgage securities, however, are usually issued by an entity other than the mortgage banking company under inspection (such as government-sponsored agencies, securities affiliates, or brokerage firms).

Many approaches are used for securitization, but the great majority of activity occurs with conduits such as GNMA, FHLMC, and FannieMae. Conduits provide many programs that a mortgage originator can use to deliver a mortgage or pools of mortgages in return for cash or securities. To investigate current program requirements and available options, the examiner should consult the seller guidelines issued by the agencies.

The securitization process presents the marketing department with a complex set of options to consider when deciding how to sell the company's loan production for maximum profit. If the company's own servicing valuation differs from pricing offered by the agencies, for instance, the marketing department can use some flexibility in pool formation guidelines to retain or divest servicing cash flows. Recourse to the originator or servicer can be negotiated to reduce agency guaranty fees. Agencies also alter guaranty fees based on different methods of remitting principal and interest payments. Sales to the agencies can be on a best-efforts or mandatory basis. A best-efforts basis is when loan delivery is not required if the loan does not close. Better prices are received for the lender's acceptance of the more rigid performance requirements of mandatory commitments. Master commitment contracts can be reviewed by the examiner to determine negotiated terms.

Although most securitization activity occurs within the programs already mentioned, private security issues are also used. The private issues are used primarily for loans that do not meet the underwriting criteria of the agencies, commonly due to larger than accepted loan amounts (jumbo loans). Nonconforming loan production is usually sold to brokers or security affiliates who have marketed the product to investors, sometimes using complex real estate mortgage investment conduits (REMICs).

3070.0.3.3 Pooling Practices

As an intermediary between the borrower and the investor, marketing personnel coordinate the flow of loan documents from the shipping department to the pool custodian and the ultimate holder. If servicing is retained, the loan will be input into the company's servicing system soon after closing. Staffing levels should be adequate to ensure that processing backlogs are managed and workloads remain reasonable. Temporary help and/or outsourcing may be used during peak volume periods.

Operating procedures governing the selection of mortgage loans for pooling, packaging, and sale should be evaluated to ensure that the shipping and pooling processes are efficient and that loan files ultimately contain complete documentation. Management reports should identify and track the number of pools that lack final agency certification and the status of missing (unavailable) and trailing (delayed) documentation.

If third-party guaranties are used during the securitization process, procedures should also establish methods for evaluating and monitoring the financial condition of all third-party entities that provide credit enhancement. If loans or securities are sold with recourse, management reports should identify and track potential recourse obligations. Management should also analyze historical recourse losses by investor and product type and determine the appropriate level of reserves to cover estimated recourse exposure.

3070.0.3.4 Marketing Risks and Risk Management

3070.0.3.4.1 Techniques

The marketing department manages several risks, which can be categorized as follows:

- unsalability
- pricing
- fallout
- counterparty performance

3070.0.3.4.2 Unsalability

Under most circumstances, a mortgage banking company will originate mortgage products that are acceptable to GNMA, FannieMae, FHLMC, or other major investors. This minimizes the risk that mortgage products originated will not be marketable to investors and have to be retained as a portfolio investment. However, the marketing department may also initiate certain products that are intended for the loan portfolio of the mortgage company or portfolios of bank or nonbank affiliates. In the case of production for bank affiliates, underwriting and pricing arrangements must be structured to ensure compliance with the restrictions imposed by sections 23A and 23B of the Federal Reserve Act. See the subsections on production activities (3070.0.2) and intercompany transactions (3070.0.7).

3070.0.3.4.3 Pricing Risk

The mortgage banking business is volume driven. Because profit margins are thin and fixed costs associated with loan production can be large (especially in the case of a retail origination network), it takes a significant volume of mortgages to generate profits. Mortgage pricing decisions are critical because the price is a major determinant in the volume of mortgages originated.

Pricing strategies can be affected by divisional profit and loss allocations or external industry practices. A neutral price structure sets mortgage prices that are equivalent to the expected price for which the mortgages will be sold to investors, plus a normal servicing spread of 25 to 50 basis points depending on the type of loan. Daily adjustments are usually made to prices to reflect market changes for future settlement of mortgage-backed securities (MBS).

Due to regional or local competition, mortgage banking companies often find it necessary to deviate from a purely neutral pricing strategy to maintain volume in certain markets. However, large deviations from market price in either a lower or even upward direction can have adverse consequences. In addition to causing marketing losses, price cutting could place operational strains on the production and servicing areas. Premium pricing can position the company as a lender of last resort with adverse credit quality implications.

The marketing department attempts to minimize price risk by matching origination pricing with the price it expects to receive from investors. However, estimating the price at which the mortgages can be sold can be difficult because it is determined in large part by external factors such as interest rates. The longer the elapsed time between when the mortgage applicant decides to lock in a loan rate and the time the loan closes, the greater the risk that the prices for which the mortgages can be sold will change. Some companies encourage customers to "float" their interest rate until closing approaches to reduce the volume and costs of hedging.

3070.0.3.4.4 Fallout

A third type of risk that the marketing department manages relates to pipeline "fallout." This is the risk that the proportion of loans in the rate-committed pipeline that are expected to close will change with a given change in interest rates. As market interest rates decline, fewer mortgages in the pipeline will close because applicants will opt to make new applications at the lower rates. As interest rates rise, the proportion of pipeline loans that will close increases as more applicants choose to lock in rates. Mismatches that occur in the long and short positions can result in financial losses when the institution needs to settle its trades.

3070.0.3.4.5 Hedging Strategies

The most common hedging strategy used to protect the inventory of closed loans and the rate-committed pipeline against adverse interest-rate movements involves the use of mandatory and optional forward sales of MBS. Under this hedging strategy, the inventory and rate-committed pipeline (the long position) are generally covered through short sales (mandatory delivery contracts with settlements corresponding to expected delivery volumes). Put and call options on MBS are sometimes purchased to manage heightened fallout risks during periods of volatile interest-rate fluctuations.

The typical practice is to hedge 100 percent of the closed loan inventory that is marketable. In addition, pipeline loans very near to closing are generally also hedged at or close to 100 percent. However, a significant degree of uncertainty exists as to the amount and timing of 30- and 60-day rate-committed pipeline closings due to interest-rate fluctuations, underwriting delays, and cancellations. To control exposure to rate movements, management must estimate the percentage of the rate-committed pipeline that is expected to close in the current economic environment.

Although estimation techniques vary, data are generally collected on a number of pipeline characteristics such as product type, whether the loan is a purchase or refinance, and whether it is retail- or wholesale-originated. Fallout behavior can vary depending on these and other factors. Based on this information, management then derives an estimated closing percentage that becomes management's operating target for coverage of the rate-protected pipeline.

Marketing personnel often use simulation modeling to assess fallout percentages, assist in balance-sheet valuations, and develop appropriate hedging strategies. Such models may be either purchased from outside vendors or developed in-house, and they vary greatly in their degree of sophistication. In any event, the primary assumptions and inputs to the model should be reasonable, well documented, and reviewed periodically by both the marketing committee and by an independent source such as an internal or external audit. Results from the marketing simulation model should be provided to management through summary reports. Information may also be provided to bank holding company personnel for asset/liability management purposes.

Other products may also be used to hedge inventory loans and the rate-committed pipeline, particularly loans with an adjustable rate feature or other specialized characteristics. The marketing committee should review and approve all specialized hedge products used, the degree of correlation between the hedge product and the underlying position being hedged, and the degree of risk that each strategy or position entails. The accounting department should also determine whether such products qualify for hedge accounting treatment, establish appropriate management reports, and establish accounting policies. See subsection 3070.0.6, "Mortgage-Servicing Rights."

3070.0.3.4.6 Position Reports

To limit risk, the marketing committee should place prudent limits on the amount of exposure that can be incurred through hedging operations. Limits, which may be contained in the marketing policy, might establish a constraint on the size of uncovered long positions, require that coverage be maintained at the marketing committee's current closure estimates, or establish a constraint based on an earnings-at-risk measurement.

Compliance with limits should be monitored through regular position reports, which should be provided to senior management (the marketing committee and perhaps the treasury function of the parent company, if they participate in decisions or policy enforcement) at least weekly. Position reports should detail the company's long and short positions in relation to limits, as well as unrealized and realized gains and losses on loans and securities. Department managers generally require daily position reports in order to effectively monitor the position. Marketing position reports may not reconcile directly with reports prepared by the accounting department for financial reporting purposes. Significant differences should be investigated.

3070.0.3.4.7 Counterparty Performance

The marketing committee is also generally responsible for managing investor/counterparty performance risk. The marketing committee (or the treasury department of the parent bank holding company) should approve all brokers and dealers to which securities are sold before trading commences. Dealer limits should be established to limit the maximum amount of trades outstanding with each firm. Frequent position reports should be prepared to monitor compliance with established limits. The accounting department may be responsible for the ongoing monitoring of the financial capacity of the brokers and dealers.

3070.0.3.5 Inspection Objectives—Marketing Activities

- To review the types of products developed.
- To determine the pricing strategies offered to borrowers and investors.
- To review pipeline fallout estimation techniques.
- To review hedging methods as they relate to loan production.
- To determine whether information systems are adequate for senior management to monitor fallout behavior and hedge performance.

3070.0.3.6 Inspection Procedures—Marketing Activities

Management Oversight

1. Review the composition of the marketing committee and minutes from recent committee meetings to determine the nature and scope of its responsibilities, the frequency of meetings, and the degree to which oversight over marketing activities is provided.

2. Review the marketing policy as it relates to product offerings, pricing strategies, loan sales, and hedging operations. Are all relevant marketing risks identified? Note the date the marketing policy was last reviewed and approved by the board of directors.

3. Determine how management measures and controls interest-rate risk associated with closed loans in inventory and rate-locked loan applications in the pipeline. How are limits established and quantified (i.e., earnings at risk, economic value of equity at risk, percentage of capital, etc.)? Are such limits reasonable? Evaluate management's oversight of asset securitization activities in accordance with SR-90-16, as applicable.

4. Assess the adequacy of management information systems and related management reports that are designed to track compliance with established policy. Determine the extent to which operational practices adhere to policy. How are exceptions handled?

Securitization and Pooling Practices

1. Determine the secondary marketing programs used to sell mortgages to investors and the volume of sales under each program.

2. Discuss the strategies and procedures used for the selection of mortgage loans for pooling, packaging, and sale. Are there quality control procedures in place to ensure that the files of pooled loans contain complete documentation? What impact does strategy have on departmental profitability?

3. Evaluate the company's securitization practices:

- Determine how much risk the company retains and in what form.
- Determine the source, conditions, and costs of third-party guaranties. Verify that the financial condition of all third-party credit enhancers is substantiated.
- Determine the procedures used to obtain final pool certifications from investors (coordinate with the examiner(s) assigned to the production function). Determine the number and volume of securities that lack final certification. Is management doing everything possible to obtain missing documents? Are problems volume-driven or due to a lack of internal controls?

4. Determine whether loans or securities are sold with recourse. If so, are management information systems in place to track recourse obligations? Are analyses of recourse losses conducted by investor and product type? Are reserves held for recourse loans? What is the methodology for determining the adequacy of reserves? Review actual and potential losses. Are reserve levels adequate to cover identified exposure? Is compensation tied to trading profit?

Unsalability

1. Review the marketing policy to determine whether all mortgage products originated by the mortgage company are intended to be salable in the secondary market (for example, do they conform to guidelines issued by GNMA, Fannie-Mae, FHLMC, or other major investors?). How is actual salability monitored?

2. Determine if mortgage loans that are not salable are generated specifically for the permanent investment portfolio of either the mortgage banking company or its bank or nonbank affiliates.

3. Determine who is responsible for the review of temporarily unsalable loans, the frequency of such reviews, the actions taken to correct documentation and/or credit deficiencies, and if internal controls are adequate. This information is needed to ensure that hedge volumes are accurate.

Pricing Strategies

1. Review the current list of mortgage product offerings and the daily price sheet. Are prices determined centrally and are they uniform? Discuss pricing strategies with management to determine whether the company uses a neutral, above-market, or below-market pricing strategy.

2. Ascertain what procedures are in place to ensure that deviations from the approved pricing policies receive the proper degree of scrutiny and approval by senior management. If such discrepancies are common, why is this occurring (competition, compensation schemes, or departmental profitability considerations)? What impact have such deviations had on production volumes and the company's overall profitability?

3. Determine what policies are in effect regarding customer rate-locks. If a rate-lock expires, is it automatically renewed or is it renegotiated at current interest rates? Are the number and dollar volume of loans with expired rate-locks adequately monitored and tracked?

Fallout

1. Discuss the methodology used to predict the volume of applications that are expected to "fall out" of the mortgage pipeline. Is fallout methodology well documented?

ALCO/Simulation Modeling

1. Determine whether the expected fallout ratio is based on intuition, historical data, or an empirical model. Are assumptions reasonable? Are volatility assumptions based on historical performance or on implied volatility levels in the market? Who is responsible for reviewing model assumptions, and are these individuals sufficiently independent from the process itself? Does management also engage in sensitivity analyses to determine the impact interest-rate fluctuations will have on expected fallout levels?

2. Determine to what extent management uses output from these models in business planning, financial management, and budgeting.

3. Assess the degree to which mortgage banking activities are incorporated into the parent company's asset/liability management reports and program.

Hedging Practices

1. Discuss management's philosophy and strategy to determine the amount of interest-rate risk they are willing to accept. How successful has the company's marketing strategy been over the past few years and how is it changing? What are management's primary sources of market information? Are sources sophisticated enough given the size of the company and the scope of its activities?

2. Review the marketing policy to determine products and strategies used to hedge the interest-rate risk associated with inventory loans and rate-locked loan applications in the pipeline. Review actual hedging practices to determine whether they conform with established policy limitations and guidelines. What percentage of closed loans held in inventory and loan applications in the pipeline are matched against specific investor commitments? How are coverage levels determined and how have they changed over

time? Is the basis for this coverage ratio adequately documented? Determine whether the current coverage ratio exposes the company to undue risk associated with potential marketing losses.

3. Determine the adequacy of management's strategies for hedging loans that have special risks (ARMs with interest-rate caps and floors).

4. Ascertain if basis risk exists for any hedging products, whether such risks are significant, and the impact on correlation. How is basis risk identified, monitored, and controlled?

5. Determine whether call options are written to enhance inventory yields. If so, verify that they are written against covered positions. Determine whether management is speculating in any way and whether this activity subjects the company to undue risk.

6. Obtain profit/loss reports on hedging activities. How frequently are they prepared, how are they used, and to whom are they distributed? Evaluate the financial results of the hedging program over the past three years. Is management taking on excessive risk to record profits in this area?

7. Review management reports relating to pipeline and closed-loan hedging operations. Determine whether such reports are complete, accurate, and timely. Do such reports adequately limit excesses, record exception approvals, and detail risk exposures?

8. Review information provided to executive management and the board to determine whether hedging practices are adequately supervised.

Counterparty Risk

1. Review the marketing committee's list of approved brokers and dealers. Have appropriate dealer limits been established and are such limits adhered to? How are exceptions monitored, reported, and controlled?

3070.0.4 SERVICING/LOAN ADMINISTRATION

Mortgage banking companies that originate and sell residential real estate loans in the secondary market often retain the right to service those loans for the investor for a fee. In return, the servicer collects monthly payments from mortgagors, collects and maintains escrow accounts, pays the mortgagors' real estate taxes and insurance premiums, and remits principal and interest payments to the ultimate investors. The servicer also maintains records for the mortgagor, collects late payments on delinquent accounts, inspects property, initiates and conducts foreclosures, and submits regular reports to investors. Such functions and responsibilities should be documented within a formal written servicing agreement.

3070.0.4.1 Revenue Generation

The right to service mortgage loans provides a stable source of earnings and the potential for one-time gains. For this reason, servicing portfolio growth has become a primary objective for many mortgage banking companies.

Mortgage-servicing revenues are derived from six sources. The primary source is the contractual servicing fee. Because this fee is usually expressed as a fixed percentage of each outstanding mortgage loan's principal balance, servicing-fee revenues decline over time as the loan balance declines.

The second source of servicing income arises from the interest that can be earned by the servicer from the escrow balance that the borrower often maintains with the servicer for the payment of taxes and insurance on the underlying property. This income may vary, however, as some states require that interest payments on escrow balances be paid to the borrower.

The third source of revenue is the float earned on the monthly loan payment. This opportunity for float arises because of the delay permitted between the time the servicer receives the payment and the time that the payment must be remitted to the investor.

The fourth source of revenue consists of income late fees charged to the borrower if the monthly payment is not made on time. A fifth source is income in the form of commissions that many servicers receive from cross-selling credit life and other insurance products to the borrowers. The sixth and last source is when the servicer might generate fee income by selling mailing lists to third parties.

3070.0.4.2 Cost Containment

Long-term profitability is achieved through cost containment, technological improvements, and economies of scale, which reduce the per-unit cost of servicing. Servicing costs vary widely across institutions depending on portfolio characteristics such as product type, loan size and age, delinquency status, and foreclosure statistics. Nevertheless, two efficiency measures frequently used within the industry to measure cost containment are unit-servicing costs and the number of loans serviced per employee. The minimum size of a loan-servicing portfolio needed to achieve economies of scale varies across institutions and depends on portfolio characteristics and the servicer's expertise and technological capabilities.

Servicing data are available through the Mortgage Bankers Association's publication, "Mortgage Banking Performance Report." Based on detailed financial-statement information from a sample of companies, the report presents a compilation of performance data on all aspects of the mortgage banking industry.

3070.0.4.3 Growth Strategies

Many companies have established aggressive growth targets for their servicing portfolios. The size of the portfolio may be increased through originations, purchases of loans (individual or bulk), or purchased servicing rights. Portfolio size is reduced through normal runoff, prepayments, and sales of either loans or servicing rights only. Management's growth strategy should be examined in light of its expertise and systems capabilities.

3070.0.4.4 Servicing Agreements

The servicer generally operates under a written contract with each investor. This contract, also known as a servicing agreement, establishes minimum conditions for the servicer such as its fiduciary responsibilities, audit requirements, and fees. Contracts may be standardized or tailored to the individual investor.

Under most servicing agreements, the servicer warrants that full principal has been advanced, the mortgage is in fact a first mortgage on the property, and that the first mortgage position will be maintained by the servicer. Additional warranties that are either unwritten or implied may create significant exposure for the servicer.

A servicer may also enter into an agreement with another company to subservice certain loans or portfolios of loans. The company's method of evaluating and monitoring the financial condition of its subservicers should also be reviewed. Servicing and subservicing agreements should be evaluated in terms of the subservicer's responsibilities, reporting requirements, performance, and fees. They should also be reviewed to determine that no additional liabilities, real or contingent, are imposed upon the company beyond its responsibilities as a servicing agent.

3070.0.4.5 Recourse Obligations

A servicing agreement may contain specific recourse obligations that go beyond the servicer's customary fiduciary obligations. A mortgage banking company can choose to service loans for investors either with or without recourse back to the mortgage banking company. Servicing agreements should be reviewed to determine the extent of any recourse obligations. The risk of recourse should also be discussed with management to assess whether the risk is being identified and effectively managed.

The degree of recourse varies by investor. FannieMae offers either "regular" or "special" servicing options. With FannieMae's regular option, the servicer retains all risk of loss from mortgage default. With FannieMae's special servicing option, the mortgage banking company only retains exposure for normal representations and warranties. FHLMC offers similar servicing options. FannieMae and FHLMC generally limit eligibility for the regular servicing option to participants with the knowledge and financial wherewithal to make good on their recourse obligations.

GNMA servicing carries no contractual recourse. However, in the event of mortgage default, the servicer may have exposure to principal loss and other nonreimbursable expenses, particularly with respect to VA-guaranteed loans. If a borrower defaults on a VA-guaranteed loan, the VA can exercise a "no-bid" put option, which allows the VA to pay out its guaranty and leave the property with the servicer for disposition.

When a borrower defaults on a VA-guaranteed loan, the VA makes a calculation that will guide its decision to accept or reject conveyance of the property. The VA's decision to exercise its no-bid option is based on the net value of loan collateral and the VA's guaranteed percentage of the indebtedness. The mortgage servicer, at its option, could pay down the outstanding principal balance on the loan to a point where the VA would not be expected to exercise its no-bid option. Such "buydowns" result in additional foreclosure losses for the servicer.

The risk-based capital guidelines require a charge to capital when any risk of loss is retained on such recourse obligations. The charge would be at the bank holding company, the bank, or both,[3] depending on ownership of the risk. For this reason, the accuracy of reported recourse obligations should be verified.

3070.0.4.6 Guaranty Fees

The amount of guaranty fee the mortgage banking company pays the government-sponsored agencies (or private issuer) is negotiated. Guaranty fees vary based on the amount of recourse assumed by the mortgage banking company (the servicer) and the timing of the cash flows. A smaller guaranty fee is negotiated when the guarantor assumes less risk or receives payments sooner in the remittance cycle. Remittance cycles vary by investor.

The examiner should discuss with servicing personnel the amount of risk that has been taken on by the marketing department in exchange for reduced guaranty fees. Excessive risk accepted by the mortgage banking company should be incorporated into the assessment of management.

3070.0.4.7 Internal Controls

The servicing process begins after the post-closing review has been completed and the loan has been set up on the mortgage banking company's servicing computer system. Servicers are responsible for adequately safekeeping loan documents. Documents must be stored in a secured and protected area such as a fireproof vault. Servicers must also maintain a tracking system for following up on missing documents.

The control environment that sets the tone of a servicing department's operation should be assessed. A servicing department's management faces a variety of risks that it should identify and control. In addition to identifying and controlling risks, management also needs to institute adequate and effective internal controls to match a servicing portfolio's growth and the department's technological changes. When assessing the control environment, the examiner needs to consider the extent to which management uses internal and external audits, quality control reports, and investor audits to ensure that its policies and procedures are followed.

The servicer's performance should be evaluated, with any loss of servicing due to operating inefficiencies or excessive risk-taking discussed and noted. A discussion of the risks within each operational area, as well as the management reports and internal controls, follows.

- *Loan accounting*. Incoming payments may be processed in-house, through a lockbox, or through some combination of both. Payments are deposited into a clearing account and then transferred to the respective investor custodial bank accounts the next day. Investor remittances may be required daily, weekly, monthly, or as funds are received. In certain cases, servicing agreements may specify that payments be sent directly to security holders. Numerous accounts through which incoming and outgoing payments pass should be reconciled daily to avoid costly processing errors. The reconcilement process should be reviewed with management to ensure that reconcilements are performed on a timely basis and without chronic discrepancies.
- *Escrow administration*. In addition to receiving and remitting payments, servicers are also responsible for paying taxes and insurance on the underlying property. Accurate information must be maintained for each loan regarding a legal description of the property; the appropriate taxing authority, due dates, and amounts for taxes owed; and the insurance provider and due dates and amounts for insurance owed. Failure to maintain such information may result in missed tax and insurance payments on the property, which may lead to penalties and/or lapsed insurance coverage. The servicer's record of tax penalties paid over the past several years should be reviewed to determine whether a problem exists in this area.

  Escrow account balances should be adequate to meet expected tax and insurance obligations. If the servicer advances its own funds to cover an escrow overdraft, such payments may be capitalized and recorded as a receivable only if the servicer is to be reimbursed by either the mortgagor or the investor. Escrow receivables should be aged, with stale or otherwise uncollectible receivables charged off.

  Escrow accounts should be analyzed at least annually, with a copy of the analysis sent to the mortgagor. Shortages (overdrafts) may be billed or spread out over 12 months.

3. If at the bank, then it is also consolidated at the bank holding company level.

Overages should be returned to the borrower or handled in a manner consistent with federal and state laws and regulations. For loans that were set up without an escrow account, the examiner should verify that adequate information has been obtained from the mortgagor to ensure that taxes and insurance are current.

- *Investor reporting.* Investor remittance and reporting requirements vary greatly. Remittances are contractually arranged. In some instances, the servicer may be required to advance to investors funds that have not yet been received from the mortgagor (for example, cash advances to ensure timely payment of principal and interest). In such cases, a receivable is created on the balance sheet. Receivables relating to investor remittances should be aged in the same manner as escrow receivables and periodically reviewed by a supervisor. Stale or otherwise deemed uncollectible receivables should be periodically charged off in a timely manner.

  Investor reports should include detailed account reconciliations and information on the mortgagor's name, principal balance outstanding, escrow balance, delinquency status of the account, and any foreclosure activity or transfer to the servicer's other real estate owned account. The quality and accuracy of investor reporting should be periodically reviewed by internal or external auditors.

- *Collections, foreclosures, and other real estate (ORE).* Investor requirements also vary concerning contact with delinquent borrowers, forbearance policies, and reimbursement for foreclosure expenses, ORE write-downs, and related losses. Detailed policies concerning collection efforts and foreclosures should be in place and followed. The property should be inspected regularly to ensure that its condition is adequately monitored. Delinquency and foreclosure statistics should be tracked by product type and originator.

  Foreclosures are generally initiated after three full installments are due and unpaid. The servicer notifies the mortgagor of its intent in writing and refers the case to an attorney. Detailed records should be maintained for all expenses that are incurred. If the loan is insured, claims may ultimately be filed against the FHA, VA, or private mortgage insurance (PMI) company. However, it should be noted that certain interest expenses and collection or foreclosure costs are not reimbursable.[4] These expenses are a cost of doing business that must be factored into the servicing fee charged for providing these services.

  The timeframe for taking title on foreclosed property varies widely and is determined by state law. *Once title is taken, the property should be classified as ORE.* Although all ORE is generally managed through a centralized unit, for accounting purposes, ORE may fall into one of two distinct categories: ORE that is owned by the mortgage banking company, and ORE that is serviced on behalf of the investor. ORE that is owned should reconcile to the balance sheet, whereas ORE that is serviced for others is an off-balance-sheet item. ORE appraisal, valuation, and financing policies should be consistent with regulatory policy. In-substance foreclosures and any troubled debt restructurings should be properly identified and accounted for.

- *Payoffs.* Loans are considered "paid off" when the loan matures, the loan is refinanced, or the property is sold. Prior to payoff, the servicer is responsible for sending payoff instructions to the mortgagor. After a loan has been paid off, the servicer makes a satisfaction remittance to the investor or the pool; obtains documentation; cancels the note; and forwards the satisfied mortgage documentation plus an escrow refund check, if applicable, to the mortgagor. A high level of refinance activity may strain payoff personnel's ability to perform this obligation accurately and promptly. Management reports should monitor the level of payoff activity and alert supervisors to operational backlogs, the need to hire temporary personnel, or the need to outsource work to third parties.

- *Customer service.* Poor service may damage the mortgage banking company's business reputation (reputation risk) and ability to originate, sell, and service loans within the community. Because of name recognition, problems in this area may also adversely affect affiliate banks or the bank holding company and its nonbank companies.

  For this reason, servicers should maintain an adequate system for logging, tracking, and responding to customer inquiries and complaints. Management reports should track the volume and disposition of such inquiries and complaints. Inordinate volumes of complaints may be an indication of operational backlogs, inefficiencies, or mishandling of accounts. If this occurs, corrective measures should be

4. For a detailed list of both reimbursable and nonreimbursable expenses, see the agency seller/servicer guides.

initiated immediately.

3070.0.4.8 Data Security/Contingency Planning

The servicing system should be of a complexity and size necessary to accommodate both the current and the projected volume of transactions. Examiners should obtain information on the servicing system in use and any limitations it might pose in terms of future growth plans.

Procedures for maintaining physical security in the workplace, data security, and file backup also should be discussed with management. A contingency plan should describe the use of alternative backup sites, as well as procedures that would be followed to reconstruct altered or destroyed files. Contingency plans should be reviewed and approved at least annually and tested regularly.

3070.0.4.9 Inspection Objectives—Servicing/Loan Administration

1. To assess the adequacy of management oversight of risk through policies and procedures, management information systems and reports, and other internal and external audits, with respect to the following:

- collecting monthly payments from mortgagors
- reporting loan activity and remitting funds to investors
- monitoring escrow account balances
- disbursing property insurance and real estate tax payments
- monitoring delinquencies, initiating collection activities, and initiating foreclosure proceedings in a timely manner

2. To evaluate the level of risk assumed by the mortgage banking company through servicing recourse arrangements.

3070.0.4.10 Inspection Procedures—Servicing/Loan Administration

Management Assessment

1. Obtain an organization chart for the servicing department and resumes for senior management and key staff members. Evaluate management's qualifications and expertise.

2. Review servicing policies and procedures manuals to determine whether reasonable operating standards have been established for each functional area. Also assess whether management reports adequately monitor compliance with established policies and procedures. Determine how exceptions are identified and addressed.

3. Review internal and external audits, quality control reports, and investor audits to determine whether internal controls are functioning effectively.

4. Evaluate safeguards in place for loan documents and determine if an adequate document tracking system exists.

5. Verify that a disaster recovery plan is in place that covers all in-house servicing functions. Verify that backup systems exist should primary systems fail. Determine if backup systems would provide information to substantiate servicing portfolio asset values.

6. Obtain a list of subservicers and vendors, if any, employed to perform servicing functions.

- Determine if a periodic review of services provided by each subservicer is conducted. In addition, the financial condition of each subservicer should be evaluated at least annually.
- Determine whether a contingent operating plan has been established should subservicers and vendors be unable to perform their contractual obligations.

Profitability Analysis

1. Review business line profitability for the servicing department to identify significant trends and/or areas of potential weakness. Discuss and review key efficiency measures such as unit cost and cost per employee.

2. Analyze servicing income and expenses to determine whether operations are profitable and economies of scale are being achieved in line with industry norms:

- Determine whether all direct and indirect costs are included.
- Compare servicing revenues with costs.
- Assess the impact of any bulk servicing purchases or sales on departmental profitability.
- Analyze efficiency in light of management's growth projections.

3. Review servicing portfolio trends and characteristics, including the following:

- investors (GNMA, FannieMae, FHLMC, private)
- recourse provisions
- loan types (30-year fixed, 15-year fixed, ARM, balloon)
- average loan size
- interest rates (particularly those above market)
- remaining contractual life
- projected life
- geographic distribution of mortgagors
- delinquency statistics
- foreclosure statistics
- number of subserviced loans and servicers

Loan Accounting

1. Review with management the procedures for receiving payments from mortgagors and depositing funds into segregated accounts. Determine that the segregation of duties and other controls over custodian accounts are adequate.

2. Review any outstanding advances to investors. Evaluate the collectibility of advances, the timeliness of charge-offs, and the adequacy of reserves.

3. Determine whether outstanding items related to investor account reconciliations are being resolved in a timely manner. Are reconciliations routinely reviewed and approved by a supervisor?

Escrow Administration

1. Review with management the system in place for ensuring the timely payment of taxes, insurance, and other obligations.

2. Review the servicer's method for analyzing the amount and adequacy of escrow account balances, and evaluate its effectiveness. Assess procedures relating to shortages and overages in escrow accounts:

- Determine whether procedures comply with 12 U.S.C. 2609 (RESPA) and to the extent possible with state laws.
- Determine whether the borrower is sent an analysis statement showing the amount of discrepancy, how it occurred, and an explanation of how it is to be corrected.

3. Determine the volume of loans with no escrow requirement and procedures for ensuring that insurance payments and taxes are current.

4. Determine how escrow funds are invested, assess the appropriateness of the investment vehicles, and review management's analysis of yield on escrow funds.

5. Evaluate whether controls are in place to prevent the use of escrow custodial accounts to meet other obligations.

6. Review outstanding escrow advances, and determine if claims for reimbursement are processed in a timely manner. Evaluate the collectibility of outstanding advances and verify that uncollectible advances are charged off in a timely manner.

Investor Reporting

1. Review the list of investors for which servicing is performed.

2. Review servicing contracts to verify that signed, current contracts exist. Discuss with management the nature of any recourse provisions, forbearance requirements, and nonreimbursable collection and/or foreclosure expenses.

3. Review the most recent investor audit reports on the servicing function. Discuss findings with management and evaluate the adequacy of any actions taken to correct deficiencies.

4. Determine whether any servicing contracts have been terminated for cause or are likely to be lost in the near future. Determine the reason for any termination and the extent of any corrective actions taken.

Collections and Foreclosures

1. Review and assess, on a statistical-sample basis, the accuracy and adequacy of loan delinquency reports by product type and originator. Ascertain the reasons for poor or declining asset quality within the servicing portfolio.

2. Review policies and procedures for collecting late payments.

- Determine when collection efforts start once an account becomes delinquent.
- Verify that all attempts at collecting past-due payments are documented, including each date of communication with borrowers, the nature of the communications, and the customers' replies.

3. Select a sample of files for borrowers who are 120 days or more delinquent and determine whether foreclosure proceedings are instituted in a timely manner.

- Determine if borrowers and investors are appropriately notified of the initiation of foreclosure action.
- Verify that contacts with borrowers are documented.
- Determine whether property inspections are conducted in accordance with policy.
- Verify that foreclosure practices comply with FHA/VA/PMI requirements and guidelines.

4. Determine the average foreclosure costs for each product type. Foreclosure costs include inspections, legal and administrative costs in excess of those defined as normal and customary, VA no-bid, and VA write-downs.

5. Obtain a list of loans in foreclosure in which action has been delayed, and determine if the justifications for delay are reasonable.

6. Determine the number and dollar volume of delinquent loans that were purchased from the servicing portfolio (buyouts or buybacks).

- Assess the impact of repurchases on profitability, the appropriateness of this practice, and the accounting procedures for these loans.

7. Discuss with management the effect that negotiated guaranty fees may have on the level of losses associated with foreclosures.

Payoffs

1. Review procedures for payoffs to determine whether—

- payoff instructions are sent to the mortgagor before payoff;
- satisfaction remittances are made to the investor or to the pool, necessary documentation is obtained, notes are canceled properly, and documentation plus any escrow refund checks are sent to the mortgagor in a timely manner; and
- internal controls are in place to ensure that funds are not misappropriated and employee fraud is detected and reported according to policy.

Other Real Estate

1. Determine the number and dollar volume of ORE by geographic location.

- Compare the volume of ORE with historical levels and the industry average for similar-sized servicers.
- Evaluate the impact of ORE on profitability.
- Review the policies and practices for ORE accounting, property supervision, and marketing. Verify that policies are consistent with investor guidelines and regulatory policies.

2. Determine whether ORE parcels are purchased from the servicing unit by the bank holding company or its affiliates.

- Evaluate the controls in place to limit or prevent this practice and the accounting treatment for such loans.
- Verify that information regarding ORE is properly reported to the parent bank or holding company for consolidation into regulatory reports.

Customer Service

1. Review the system for logging, tracking, and responding to customer complaints. Has the volume of complaints grown? Are complaints addressed promptly with any problems resolved in a timely manner?

2. Review the servicer's customer-complaint file to gain more insight into the nature of the complaints. Do complaints suggest that internal policies and procedures are not being followed or that staffing levels are inadequate?

3070.0.5 FINANCIAL ANALYSIS

This section provides the examiner a framework with which to analyze the financial condition of a mortgage banking company. The analysis begins with a review of the mortgage company's balance sheet and income statement. The financial analysis should incorporate a review of primary balance-sheet and income-statement levels and trends, off-balance-sheet assets and liabilities, asset quality, market share and earnings performance, funding sources, liquidity needs, and capital adequacy. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or its parent bank holding company to undue financial risk should be brought to management's attention and documented in page one, Examiner's Comments and Matters Requiring Special

Board Attention. The examiner should focus on items that are either large relative to the company's operations or that may pose undue financial risk. The examiner should also investigate any trends that appear inconsistent with the mortgage banking company's industry peer group, business orientation (such as wholesale versus retail, originations versus servicing, etc.), and future growth plans or with the current economic and interest-rate environment.

Financial-statement presentation may vary across mortgage banking companies. If questions arise, financial-statement presentation and accounting should be reviewed with the company's internal and/or external accountants for propriety. During the review of the financial statements, the examiner should establish whether regulatory reports are prepared accurately. Banks must conform to the reporting requirements of the Commercial Bank Reports of Condition and Income (call report). Bank holding companies and their direct subsidiaries must conform to generally accepted accounting principles (GAAP). Relevant GAAP statements of the Financial Accounting Standards Board include SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," as amended; SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases"; SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities"; SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities;" and SFAS No. 80, "Accounting for Futures Contracts." Other relevant accounting pronouncements are identified in appendix B, Accounting Literature.

The financial analysis should also include an assessment of asset quality, earnings, liquidity and funding, and capital. Any problems or conditions that expose the mortgage banking company, affiliate banks and nonbanks, and/or the parent bank holding company to undue financial risk should be brought to management's attention and discussed in the Examiner's Comments and Matters Requiring Special Board Attention.

3070.0.5.1 Balance Sheet

3070.0.5.1.1 Assets

The asset side of the balance sheet may consist of cash, reverse repurchase agreements, marketable securities, receivables and advances, mortgage loans held for sale, mortgage loans held for investment, mortgage-servicing assets (MSAs) (including mortgage-servicing rights), reserves for loan and other credit-related losses (contra accounts), other real estate owned (OREO), and other assets.

3070.0.5.1.1.1 Mortgage-Related Securities

The examiner should determine whether the accounting treatment for mortgage-related securities reported on the balance sheet is consistent with SFAS 115. SFAS 115 applies to equity securities having readily determinable fair values and to all debt securities. It does not apply to loans purchased.

Under SFAS 115, at acquisition and at each subsequent reporting date, all debt and equity securities that fall under the scope of the statement should be classified into one of the following categories:

- trading securities
- available-for-sale securities
- held-to-maturity securities

Both debt and equity securities can be assigned to the above first two categories. The third classification can only consist of debt securities.

Trading. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value. Debt securities not held to maturity and equity securities that have readily determinable fair values should be classified as trading securities when (1) they are held for short periods of time and (2) they have been acquired with the expectation of a profit from short-term price differences. Securities that are actively traded should be carried at fair value on the balance sheet, with net unrealized gains or losses included in income.

Available-for-sale. Debt and equity securities having readily determinable fair values that are not otherwise classified, as above, should be categorized as available-for-sale and carried at fair value on the balance sheet. Unrealized holding gains and losses should be reported in a separate component of shareholders' equity and should not be included in income.

Held-to-maturity. For a security to qualify as held-to-maturity under SFAS 115, the mortgage banking company must demonstrate the positive intent and ability to hold it until maturity.

3070.0.5.1.1.2 High-Risk Securities

The examiner should also review any high-risk mortgage securities that are on the balance sheet, such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), CMO and REMIC residuals, and stripped mortgage-backed securities (stripped MBSs). See sections 2126.1 and 2190.0.5.

3070.0.5.1.1.3 Mortgage Loans Held for Sale

The examiner should determine whether the accounting treatment for mortgage loans held for sale is consistent with SFAS 65, as amended. Mortgage loans held for sale shall be reported at the lower of cost or market value, determined as of the balance-sheet date.[5] The amount by which the cost exceeds market value shall be accounted for as a valuation allowance. Changes in the valuation allowance shall be included in net income of the period in which the change occurs.

3070.0.5.1.1.4 Mortgage Loans Held for Investment

Mortgage loans held for investment may include loans that (1) do not meet secondary-market guidelines and are therefore unsalable, (2) loans that were repurchased from an investor due to poor documentation and/or improper servicing, (3) loans put back to the mortgage banking company under recourse agreements, and (4) loans intentionally originated for portfolio.

SFAS 65 states that a mortgage loan transferred to a long-term investment classification shall be transferred at the lower of cost or market value as of the transfer date. The securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan and the purchase of an MBS classified as a trading security at fair value. Any difference between the carrying amount of the loan and its principal balance shall be recognized as an adjustment to yield by the interest method.

A mortgage loan shall not be classified as a long-term investment unless the mortgage banking company has both the intent and the ability to hold the loan for the foreseeable future or until maturity. If the ultimate recovery of the carrying amount of the loan is doubtful and the impairment is considered to be other than temporary, the carrying amount of the loan shall be reduced to its expected collectible amount, which becomes the new cost basis. The difference is recognized as a loss. A recovery of the new cost basis shall only be reported as a gain upon sale, maturity, or disposition of the loan.

5. According to SFAS 65, as amended, the capitalized costs of acquiring rights to service mortgage loans, associated with the purchase or origination of mortgage loans, shall be excluded from the cost of mortgage loans for the purpose of determining the lower of cost or market value.

3070.0.5.1.2 Liabilities

The liability side of the balance sheet may include repurchase agreements, commercial paper, revolving warehouse lines of credit, long-term debt instruments, intercompany payables, and equity capital.

3070.0.5.1.2.1 Repurchase Agreements

A mortgage banking company may finance its mortgage loans or MBSs held for sale by transferring mortgage loans or MBSs temporarily to banks, nonbanks, or other financial institutions under formal repurchase agreements that indicate that control over the future economic benefits relating to those assets and the risk of market loss are retained by the mortgage banking company.

Repurchase agreements can provide a cost-effective method of holding mortgage-backed securities before their sale to investors. Securities dealers repo the securities for a period of 30 to 180 days at a substantial cost advantage to warehouse facilities. Repurchase agreements involve delivery of the security to the dealer with an agreement to repurchase it on a specified date. Upon receipt, the dealer wires the haircut proceeds to the mortgage company. The mortgage company then reduces the amount of its outstanding warehoused loans. If the repo is being handled by the dealer that is arranging the ultimate sale of the security, the amount of that discount should approximate the discount on the sale. If another dealer is involved in the ultimate sale, the haircut may be greater because the security must be repurchased and redelivered to the second dealer. This may also require a rehousing to provide funds to honor the repurchase commitment. Most warehouse lenders allow traditional warehouse lines to be collateralized by individual mortgages and mortgage-backed securities.

A mortgage banking company may use repurchase agreements in conjunction with sales of loan pools. The company may use repurchase agreements to pledge mortgage loans and/or MBSs as collateral for borrowings. In return, it receives advanced funds against future deliveries. The lenders are repaid through the sales of MBSs. The amount outstandings bear interest for the number of days the funds are outstanding.

Under repurchase agreements, the same loans or MBSs are generally reacquired when they are sold to permanent investors. Mortgages or MBSs may also be transferred temporarily without a repurchase agreement. However, some type of informal agreement generally exists. Mortgage loans and MBSs held for sale that are transferred under either formal or informal repurchase agreements shall be accounted for as collateralized financing arrangements and reported as either mortgage loans held for sale or MBSs classified as trading securities on the mortgage banking company's balance sheet.

3070.0.5.1.2.2 Commercial Paper

Another source of short-term funding is the issuance of commercial paper. In general, commercial paper represents unsecured notes with maturities up to 270 days from the date of sale. Because of its short maturity, proceeds should be limited to current transactions with short-term maturities. Commercial paper proceeds should not be used to fund loans held for sale for a period greater than one year.

Commercial paper can be less reliable than warehouse lines of credit. If commercial paper funding is used, examiners should review related commercial paper backup lines of credit and ratings issued by credit rating agencies. The reason for any rating changes during the prior year should be investigated. Additional guidance on this topic is set forth in sections 2080.05, 2080.1, and 5010.23.

3070.0.5.1.2.3 Revolving Warehouse Lines of Credit

Short-term revolving warehouse credit lines are often used to fund loans held for sale, which is generally the largest asset on the company's balance sheet. Revolving credit lines may be obtained from an affiliate bank, the parent bank holding company, or an unrelated third party.

The extension of credit for a particular loan is paid off when the mortgage lender sells the mortgage loan to a government-sponsored agency such as GNMA, FannieMae, or FHLMC or to a private investor. Lenders who provide warehouse lines of credit typically enter into a warehouse credit agreement with the borrower. Under the agreement, the warehouse lender agrees to extend credit to the mortgage banking company for the purpose of originating loans. The mortgage banking company agrees to repay each extension of credit within the terms of the agreement. Each extension of credit is secured by placing a lien on the originated mortgage loan. The warehouse lender perfects its security interest by taking possession of the original promissory note executed by the borrower, endorsed "in blank," together with an assignment of the mortgage securing the loan. To further protect its security interest, the warehouse lender usually takes the responsibility of delivering the loan package to the secondary market investor for purchase. The investor, in turn, delivers the purchase price of the mortgage directly to the warehouse borrower (mortgage banking company). Each portion of the warehouse line may be priced separately to reflect various levels of risk and the documentation requirements of each.

The details of all credit lines should be specified in formal, written credit agreements. Revolving credit lines may be either unsecured or secured by a lien on the underlying mortgages. Under most secured lines, a formula is used to calculate the borrowing base, which generally consists of cash, cash equivalents, loans held for sale, securities, and a percentage of the mortgage-servicing portfolio less certain short-term indebtedness. Some credit lines require the maintenance of compensating balances.

Internal credit arrangements (conducted either by a mortgage banking subsidiary of a bank or bank holding company) must comply with sections 23A and 23B of the Federal Reserve Act. See sections 2020.1 and 3070.0.7 of this manual.

Examiners should evaluate the adequacy and efficiency of warehouse funding operations. The examiner should determine whether the warehouse lender is of a sufficient size and whether it is well positioned financially to provide adequate lines of credit, as needed. Examiners should ascertain whether funding must be regularly derived from more than one warehouse lender (including whether the warehouse line has to be participated out to other lenders) and whether the lender has proper internal controls to safeguard collateral documents for pool certification. The examiner should also determine what management's contingency plans are for the use of alternative financing sources beyond standard warehouse lines of credit for backup financing and lower-cost efficiency purposes. Has management (1) explored variations in existing lines of credit to reduce overall borrowing costs and (2) determined what competitor lenders are paying for similar financing facilities?

Procedures should be in place to monitor compliance with all short-term debt covenants. Covenants may limit servicing of loans with recourse, limit total debt to specified levels, and/or require minimum tangible net worth, leverage, and current ratios. Most credit agreements also limit the borrower's financial flexibility if the company's long-term debt ratings decline or the company becomes unrated or if certain events occur related to securities.

3070.0.5.1.2.4 Long-Term Debt

Longer-term assets are more appropriately funded through the issuance of longer-term liabilities or capital. Toward this end, mortgage banking companies may issue medium- or long-term public debt securities (including warrants to purchase debt securities). Debt may be issued in the form of fixed-rate or floating-rate notes with various repayment or redemption terms. Loan agreements should specify all relevant terms and conditions and may contain debt covenants similar to those found in the warehouse funding arrangements.

Long-term debt may incorporate restrictive covenants which limit the company's activities in certain respects. These covenants may set limits on the amount of senior debt outstanding and the minimum amount of liquid net worth (as defined by the documents), and may limit the proportions of specific categories of assets. Such covenants should be reviewed to make certain that they are not too restrictive and that they permit financial flexibility.

3070.0.5.1.3 Equity Capital

Funding is also provided through equity capital, which may be supplemented by capital contributions from the parent company or the direct issuance of equity securities.

3070.0.5.2 Income Statement

Mortgage banking revenues generally consist of the following: loan servicing/administration revenue; loan-origination-fee revenue; interest income; gains (losses) on the sale of mortgage loans, mortgage securities, or mortgage-servicing rights; and management and other fee income. The examiner may find that gross gain (loss) on the sale of mortgage loans or securities is reported on the income statement net of loan-origination fees and direct loan-origination costs such as personnel and office expenses.

Expenses may include interest expense; salaries, commissions, and other personnel costs; interest losses on MBS pools; amortization of mortgage-servicing assets and any other purchased intangible assets; electronic data processing and other selling, general, and administrative costs; occupancy and equipment; depreciation; provision for foreclosure and other loan losses; and a provision for income taxes. Some companies net amortization of MSAs directly against loan-servicing revenues.

3070.0.5.3 Unique Characteristics

The financial analysis should reflect certain operational characteristics that are unique to the mortgage banking industry. Many of these characteristics are cyclical based on interest rates and economic conditions.

For example, the cost of funding loans in the warehouse is relatively inexpensive during periods of low interest rates, but may increase significantly as interest rates rise. Marketing operations are also highly dependent on the interest-rate cycle. During periods of falling interest rates, the company may experience substantial gains on the sale of mortgage loans and securities to permanent investors. Alternatively, during periods of rising interest rates, the company will usually experience losses on the sale of mortgages and securities. Interest-rate volatility can cause large fluctuations in warehouse funding costs and marketing gains and losses.

The examiner should also consider the impact of current economic conditions on the size and composition of the mortgage banking company's balance sheet. When the economy expands, loan volume increases and the overall size of the balance sheet tends to grow. During recessions, the balance sheet should contract, reflecting the lower demand for new loans. Management's planning efforts should incorporate this type of economic trend analysis in their growth targets. Steady annual growth may or may not be anticipated.

Efficiency measures, such as activity ratios (inventory turnover and efficiency ratios), should be used to determine management's ability to originate and sell loans efficiently. The inventory of loans held for sale is transitory, lasting between 45 to 60 days. A buildup of loans on the balance sheet may indicate processing delays and/or asset-quality problems that may prevent their ultimate sale to permanent investors. Because of the transitory nature of the balance sheet, traditional leverage ratios (asset-to-equity capital) may not be meaningful and should be used sparingly.

Another unique characteristic of a mortgage banking company is the economic value of its mortgage-servicing operations, which constitutes an off-balance-sheet item. Failure to incorporate this economic value into the financial analysis may overstate the degree of financial leverage that is employed within the company.

3070.0.5.4 Asset Quality

The quality of assets that are on the balance sheet is evidenced by the following: compliance with original underwriting standards; the existence of effective loan review and quality control programs; borrower payment and agreement performance; the fair value of MBSs held for sale or investment; the collectibility, independent valuation, nature, volume, and existence of recorded assets; the application of GAAP in accounting for the assets; and the degree of protection afforded by real estate mortgage collateral, including any private mortgage insurance. The value afforded by real estate mortgage collateral includes the extent of compliance with the Federal Reserve Board's real estate appraisal regulations and guidelines. (See section 2231.0.) Asset quality should be analyzed in terms of regional and national economic factors as well as portfolio and managerial factors.

For any review of any loan portfolio, a sampling of real estate appraisals should be included to determine whether the appraisal results reasonably support the amount loaned. If the property appears to be overappraised or if there is a problem with the appraisal (for example, the appraisal is obsolete or the validity of the appraisal is in question), the examiner should consider recommending that a new appraisal be performed.[6] It may be necessary for the examiner to classify the loan (i.e., as a loss) and for the parent holding company to increase its allowance for loan and lease losses.

Bank holding companies and/or their nonbank subsidiaries should be criticized if initial appraised values appear to be inadequate and/or not properly supported by proper documentation. If corrective action is not taken by management, formal enforcement action should be considered. Such actions may require the bank holding company to revamp its appraisal activities and/or collection procedures and, if warranted, to retain the services of an independent appraiser to conduct an evaluation of loan collateral.

With respect to MBSs, the quality characteristics of the underlying mortgage collateral should be considered. If the securities are backed by GNMA, FannieMae, or FHLMC, the rating agencies consider such securities to be the highest quality asset because of their linkage to the federal government. If the collateral consists of unsecuritized mortgages, the examiner should consider the geographic dispersion, type of mortgage and property, underwriting standards, and term to maturity of the underlying pool of mortgage loans. External factors can affect the value of mortgage securities directly, such as the default or downgrading (by a credit rating agency) of a private mortgage insurer.

To a large extent, insurance and guaranties provided by government-sponsored agencies and other third parties (for example, private mortgage, bankruptcy protection, fraud, and mortgage pool insurers, as well as performance bond insurers and other guarantors) mitigate credit risk for an originator; however, the originator still remains responsible for the quality of loans sold to investors for at least the first 90 days, as well as for any loans sold under recourse arrangements. As a servicer, the company also can be held liable if it does not initiate collection and foreclosure actions in strict accordance with investor-servicing agreements. In addition, certain interest losses and expenses relating to collections, foreclosure, and ORE are not fully reimbursable and should be anticipated.

The mortgage banking company must maintain adequate management reports to measure and track the quality of originated, purchased, and serviced assets. Proper administration over loans and other assets held for sale or investment requires the use of aging and other tracking reports. For assets held for sale, the reports should identify loans and other marketable assets,

6. For certain credits, the bank holding company should develop criteria for obtaining reappraisals or revaluations as part of a prudent portfolio review and monitoring program.

other than marketable securities,[7] that have been in this category longer than 60 days. In such instances, a determination should be made as to whether credit quality problems and/or documentation deficiencies exist that will prevent the timely sale of the loan in the secondary market. If problems are not correctable within a reasonable timeframe, the loans and other related assets should be revalued and transferred to the held-for-investment category. Procedures governing the valuation and transfer of poor-quality assets should be in writing and should be followed.

The MIS should also generate for management's review reports on the delinquency status of loans held for investment and loans serviced for investors. Such reports provide an early warning system and an analysis tool to evaluate internal collection activities. If a loan becomes delinquent (30 days or two payments past due), the borrower should be contacted. Collection efforts should be strengthened if the delinquency continues. If the loan becomes severely delinquent, foreclosure proceedings should be initiated consistent with the investor-servicing agreement, and the value of the collateral supporting the loans should be assessed. Anticipated shortfalls should be recognized as losses in a timely manner.

MIS should also include an internal loan-grading system, which tracks the borrower's ability to meet its monthly payment obligations. Although MIS should be tailored to meet management's needs, information should be consistent with loan-grading systems that are used by the controlling bank holding company and federal bank regulatory agencies. Reports should also track collection and foreclosure actions initiated by the servicer and repurchase requests initiated by a permanent investor or other third party.

Examiners should also verify that appraisal practices are consistent with the Board's appraisal regulations,[8] the interagency appraisal and evaluation guidelines (see SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-99-26), and any other state and federal laws and regulations. Mortgage banking companies that are subsidiaries of either state member banks or bank holding companies are subject to the same appraisal standards and requirements as their parent companies.

7. For mortgage-backed securities available-for-sale, similar account classification procedures apply, but those are accounted for in accordance with SFAS 115.

8. See Regulation Y, subpart G (12 C.F.R. 225.61–67), and its incorporation by reference into Regulation H (12 C.F.R. 208.18).

3070.0.5.4.1 Classification Procedures

The classification process begins with an analysis of delinquent loans. The examiner should begin by obtaining an aged listing of all delinquent loans in the held-for-sale and the held-to-maturity portfolios. Clear-cut shortfalls in property values compared with loan or investment values should usually be classified unless there are mitigating circumstances. Usually loans or investments with doubtful or loss elements have other significant weaknesses that will ordinarily justify a classification of substandard for the remaining balance. Loans secured by collateral such as real estate should be classified in accordance with these guidelines and the applicable classification guidance found in sections 2060.1 and 2090.1 of the *Commercial Bank Examination Manual* and sections 2010.2, 2065.1, 2240.0, and 5010.10 of this manual.

Portions of these loans may warrant a more severe classification if the value of the underlying collateral is insufficient to fully repay the loan. The identification of potential or actual loss exposure may warrant the use of either a split (substandard and loss) or a doubtful rating.

The examiner should also review the ORE portfolio, notes and accounts receivable, and other investments on the company's balance sheet for potential classifications. ORE may usually warrant a substandard classification due to an investment's nonearning status and an increased probability of loss on disposal of the underlying assets.

Assets that represent illegal or impermissible holdings or those that are subject to some regulatory concern should not be classified, per se, for these factors. Such holdings should be treated separately within the report. In those instances where a credit-quality issue is also present, the classification and the separate treatment should be cross-referenced.

The examiner should also review any off-balance-sheet exposure for which credit risk is retained. Loans sold to investors on a recourse basis have the potential of being put back to the servicer. The portion of the recourse portfolio that is severely delinquent should be classified according to the guidelines provided previously, since the exercise of this "put option" is highly likely.

At the end of the classification process, the examiner should evaluate the level and trend of classified assets to determine whether asset quality poses undue financial risk to the mortgage banking company or its parent bank holding company. A list of total classifications should be compiled and left with management.

As part of the analysis of asset quality, the aggregate of loss classifications plus an amount expected to ultimately be loss should be compared with the existing allowance for loan and lease losses. If the aggregate exceeds the existing contra asset balance(s) then additional loan-loss provisions are needed. In such situations, the parent company should be advised of the deficiency and reminded of its responsibility to ensure that an adequate allowance for loan and lease losses, as well as other contra asset valuation balances, is maintained by the subsidiary for its asset portfolio.

Any discrepancies between the classifications list and information contained on the company's MIS should also be discussed with management. If asset quality presents undue or excessive risk, appropriate comments should be documented and brought forward on Examiner's Comments and Matters Requiring Special Board Attention, page one of the report.

3070.0.5.4.2 Presentation of Classifications

As a minimum standard, brief write-ups stating the reason for classifications should be provided for any nonbank subsidiary's asset whose doubtful and/or loss classification exceeds the lesser of $100,000 or 5 percent of the subsidiary's total assets. In general, substandard assets should be listed without a write-up, regardless of size. However, a brief write-up is required for any asset whose classification is challenged by management. The examiner has the option to provide a write-up for any classified assets, regardless of size.

While the following presentation guidelines may be useful in structuring the write-ups, the examiner may include any other format appropriate to the situation:

- recapitulation of the status and purpose of the loan, the lien position, type and appraised value of the collateral, its delinquency and accrual status, guarantors and other debit or credit balances related to the loan
- the problems with the loan, borrower, or collateral, presented in a concise, descriptive narrative
- the examiner's evaluation of the situation, indicating estimated values, major assumptions, and mitigating or negative factors
- the classification, which should represent a logical combination of the relevant factors presented in the first three elements

Within the elements presented, the examiner should stress accuracy, brevity, and clarity in the presentation, as well as a logical pattern leading to the classification. Historical information and financial data that are not pertinent or that are too stale to have a direct bearing on the present situation should not be included.

Presentations for OREO properties need not include the original loan date, history, and financial information, unless there is some relevance to the current condition (for example, the property has been foreclosed on for the second time or some circumstance before foreclosure continues to have an impact). For those companies in which numerous loans and OREO properties are classified, a summary of classifications, segmented by loans and real estate owned and indexed to the pages containing the classifications, presents clear benefits to the users of the report. This becomes more pertinent when numerous assets below the write-up line are included in total classifications. In addition, both management and the subsequent examiners will have an official listing of the classifications.

3070.0.5.4.3 Reserves

Management should establish and maintain adequate contra asset allowances and other contingency reserves to cover identified loss exposure. Policies and procedures, and financial statement disclosures, should clearly state the purpose of and intended accounting treatment for each reserve. Management should evaluate the level of each reserve account at least quarterly, document this analysis, and replenish each reserve as necessary.

The financial presentation for reserves varies. Reserves maintained for on-balance-sheet exposure are generally reported as a contra asset. Reserves maintained for contingent liabilities relating to the sale of loans and servicing of loans for investors may be shown as a liability in practice.

Disclosures relating to valuation reserves should be consistent with GAAP. Examiners may wish to confer with the mortgage banking company's external auditors regarding the nature or appropriateness of any reserve accounts that are unusual.

3070.0.5.5 Earnings Performance

Earnings performance should be assessed in terms of the level, composition, quality, and trend of net income. The earnings analysis should consider internal factors such as the company's business orientation and management's growth plans, as well as relevant external factors such as interest rates and economic trends.

Unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, provisions for losses, salaries and overhead items, or income taxes should be discussed with management, as well as with internal or external auditors. Large write-downs or amortization adjustments relating to mortgage-servicing rights should also be investigated. (See section 3070.0.6.)

Current and historical ratio trend analysis, compared with published industry results (for example, see the Mortgage Bankers Association's annual statistics in the "Mortgage Banking Performance Report"), should also be incorporated into the profitability analysis, where appropriate. This includes income structure, expense structure, and operating performance ratios. However, ratios that compare earnings to average assets or equity may be of limited use unless the examiner also considers the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage. Finally, the examiner should consider the company's ability to generate sustainable positive earnings consistently over time, as well as the proportionate share of consolidated earnings (or losses).

3070.0.5.6 Liquidity and Funding

Management's ability to satisfy the company's liquidity needs and plan for contingencies without placing undue strain on affiliate bank or nonbank resources or reliance on the parent bank holding company is crucial. Liquidity needs depend on the size of the warehouse, the nature and extent of longer-term assets, opportunities to issue debt at a reasonable price, and management's ability to forecast and plan for contingencies. Liquidity is often dependent on cash generated through short-term liquid assets and on short-term borrowings to fund operations. Earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity plans are all significant factors in the evaluation of liquidity. Liquidity can quickly erode if investor perceptions of a company's credit standing change. Consequently, the ability to fund mortgage operations under economic duress and access to alternate liquidity sources become key considerations.

Funding needs are driven by the need to temporarily finance mortgage loans and MBSs before their sale to a permanent investor. The examiners should do a trend review of external liquidity to assess how easy it is to sell mortgage-backed securities by the firm in the secondary market. The analysis should include the normal trading volume in MBS securities, the volume of loans held for sale and their market value, and the size of the "floating" supply of mortgage securities or loans that are not closely held. Liquidity needs must also take into consideration longer-term assets such as fixed assets, mortgage-servicing rights, and permanent loan and MBS portfolios. (See section 2080.05.)

3070.0.5.6.1 Financial Flexibility

The liquidity analysis should include a determination as to the company's financial flexibility. Financial flexibility is the ability to obtain the cash required to make payments as needed. Cash can be obtained from (1) business operations; (2) liquid assets already held by the company either in the form of cash or marketable securities or by selling liquid assets such as receivables or inventories for cash; and (3) external lines of credit, bank borrowings, or the issuance of debt or equity securities in the capital markets.

3070.0.5.6.2 Cash-Flow Analysis

The liquidity analysis should also include a review of the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. The examiner's analysis of cash flows may reveal transactional trends between cash inflows and outflows. For example, within the Cash Flows from Operating Activities, cash flow from the sale and principal repayments on mortgage loans held for sale may correlate with originations and purchases of mortgage loans available for sale. With regard to investing activities, attention should be given to the differences between short-term purchases of mortgage loans held for investment versus principal repayments on mortgage loans held for short-term investment. In addition, purchases of real estate owned from the loan-servicing portfolio may correlate with net sales of real estate owned. A review of the financing activities should indicate if there is sufficient cash flow provided from revolving warehouse lines of credit, commercial paper, proceeds from the issuance of any other short-term debt, and net changes in advances payable to affiliates.

The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity. When analyzing liquidity, the examiner needs to consider the principles and guidelines set forth in section 2080.05, "Funding (Bank Holding Company Funding and Liquidity)" of this manual.

3070.0.5.6.3 Asset/Liability Management

In general, funding liability maturities should closely approximate the maturities of underlying assets to mitigate the risk of a funding mismatch. Otherwise, the company is exposed to short-term interest-rate fluctuations unless appropriately hedged. Funding mismatches can lead to significant earnings volatility in the event that interest rates change rapidly. Management's asset/liability management program should be evaluated in terms of the degree of matching, risk aversion, and the accuracy of information that is provided to the holding company through daily, weekly, or monthly management reports.

3070.0.5.7 Capital Adequacy

Capital must be adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by third-party creditors and investors. At a minimum, a mortgage banking company must meet the nominal capital levels required by investors such as FannieMae ($250,000) or FHLMC ($1 million, based on financial reporting under GAAP, or $500,000, adjusted for certain assets and any deferred-tax liability). Additional capital is required based on the outstanding principal balance of loans serviced for investors. If these requirements are not met, the company may not be able to sell mortgages to and/or service mortgages for these investors.

As noted above, these are minimum capital requirements. Management should identify the level of capital that is required to support current operations and projected future growth, given the risk tolerance preferences of management and the board. Capital levels, dividend payments, and capital planning should be addressed in a written capital plan that is reviewed and approved by the board at least annually in conjunction with the budgeting and strategic planning activities.

There also may be a need to meet minimum leverage ratios established by the parent bank holding company or to meet debt covenants set forth in either warehouse credit facilities or long-term debt instruments. Companies that have excessive off-balance-sheet risk or high growth expectations may require additional capital. In addition, risk-based capital guidelines impose certain reporting requirements and limitations regarding the amount of MSA mortgage banking companies may include in their regulatory capital.

Capital levels should be monitored and reported to the company's board of directors regularly to mitigate the risk of inadequate or eroding capital. Management and the board are further encouraged to adopt a capital policy that specifically addresses the particular needs of the company.

The examiner should evaluate capital adequacy, the amount of dividends that are upstreamed to the parent bank holding company, and the extent to which the parent company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. In some instances, the parent company may operate on the premise that the mortgage banking company requires little capital of its own as long as the parent company remains adequately capitalized.[9] Under the Federal Reserve's source-of-strength doctrine, the parent company must be prepared to support its subsidiaries should the financial need arise. If the parent is not prepared to inject capital and capital levels have declined, the examiner should comment on the mortgage banking company's extended leveraged position on page one of the inspection report. Under extreme circumstances, the examiner should also recommend that its leverage be reduced and its capital structure augmented to ensure that mortgage operations are conducted in a safe, sound, and prudent manner.

9. When MSAs are valued for inclusion in capital, the risk-based capital guidelines for banks and BHCs require the discount rate to be not less than the original discount rate inherent in the intangible asset at the time of its acquisition, based on the estimated future net cash flows and price paid at the time of purchase.

3070.0.5.8 Overall Assessment

The overall financial condition of the mortgage banking company should reflect its financial statement presentation, asset quality, earnings, liquidity and funding practices, and capital adequacy. Report comments should be prepared to the extent necessary.

3070.0.5.9 Inspection Objectives

1. To evaluate the financial condition of the mortgage banking company based on a review of the following:

- primary balance-sheet and income-statement levels and trends
- off-balance-sheet exposure such as the servicing portfolio
- asset quality
- earnings performance
- funding sources and liquidity needs
- capital adequacy

2. To determine the accuracy of regulatory reporting (regulatory accounting practices (RAP) and GAAP) and compliance with applicable state and federal laws and regulations.

3. To evaluate the quality of the mortgage banking company's assets for collateral sufficiency, performance, credit quality, and collectibility.

4. To assess earnings performance through the analysis of the level, composition, and trend of net income. If material, interest income, impairment of mortgage-servicing assets, gains and losses on asset sales, and personnel and other expenses should be factored into the analysis.

5. To assess the funding and liquidity needs of the mortgage banking company through ratio analysis and a review of the funding instruments used.

6. To assess capital adequacy by ensuring that investor minimum requirements are met and by comparing capital levels with peer and industry data. Consideration of the capital needs of the individual mortgage banking company should override any comparison with peers.

3070.0.5.10 Inspection Procedures

Financial Statement Level and Trends

1. Review the mortgage banking company's financial statements and related notes over the previous three-year period.

2. Discuss significant balance-sheet and income-statement categories with management, as well as with internal and external auditors.

3. Determine whether financial trends are consistent with the economic environment, interest-rate movements, the company's business orientation, and management's intended growth strategy.

4. Determine whether reports filed with regulatory agencies are prepared accurately and submitted in a timely manner, with particular attention paid to the reporting for mortgage-servicing assets and recourse obligations retained by the mortgage banking company.

Asset Quality

1. Spread past-due and nonaccrual loans by balance-sheet asset category (for example, mortgage loans held for sale, mortgage loans held for investment), product type, and delinquency status (for example, 31–90 days, 91–180 days, and 181 days and over). Include any loans in the process of foreclosure.

2. Obtain a trial balance and delinquency listing for loans held for sale and loans held for investment.

a. Reconcile balances of the real estate held for sale and investment to the respective general ledger accounts.

b. Classify severely delinquent loans as required based on the financial condition of the borrower, his or her inability to make monthly payments as required, and the protection afforded by current collateral values.

c. Determine accounting policies and practices with respect to these loans. Review aging reports for loans held for sale and for investment. Discuss the frequency of reviews for loans held for sale, revaluation practices, and transfers among accounts. Verify that accounting practices are consistent with GAAP and RAP.

3. Obtain a listing of loans in the process of foreclosure and bankruptcy and discuss these with management for potential classification.

4. Reconcile all other real estate owned by the mortgage banking company to the general ledger and classify based on risks and any income-producing characteristics of the properties. Compare current appraisals to carrying value for potential write-downs.

5. Obtain a list of loans sold under recourse

arrangements and assess for potential classification.

6. Discuss the methodology used to establish foreclosure reserves and related accounting procedures. Review analysis used to project future foreclosures.

- Evaluate the adequacy of foreclosure reserves based on the volume of projected foreclosure actions, average foreclosure costs, and the past history of reinstated loans.

7. Review other reserve accounts and assess for reasonableness.

Earnings Performance

1. Assess earnings performance in terms of the level, composition, and trend of net income. Consider internal factors, such as the company's business orientation and management's growth plans, and external factors, such as interest rates and the economic environment, when evaluating earnings trends.

2. Discuss any unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, reserves, write-downs or adjustments in MSA amortization, salaries and overhead items, or income taxes with management, as well as with internal or external auditors.

3. Incorporate ratio and industry comparisons into the earnings analysis, where appropriate. Bear in mind that ratios that compare earnings to total assets or equity are of limited use unless the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage are taken into consideration.

Liquidity and Funding

1. Determine the mortgage banking company's liquidity needs based on a review of the size of its warehouse and the nature and extent of other longer-term assets.

2. Determine whether sources of liquidity are adequate, both under current conditions and economic duress. Consider earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, maintenance of debt covenants, and contingent liquidity-planning capabilities.

3. Evaluate financial instruments used to fund mortgage operations. Financial instruments may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and/or long-term debt. Review related credit agreements and systems used to monitor compliance with debt covenants.

4. Establish whether excessive borrowing activities have led to a highly leveraged financial condition that exposes the company to money market changes in the cost of funds. Evaluate the impact a change in the company's cost of funds would have on its net interest margin and earnings.

5. Determine the degree of financial flexibility the company maintains. Financial flexibility is the ability to obtain the cash required to make payments as needed. Does the company possess adequate financial strength and have access to lines of credit and/or assets that can be easily collateralized?

6. Review the net current items on the cash-flow statement pertaining to cash flow from operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. Determine whether sufficient positive cash flow exists from the level of current transactions. The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity.

7. Review asset/liability management practices to determine whether funding maturities closely approximate the maturities of underlying assets or whether a funding mismatch exists. Is the company exposed to short-term interest-rate fluctuations that may lead to significant earnings volatility in the event that interest rates change rapidly?

Capital Adequacy

1. Determine whether capital levels are adequate to absorb potential operating losses, provide for liquidity needs and expected growth, and meet minimum requirements set by investors whose loans are serviced and other external parties.

2. Review policies and procedures to determine whether management adequately monitors and reports capital levels to the board of directors. Review the capital plan to determine whether it adequately addresses the particular needs of the company.

3. Evaluate the amount of dividends that are upstreamed to the parent bank holding company, as well as the extent to which the parent

company can be relied on to augment the ongoing capital needs of its bank and nonbank subsidiaries. Is the parent company prepared to support its subsidiaries should the financial need arise? Are cash dividends paid by the mortgage banking subsidiary to the parent company reasonable?

Accounting

1. Review accounting procedures for retail loans. Determine whether loan fees in excess of cost are deferred in accordance with SFAS 91. Verify that income is recognized over the estimated life of the asset and not in the current period and that fees and costs are allowable under SFAS 91. Are controls in place to ensure proper recognition for net fee income when loans are sold? (SFAS 91 applies to loans held in portfolio, as well as to loans swapped for securities when the securities are retained.)

2. Determine if the accounting for recognizing sales of loans and mortgage-backed securities (including participation agreements) is in accordance with the three conditions for true sales recognition specified in SFAS 77, ''Reporting for Transfers of Receivables with Recourse.''[10] Also determine if the sales price was adjusted for all probable adjustments (as defined in SFAS 5, ''Accounting for Contingencies''). If the mortgage banking company is a subsidiary of a bank, refer to the bank call report, glossary entry on ''sales of assets.''

3. If servicing is retained, determine if a ''normal servicing fee'' is set and how it conforms to FannieMae/FHLMC fees and to FASB Technical Bulletin 87-3, ''Accounting for Mortgage-Servicing Fees and Rights.''[11] If the mortgage banking subsidiary is a subsidiary of a bank, see the reporting instructions for Schedule F of the bank call report (Schedule RC-F for Other Assets, Item 3—Excess residential mortgage-servicing fees receivable).

Overall Financial Condition

1. Evaluate the overall financial condition of the mortgage banking company, considering its asset quality, earnings, liquidity, and capital adequacy. Update the financial component of the supervisory rating and prepare report comments as necessary.

3070.0.6 MORTGAGE-SERVICING ASSETS AND LIABILITIES

This subsection discusses mortgage-servicing assets (MSAs) and liabilities and provides guidance with respect to the measurement, impairment testing, and financial reporting requirements of MSAs. The subsection concludes with a discussion of MSA hedging practices and instruments.

SFAS No. 125 ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' was issued in June 1996 as an amendment to SFAS Nos. 65, 76, 77, and 115. The provisions of SFAS 125 supersede SFAS 122 and are to be applied prospectively in fiscal years beginning after December 31, 1996. The statement requires that a liability be derecognized when either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor.

Under SFAS 125, a mortgage banking company is required to recognize as separate assets or liabilities the right to service mortgage loans for others, however those servicing rights are acquired. Servicing of mortgage loans includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure

10. A transfer is recognized as a sale if—

a. The transferor surrenders control of the future economic benefits of the receivables;

b. The transferor's obligation, under the recourse provisions of the sale agreement, can be reasonably estimated. The transferor should have had past experience with the recourse provisions so that a reasonable estimate can be made. The current transferred receivables should possess characteristics similar to previously transferred receivables evidencing the transferor's relevant prior experience.

c. The transferor cannot require the transferee to repurchase the receivables, except as stated in the agreement's recourse provisions.

11. According to FASB Technical Bulletin No. 87-3, the servicing-fee rates set by GNMA, FHLMC, and FannieMae in servicing agreements should be considered a normal servicing-fee rate for transactions with those agencies. If the normal service fees are expected to be less than the estimated servicing costs, the expected loss should be recognized at the time the loans are sold. If a seller/servicer sells mortgage loans directly to private-sector investors and retains servicing on the loans, the seller/servicer should consider the normal servicing-fee rate that would have been specified in comparable servicing agreements if the loans had been sold to or securitized by one of the federally sponsored secondary market makers. As of May 1995, normal servicing-fee rates established by GNMA, FHLMC, and FannieMae were 44, 25, and 37.5 basis points, respectively.

if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interest in the mortgage loans. Servicing is inherent in all mortgage loans; however, it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

3070.0.6.1 Measurement

A mortgage banking company initially acquires MSAs either by (1) purchasing the right to service mortgage loans separately or (2) purchasing or originating mortgage loans and selling those loans with servicing rights retained. When a mortgage banking company purchases or originates mortgage loans, the cost of acquiring those loans includes the cost of the related MSAs.

With respect to SFAS 125, when an entity incurs an obligation to service financial assets, it must record servicing assets or a servicing liability for each servicing contract, unless it securitizes the assets and retains all of the resulting securities, classifying them as debt securities that are to be held to maturity. When servicing assets or liabilities are assumed, rather than being acquired by a sale or undertaken in a securitization of the financial assets that are to be serviced, they are measured initially at fair value (that is, the price paid). A servicing asset or liability is amortized in proportion to and over the period of estimated net servicing income (loss). Any impairment of a servicing asset or liability is determined based on fair value.

When the mortgage banking company sells or securitizes the loans and retains the MSAs, management shall allocate the total cost of the mortgage loans (the recorded investment in the mortgage loans including net deferred loan fees or costs and any purchase premium or discount) to the MSAs and the loans (without the MSAs) based on their relative fair values if it is practicable to estimate those fair values. If a mortgage banking organization undertakes a servicing liability in a sale or securitization, the servicing liability should initially be measured at fair value.

The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information that is available, including prices for similar assets and the results of valuation techniques used by management. Valuation techniques may include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved; option-pricing models; matrix pricing; option-adjusted spread models; and fundamental analysis. Valuation techniques for measuring MSAs should be consistent with the objective of measuring fair value and should incorporate assumptions that market participants would use in their estimates of future servicing income and expense, including assumptions about prepayment, default, and interest rates. If it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs), the entire cost of acquiring the mortgage loans shall be allocated to the mortgage loans (without the MSAs) and no cost shall be allocated to the MSAs.

The amount capitalized as MSAs shall be amortized in proportion to and over the period of estimated net servicing income. Estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental-cost basis.

MSAs are highly subject to interest-rate and prepayment-rate risk since the amount of future cash flows that are provided to the holder is derived from, and is thus dependent on, the outstanding balances of the underlying mortgage loans.[12] Prepayments of underlying mort-

12. Several conventions exist for quantifying prepayment speed. The most common convention is a measure developed by the Public Securities Association (PSA). The PSA measure was based on actual historical experience of FHA mortgages, but it is not predictive. The PSA measure assumes that mortgages prepay at a rate of .2 percent per year in the first month, increase by .2 percent each subsequent month up to 30 months, and remain at 6 percent per year thereafter until maturity. This 6 percent level is referred to as 100 percent PSA. Mortgages that prepay at 200 percent PSA pay off twice as fast as a mortgage that is performing at 100 percent PSA. Another convention is known as the conditional prepayment rate (CPR) measure. CPR assumes that a constant fraction of the

gage loans accelerate during periods of declining interest rates as borrowers take advantage of the option they hold to refinance their loans. As interest rates decline, holders of MSAs are exposed to a risk of prepayment of the underlying loans, and thus a diminished amount of cash flow from their investment. Holders of interest-only stripped securities (I/O strips) are exposed to similar interest-rate and prepayment risks when interest rates decline. I/O strips possess very similar prepayment risk characteristics.

A particular mortgage company's exposure to prepayment risk can also be influenced by portfolio composition factors such as geographical mix, loan-to-value ratios, and the proportion of government (FHA/VA) and conventional loans in the portfolio. Government loans that may be assumable by the purchaser of a home are generally for smaller amounts and may be extended to borrowers with limited financial resources. As a result, government loans tend to prepay more slowly than conventional loans.

Unanticipated changes in interest rates, prepayment speed, or other valuation assumptions may impair the carrying value of MSAs and require accelerated amortization or a write-down. Therefore, the recoverability of the unamortized balance should be evaluated periodically, and amortization and/or the value of the asset should be adjusted accordingly. To the extent that impairment is not recognized, MSA values may be inflated. As a result, assets, earnings, and capital may be overstated.

3070.0.6.2 Impairment Testing

SFAS 125 states that a mortgage banking company shall measure impairment of capitalized MSAs[13] based on their fair value. For the purpose of evaluating and measuring impairment of capitalized MSAs, management should stratify those assets based on one or more of the predominant risk characteristics of the underlying loans.[14] Those characteristics may include loan type, loan size, note rate, date of origination, term, and geographic location.

Impairment shall be recognized through a valuation allowance for an individual stratum. The amount of impairment that is recognized shall be the amount by which the capitalized MSAs for a given stratum exceed their fair value. The fair value of MSAs that have not been capitalized shall not be used in the evaluation of impairment.

Subsequent to the initial measurement of impairment, management shall adjust the valuation allowance to reflect changes in the measurement of impairment. Fair value in excess of the capitalized MSAs shall not be recognized. If the fair value of a mortgage-servicing liability increases above the book value, the increased obligation shall be recognized as a loss in current earnings. SFAS 125 does not address when a mortgage banking company should record a direct write-down of capitalized MSAs; therefore, examiner judgment in this area is required.

3070.0.6.3 Disclosures

SFAS 125 requires that the fair value of capitalized MSAs, and the methods and significant assumptions used to estimate that fair value, be disclosed. If no cost is allocated to certain MSAs, management shall describe those MSAs and describe the reasons why it is not practicable to estimate the fair values of the MSAs and the mortgage loans (without the MSAs). The risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment shall also be disclosed. For each period for which results of operations are presented, the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances shall be disclosed.

3070.0.6.4 Intercompany MSAs

Intercompany MSAs may arise when a mortgage banking company originates loans, sells the loans to an affiliate bank, and the affiliate bank records related MSAs. Intercompany MSAs should be evaluated closely to determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has

remaining principal is prepaid each period, "conditional" on the previous period's remaining balance. Typically, CPR is computed over a one-month time period. The PSA model simply represents a series of stable CPR assumptions.

13. The term "capitalized mortgage-servicing rights" refers to the cost originally allocated to the MSAs less the amount amortized.

14. SFAS 65, as amended, applies to impairment evaluations of all capitalized MSAs. However, a mortgage banking company may continue to apply its previous accounting policies for stratifying MSAs to MSAs that were capitalized before the adoption of the amendments to SFAS 65.

revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

3070.0.6.5 Table Funding

One method of acquiring mortgage loans, and recording related MSAs, is through so-called "table-funding arrangements." In a table-funding arrangement, the mortgage banking company provides the original funding when a mortgage broker or correspondent closes the mortgage loan with the borrower. Concurrent with the loan closing, the mortgage banking company acquires the loan and the related MSAs.

Emerging Issues Task Force Issue No. 92-10 (EITF 92-10), "Loan Acquisitions Involving Table Funding Arrangements," clarified under what conditions these arrangements could be characterized as loan purchases. According to EITF 92-10, a mortgage banking company may account for a loan acquired in a table-funding arrangement as a purchase only if *all* of the following conditions are met:

- The correspondent is registered and licensed to originate and sell loans under the applicable laws of the states or other jurisdictions in which it conducts business.
- The correspondent originated, processed, and closed the loan in its own name and is the first titled owner of the loan, with the mortgage banking company becoming a holder in due course.
- The correspondent is an independent third party and not an affiliate of the mortgage banking company as defined in SFAS 65. As a nonaffiliate, the correspondent must bear all of the costs of its place of business, including the costs of its origination operations.
- The correspondent must sell loans to more than one mortgage banking enterprise and not have an exclusive relationship with the purchaser.
- The correspondent is not directly or indirectly indemnified by the mortgage banking company for market or credit risks on loans originated by the correspondent. However, a commitment by the mortgage banking company for the purchase of loans from the correspondent is not considered to be an indemnification for purposes of this requirement.

If any one of the above criteria is not met, the mortgage banking company must account for the loan as an origination. MSAs that were recorded before the adoption of the SFAS 65 amendments should be reviewed to ensure that they were originated and funded consistent with the above requirements. MSAs that are recorded under SFAS 125 may arise in connection with either originated or purchased mortgage loan transactions.

3070.0.6.6 Regulatory Reporting

The examiner should also determine whether the method used to value MSAs is in accordance with the instructions for the Bank Report of Condition and Income (call report) and the BHC reporting instructions (FR Y-9C). If capitalized MSAs are not appropriately valued, they cannot be included in capital. Management should review the carrying amount at least quarterly, adequately document this review, and adjust the book value as necessary.

3070.0.6.7 Risk-Based Capital

Readily marketable MSAs may be included in a bank or bank holding company's tier 1 capital subject to certain limitations. Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and limited qualifying cumulative perpetual preferred stock.[14a] Tier 1 capital excludes goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, exceed 25 percent of tier 1 capital;[15] all other identifiable intangible assets; and deferred-tax assets that are dependent upon future

14a. Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.

15. Amounts of MSAs, non-MSAs, and PCCRs in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital requirements in determining tier 1 capital. Identifiable intangible assets, however, exclusive of MSAs and PCCRs, acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes. They will, however, continue to be deducted for applications purposes.

taxable income, net of their valuation allowance, in excess of certain limitations.

The amount of MSAs which may be included in capital is also limited to the *lesser* of—

- the amount recorded on the balance sheet under GAAP, or
- 90 percent of their fair market value. If both the application of the limit on MSAs and the adjustment of the balance-sheet amount for MSAs would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

3070.0.6.8 Previously Recognized Excess Servicing-Fee Receivables

SFAS No. 125, "Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (paragraph 20), addresses the accounting treatment for excess servicing-fee receivables based on contracts that were in existence before January 1, 1997. Previously recognized servicing rights and excess servicing-fee receivables are to be combined, net of any previous servicing obligations under the contract, as a servicing asset or a servicing liability. Any previously recognized excess servicing-fee receivables that exceed contractually specified servicing fees are to be reclassified as interest-only strips receivables.

3070.0.6.9 MSA Hedging Practices and Instruments

During the refinancing waves of 1992 and 1993, several mortgage banking companies experienced large losses due to the impact of rising prepayments on the value of servicing rights. As a result, many companies have begun to hedge MSAs. An effective hedge program should reflect a solid understanding of the underlying MSA risk characteristics.

3070.0.6.9.1 Hedging Practices

Interest-rate and prepayment-rate risk are often reduced through the natural offset between the production and servicing functions; however, the degree of protection afforded by this relationship depends on the company's business orientation (originations versus purchases) and can be very difficult to measure.[16] Other financial instruments are also used to mitigate interest-rate and prepayment-rate risks. The remainder of this subsection discusses existing hedge accounting guidance and rudimentary descriptions of certain customized MSA hedge products. Examiners should also refer to the Federal Reserve System's *Trading Activities Manual* for additional guidance on derivatives.

3070.0.6.9.2 Hedge Accounting

Existing accounting literature is vague with respect to the accounting treatment for MSA hedge products, particularly in the area of derivatives. However, analogies exist that facilitate the application of existing accounting standards. SFAS No. 80, "Accounting for Futures Transactions," provides financial reporting standards for exchange-traded futures contracts on both interest-rate products and raw materials (commodities). Several EITF issues releases provide financial reporting guidance for interest-rate swap transactions. Finally, an issues paper prepared by the American Institute of Certified Public Accountants (AICPA), "Accounting for Options," provides informal but nonauthoritative guidance relating to options contracts. The AICPA issues paper addresses options on all tangible goods, including both exchange-traded options and nonexchange traded options on interest-rate caps and floors.

To qualify for hedge-accounting treatment under SFAS 80, a financial instrument must meet two criteria:

- The hedged item exposes the entity to price or interest-rate risk.
- The financial instrument used as a hedge reduces that exposure and is designated as a hedge.

SFAS 80 states that at the inception of the hedge and throughout the hedge period, changes in the market value of the financial instrument used as a hedge should correlate highly with changes in

16. When interest rates fall, increases in production volumes and related revenues tend to offset runoff in the servicing portfolio and reductions in servicing-fee income. Alternatively, to the extent that the marketing department hedges less than 100 percent of its estimated long position (closed loans plus rate-locked loans that are expected to close) and interest rates fall, the resulting marketing gains on the uncovered position tend to offset a portion of any required write-downs in the servicing portfolio.

the fair value of, or interest income or expense associated with, the hedged item(s) so that the results of the financial instrument(s) used as a hedge will substantially offset the effects of price or interest-rate changes on the exposed item(s). Although required correlation levels are not specifically defined, the accounting industry has determined that 80 percent is a reasonable benchmark.

Before claiming hedge-accounting treatment, management must obtain an opinion from its CPA or internal accountant confirming that the instrument that is proposed would qualify for such treatment. If these criteria are not met, the financial instrument should be carried at its market value (i.e., marked to market). Hedge performance should be monitored daily and reported to the responsible management or board committee at least quarterly.

3070.0.6.9.3 Relevant MSA Characteristics

To evaluate a mortgage banking company's hedge program for MSAs, one must first understand how MSAs perform. Duration, convexity, and amortization are useful concepts that will be reviewed as they relate to MSAs. Duration measures the change in the value of MSAs (or their cash flows) for a given change in interest rates. Duration can be either positive or negative. An asset with a positive duration, such as a fixed-income bond, tends to increase in value as interest rates fall. Conversely, an asset with a negative duration, such as an MSA, tends to decrease in value as interest rates fall.

Convexity measures the rate of change in an instrument's duration, or the nonlinearity of its price/yield curve. Like duration, convexity can be either positive or negative. An asset with a positive convexity will rise more in value for a given change in interest rates than it will fall if interest rates move equally in the opposite direction. Conversely, an asset with a negative convexity will decline more in value for a given change in interest rates than it will increase in value if interest rates move equally in the opposite direction. Because of their prepayment characteristics, MSAs and most other mortgage-related assets are negatively convex within a specified range of interest rates. Borrowers can be expected to exercise their option to prepay a loan at a time that is most disadvantageous to the MSA holder.

MSAs are also an amortizing asset. When a prepayment occurs, the loss of value is permanent and cannot be recovered. The use of a nonamortizing asset as a hedge would necessitate an active hedge-management strategy to adjust the position as the unamortized balance of the MSAs declines. If the position is not adjusted correctly, this strategy may expose earnings and capital to additional risks that are not within the scope of the company's MSA hedge program.

3070.0.6.9.4 Hedge Instruments

An effective MSA hedge instrument will possess characteristics that mitigate the interest-rate and prepayment risks associated with MSAs without assuming additional basis risk. Basis risk measures how well changes in the value of the hedge instrument correlate to changes in the value of the MSA. An effective hedge should also be reasonable in terms of transaction costs and management's time.

Several types of specialized derivative products have evolved to meet the needs of mortgage banking companies. Early MSA hedge products were interest-rate-driven, utilizing zero-coupon Treasury bonds or interest-rate swaps. However, the basis risk of such hedges proved to be excessive. Next came principal-only (PO) and super-principal only (SPO) bonds, which were prepayment-driven.[17] However, these products also proved ineffective due to geographic basis risk, potential average-life mismatches, additional capital requirements, and dissimilar accounting treatment which led to accounting losses.

MSA hedge products generally fall into three categories: bond hedges, short-term option hedges, and long-term option hedges. Bond hedges use Treasury bonds, "plain vanilla" interest-rate swaps, interest amortizing rate swaps, positive convexity swaps, POs, and SPOs. Bond hedges may be either interest-rate-driven or prepayment-rate-driven. Prepayment-rate-driven products reduce more basis risk and are therefore more expensive. Although most bond hedges are positively convex, they fail to provide enough positive convexity to offset the negative convexity in MSAs. In other words, when interest rates decline, the value of the bond hedge will not increase in an amount sufficient to offset the simultaneous decline in the MSAs. Another disadvantage to bond hedges is that the downside

17. A special class of REMIC securities backed by POs. SPOs are a more leveraged type of PO.

risk is generally unlimited.

Short-term option hedges consist of over-the-counter (OTC) Treasury options, options on futures contracts, and options on OTC mortgage securities. Short-term option hedges generally contain enough positive convexity to offset the negative convexity of MSAs, and the downside risk is limited to the option premium paid at inception. However, option strategies using these products require frequent rebalancing, are therefore expensive, and do not work well in a rapidly changing interest-rate environment because they are not amortizing assets.

Long-term option hedges include prepayment caps, interest amortizing rate (IAR) servicing hedges, LIBOR floors, and swaptions. These products may protect the servicer and/or seller against changes in either interest rates or prepayments. As off-balance-sheet products, they impose very few capital constraints on the MSA holder.

A prepayment cap is an off-balance-sheet, prepayment-driven option product that can be used to hedge a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a payment from the counterparty every month that the option is "in the money." The option is in the money if the difference between the "strike balance" and the actual balance of a "reference portfolio," less the sum of previous balance differences, is positive. Each month the option is in the money, the counterparty will pay the "strike price," usually the book cost of the servicing portfolio, multiplied by this balance shortfall. The reference portfolio, strike price, and strike balance can be customized to match the servicer and/or seller's risk parameters and individual portfolio.

An IAR servicing hedge is an off-balance-sheet, interest rate–driven option product that can be used as either a revenue or a balance-sheet hedge of a mortgage-servicing portfolio. In exchange for paying a fee, either up-front or over the life of the hedge, the servicer and/or seller receives a series of payments from the counterparty to the extent that amortization of a "reference balance" exceeds scheduled amortization of a "strike balance." The main difference between an IAR and a prepayment cap is that with an IAR, option payments are based on the performance of a "reference portfolio" rather than the seller and/or servicer's actual portfolio. For an IAR revenue hedge, the option payout is based on the current balance shortfall between the reference and strike balances. For an IAR balance-sheet hedge, option payouts are based on the cumulative excess amortization of the reference balance over the strike balance. IAR hedges are less expensive than comparable prepayment-linked hedges because they contain basis risk. If actual prepayments occur more rapidly than predicted at the onset of the hedge, the servicer and/or seller will be underhedged.

Numerous other types of customized hedge products are available. The advantages and disadvantages of each product should be well understood before it is incorporated into a mortgage banking company's interest-rate risk management strategies.

3070.0.6.10 Inspection Objectives

1. To determine whether MSAs pose a significant financial risk to earnings and capital.
2. To evaluate management's expertise and the oversight provided by the board of directors.
3. To determine whether policies and procedures used to initially record, amortize, and reevaluate MSAs are in conformance with GAAP and risk-based capital requirements, and whether actual practice is consistent with stated policies and procedures.
4. To verify that asset values are fairly stated.
5. To evaluate the methods used to hedge interest-rate and prepayment risks associated with MSAs, the degree of oversight provided by management or the board of directors, the adequacy of written policies and procedures, and the effectiveness of the company's hedge program for MSAs.
6. To identify any excessive risk-taking which is caused by the company's business mix and/or strategy.

3070.0.6.11 Inspection Procedures

1. Determine the extent of financial risk associated with MSAs through a review of the following:

    a. Significant changes in the size of the servicing portfolio. Obtain a reconciliation for the servicing portfolio for the prior fiscal year and the most recent interim period. If significant growth has occurred, determine whether loans were originated, purchased individually (on a flow basis), purchased in bulk transactions, or acquired through whole company acquisitions. If the portfolio size has declined, determine the reason for such decline (sales of servicing rights, prepayments) and the impact on the remaining servicing portfolio.

b. The proportion of capitalized MSAs relative to the outstanding principal balance of mortgage loans in the servicing portfolio.

c. Other unusual characteristics of the servicing portfolio that may present undue risk, such as the weighted average coupon rates, weighted average maturities, delinquency characteristics, or mix of government (FHA/VA) loans versus conventional loans.

If the level of financial risk is sufficient to place earnings and capital at risk, the examiner should complete the remainder of the MSA procedures.

2. Review the qualifications of the individuals who are responsible for initially recording, amortizing and evaluating MSAs. Does management possess the necessary accounting expertise and experience with respect to valuation methodologies?

3. Review the accounting systems used to track MSAs. Is the necessary information being maintained in an understandable and useable form? Does the adoption of SFAS 65, as amended, and 125 pose any system problems for the company? Are such problems being addressed in a timely manner? At a minimum, MSAs should be tracked by product type and year of origination. The following information should be maintained for each pool of loans: the original and current principal balance for each pool; original and current book values of related MSAs; prepayment speeds, normal servicing fees, and the original discount rate used; and the actual historical payment experience for each pool.

4. Review written policies and procedures for initially recording, amortizing, and periodically revaluating MSAs. Determine the management or board committees responsible for approval of such policies, the date of last approval, and the frequency of their review.

5. Determine whether MSA policies and procedures are in conformance with GAAP and risk-based capital requirements and whether actual practice conforms with established policies and procedures. At a minimum, policies and procedures should clearly address the following areas:

a. Initial valuation of MSAs and related pricing policies. With respect to MSAs, policies and procedures should describe the method for allocating the total cost of originated and purchased mortgage loans to the MSAs and the related loans (without the MSAs) based on their relative fair values at the date of origination or purchase; procedures to be followed if a definitive plan for sale of the loans does not exist and loans are sold at a later date; procedures to be followed in the event that it is not practicable to estimate the fair value of the MSAs and the related loans (without MSAs); and MSAs recorded under table funding relationships with correspondents and/or brokers.

b. The method for amortizing MSAs over the estimated lives of the assets, and instances where amortization lives may be adjusted.

c. The method for measuring impairment of capitalized MSAs based on their fair value. Policies and procedures should address the basis for stratification of MSAs based on the risk characteristics of the underlying loans; the types of valuation allowances used to reflect changes in the measurement of impairment; the method used to arrive at the fair value of assets (quoted market prices, estimated prices for similar assets, and the results of valuation techniques); the frequency of revaluation tests; the presentation of valuation test results to senior management and the board of directors; instances where write-downs would be required; disclosures; and the basis for assumptions used.

6. Verify that the valuation techniques for measuring MSAs are consistent with the objective of measuring fair value. Review model output and related manuals and/or marketing materials. Evaluate the reasonableness of all key parameters and assumptions, with an emphasis on the source for prepayment speed estimates, the number of interest-rate "paths" used (vectoring or binomial models being more desirable than a single interest-rate projection path), the basis for the interest rate used to discount cash flows, and the source of servicing revenue and cost data.

7. Review the most recent quarterly valuation process and the related output to determine whether necessary write-downs or amortization adjustments were made, management or board oversight was adequate, and actual practice is consistent with established policies and procedures. Ensure that any significant changes to the model's parameters and/or output are approved by the appropriate management or board committee and that such changes are adequately documented.

8. Verify that disclosures are accurate with respect to the following:

- the fair value of capitalized MSAs
- the methods and significant assumptions used to estimate that fair value
- a description of MSAs for which no cost

has been allocated and the reasons why it is not practicable to estimate the fair values of those MSAs and the mortgage loans (without the MSAs)
- the risk characteristics of the underlying loans used to stratify capitalized MSAs for the purposes of measuring impairment
- the activity in the valuation allowances for capitalized MSAs, including the aggregate balance of the allowances at the beginning and end of each period; aggregate additions charged and reductions credited to operations; and aggregate direct write-downs charged against the allowances

9. Obtain a list of intercompany MSAs as of the close of business for the most recent quarter-end. Determine whether a valid business purpose exists, the loans are actually sold, the entity holding the MSAs has revalued the rights correctly, and such intercompany MSAs are eliminated in consolidation. If the purpose of the transaction is merely to bolster capital levels at the bank, the practice may constitute an unsafe and unsound banking practice.

10. Review policies and practices regarding the sale of MSAs and liabilities to investors.

11. If the company sells loans with recourse, are recourse reserves established at the time of sale? Are estimated losses factored into the calculation of gain/loss on sale of loans?

12. Obtain an organizational chart to determine the individuals responsible for hedging MSAs. Review biographies to ensure that staff members responsible for this function are knowledgeable regarding accounting guidance, hedge products, and related strategies.

13. Review methods used to hedge the interest-rate and prepayment-rate risk associated with MSAs. Verify the management or board committee responsible for approving hedge instruments, the list of approved products, and the frequency and date of last review.

14. Review management reports to determine the correlation between hedge instruments and the underlying assets, the accounting treatment for hedges, related gains and losses, and the overall effectiveness of the company's hedge program. If hedge accounting treatment is being used, management and/or the company's external accountants must perform the appropriate level of due diligence and maintain adequate supporting documentation. In determining the effectiveness of the hedging program, the examiner should compare the actual results of hedge performance with the expected results.

15. Evaluate the quality of information that is communicated to senior management, the board of directors (if applicable), and the parent company's senior management and board of directors to determine whether management and directors are adequately informed regarding the financial risks associated with MSAs, amortization methods and hedging techniques, and the degree of risk inherent in the company's strategic focus and business mix with respect to the projected volume of MSAs.

3070.0.7 INTERCOMPANY TRANSACTIONS

A mortgage banking company that is organized as a nonbank subsidiary of a bank holding company often sells assets to, receives funding from, or services loans for its bank affiliates. Given the trend toward managing mortgage banking activities as a line function rather than by legal entity, such intercompany transactions have become an area of heightened supervisory concern.

In general, sections 23A and 23B of the Federal Reserve Act are designed to prevent a bank from being disadvantaged through the purchase of low-quality assets from an affiliate, the pressure to fund the majority of an affiliate's working-capital needs, and intercompany transactions that either inadequately compensate the bank or are not conducted on an arms-length basis.

3070.0.7.1 Section 23A of the Federal Reserve Act

Section 23A was enacted as part of the Banking Act of 1933 (the Glass-Steagall Act) for state member banks and later extended to all federally insured banks.[18] Section 23A defines companies that control or are under common control with the bank as affiliates of the bank. For example, the term "affiliates" includes bank holding companies and their subsidiaries as well as banks and nonbanking companies that are under common individual control.[19] The two

18. As originally enacted, the Banking Act of 1933 covered only member banks. In 1966, Congress amended section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. 1828(j), to extend the coverage of section 23A to include insured nonmember banks. As a result, section 23A now applies to all federally insured banks. (12 U.S.C. 371c)

19. Nonbank subsidiaries of banks, as opposed to nonbank subsidiaries of bank holding companies, are not affiliates for purposes of section 23A, unless the Board of Governors of the Federal Reserve System determines otherwise. Banks that are

primary aspects of section 23A—quantitative restrictions and collateral requirements—are discussed next.

3070.0.7.1.1 Quantitative Restrictions

The quantitative restrictions imposed by section 23A generally limit the aggregate amount of so-called "covered transactions" to 10 percent of the bank's capital and surplus for transactions with a given affiliate, and 20 percent of the bank's capital and surplus for transactions with all of its affiliates.[20] Covered transactions include—

- a loan or extension of credit by a bank to an affiliate, such as a warehouse line of credit provided to the affiliate;
- the purchase of or investment in securities such as a privately issued MBS issued by an affiliate;
- the purchase of assets from an affiliate, such as a loan purchased either as an accommodation to a bank customer or for the bank's asset/liability management purposes;
- the acceptance by a bank of securities issued by an affiliate as collateral for a loan or extension of credit by the bank to any person or company (Securities might include either the stock of a publicly held affiliate or the stock from one of its officer's own business enterprises.); or
- the issuance by a bank of a guaranty, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate (A letter of credit might be posted by the bank to cover an excessive number of GNMA pools that lack final pool certification.).

The examiner should determine the bank's method for identifying covered transactions and applying the quantitative limits for section 23A purposes. If a covered transaction is found that exceeds these quantitative limits, either on an individual or an aggregate basis, an apparent violation of section 23A has occurred. All such apparent violations of law should be discussed with management and cited in the report.

Particular attention should be paid to intercompany asset transfers and funding arrangements to determine whether they constitute covered transactions under section 23A. In Interpretation 250.250 (12 C.F.R. 250.250)[21] the Board determined that a member bank's purchase, without recourse, and at face value, of a mortgage note, or a participation therein, from a mortgage banking subsidiary of the parent bank holding company, which had no financial interest in the underlying asset on which it had granted credit through the note, did not involve a "loan" or "extension of credit"[22] from the member bank to the seller of the mortgage note within the meaning of section 23A if—

- the member bank's commitment to purchase the loan or participation therein was obtained by the affiliate within the context of a proposed transaction or series of proposed transactions in anticipation of the affiliate's commitment to make such loan(s),
- the commitment to purchase the loan was based on the bank's independent credit evaluation of the creditworthiness of the mortgagor(s),[23] and
- there could be no blanket advance commitment by the member bank to purchase a stipulated amount of loans that bore no reference to specific proposed transactions. Accordingly, the nonbank affiliate must have adequate and independent working capital to fund its operations.

The Board stated that if the bank followed these procedures, then the bank would be taking advantage of an individual investment opportunity and thus should be exempt from section 23A. However, the Board was concerned that the bank should not be allowed to set up a business relationship with any affiliate which could create the opportunity for the bank, at some time in the future, to engage in unsafe transactions because the bank felt impelled by an improper incentive to alleviate the working-capital needs of the affiliate. Accordingly, the bank's transactions with the affiliate should not be of such a volume as to create pressure on the bank to relax its sound credit judgment concerning the individual loans involved and thereby

part of a chain banking organization are subject to the restrictions of section 23A.

20. For section 23A purposes, the definition for capital and surplus includes the allowance for loan and lease losses.

21. See also *Federal Reserve Regulatory Service*, 3–1133.

22. Under section 23A, as amended by the Garn–St Germain Act in 1982, a member bank's purchase of a loan from its nonbank affiliate that was made to an unaffiliated party is now considered a purchase of an asset from the affiliate unless it is excepted under interpretation 250.250.

23. Dual employees may not be used to satisfy the independent credit evaluation requirement.

result in an inappropriate risk to the soundness of the bank.

3070.0.7.1.2 Collateral Requirements

In addition to the quantitative restrictions, certain covered transactions between a bank and an affiliate must also be secured at the time of the transaction by collateral having a certain market value. Unless otherwise exempted, covered transactions that must be adequately secured include loans or extensions of credit, guaranties, acceptances, and letters of credit issued on behalf of the affiliate.

Collateralization requirements range from 100 percent to 130 percent depending on the type of collateral used. Acceptable forms of collateral include U.S. government or U.S. government–guaranteed obligations, instruments that are acceptable at the Federal Reserve's discount window, bank deposits that are segregated into accounts specifically earmarked for this purpose, other debt instruments, stock, leases, or other real or personal property. According to an August 31, 1987, Board interpretation (at FRRS 3–1164.3), mortgage-servicing rights do not constitute a permissible form of collateral for purposes of section 23A because of (1) their inherent volatility, making it difficult to accurately value the rights, and (2) the need to secure permission to transfer servicing rights from the legal owner of the underlying mortgage.[24]

An example of a covered transaction that is subject to both the quantitative restrictions and the collateral requirements of section 23A would be an overdraft in the mortgage company's checking account with an affiliate bank, which is considered an extension of credit. A line of credit by a bank to a nonbank affiliate also constitutes a covered transaction. It is important to remember that the full value of the line, not just the portion drawn down, must satisfy the quantitative and the collateral requirements of section 23A at all times. The examiner should review checking accounts and funding arrangements to ensure that the appropriate level and type of collateral is maintained. Collateral values should be monitored regularly so that depreciated or matured collateral is replaced as needed.

24. Item (2) refers to the bank's ability to sell the mortgage-servicing rights if the affiliate defaults on its loan.

3070.0.7.1.3 Prohibited Transactions

In addition to the quantitative and collateral requirements, section 23A also prohibits certain affiliate transactions altogether. Most importantly, a bank and its subsidiaries may not purchase a low-quality asset (generally a classified or past-due asset) from an affiliate or accept a low-quality asset as collateral for a loan. Section 23A also requires that all covered transactions be conducted on terms that are consistent with safe and sound banking practices.

3070.0.7.1.4 Exemptions from Section 23A of the FRA

As mentioned previously, several types of intercompany transactions are exempted from the requirements of section 23A. For example, transactions between banks in which 80 percent or more of each bank's stock is owned by the same bank holding company (so-called "sister banks") are exempt from most provisions of section 23A.[25] Other transactions that are exempt include the following:

- deposits received from the affiliate during the ordinary course of business (checks in the process of collection)
- immediate credit given to an affiliate for uncollected items received in the ordinary course of business
- loans, extensions of credit, guaranties, acceptances, or letters of credit issued on behalf of the affiliate that are fully secured by obligations issued or guaranteed by the U.S. government or a segregated earmarked account in the bank
- the purchase of assets having a readily and identifiable market price at the time of purchase
- transactions that are deemed to be in the public interest and consistent with the purposes of the act

Internal controls should be in place to ensure

25. Foreign banks do not qualify as sister banks for section 23A purposes. These transactions are still subject to the prohibition against the purchase of low-quality assets and to the requirement that covered transactions be on terms and conditions that are consistent with safe and sound banking practices. It should also be noted that federal savings banks do qualify for the sister-bank exemption if all banks in the corporate chain have met their fully phased-in capital guidelines, as provided for in the Home Owner's Loan Act.

that all transactions are adequately reviewed. Documentation should be maintained for intercompany transactions that are exempted from the requirements of section 23A.

3070.0.7.2 Section 23B of the Federal Reserve Act

The Competitive Equality Banking Act of 1987 amended the Federal Reserve Act to add a new provision, known as section 23B. In general, section 23B provides that covered transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. If no comparable transactions exist, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or applied to nonaffiliated companies. A bank is also generally prohibited from purchasing as a fiduciary securities or assets from an affiliate except under specified circumstances. Finally, a bank and its affiliate may not advertise or enter into an agreement that suggests the bank is in any way responsible for the obligations of the affiliate.

Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A. However, section 23B excludes banks from the term ''affiliate.'' Therefore, transactions between sister banks and banks that are part of a chain banking organization are exempt from section 23B.

3070.0.7.3 Management and Service Fees

The Federal Reserve System's 1979 policy statement on diversion of bank income practices is intended to prevent excessive or unjustifiable management or service fees, as well as any other unwarranted payments or practices that, by diverting bank resources to the parent company or a nonbank affiliate, may have an adverse financial impact on a subsidiary (paying) bank (see section 2020.6). Diversion of income practices with respect to a mortgage banking company might potentially include, but are not limited to—

- servicing fees, or other payments assessed by the mortgage banking company and paid by the bank that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the nonbank subsidiary in its role as servicer and/or seller;
- balances maintained by the bank primarily in support of mortgage banking company borrowings without appropriate compensation to the bank;
- prepayment of fees to the mortgage banking company for services not yet rendered;
- nonreimbursed origination fees, marketing costs, or other expenses incurred by the bank that primarily support the mortgage banking company's activities; and
- loan repurchase agreements between the bank and the mortgage banking company while the mortgage banking company is processing loans in the mortgage pipeline.

Purchase and funding agreements should adequately itemize and document the types of services provided and the basis for fees. Billing statements and other documentation should clearly evidence that fees actually charged and paid are reasonable and consistent with regulatory policy requirements as described.

3070.0.7.4 Tie-In Considerations of the BHC Act

Section 106 of the BHC Act Amendments of 1970 contains five restrictions intended to prohibit anticompetitive behavior by banks: two prohibit tying arrangements; two prohibit reciprocity arrangements; and one prohibits exclusive dealing arrangements.[26] The tying restrictions, which have the greatest effect on industry practices, prohibit a bank from restricting the availability or varying the consideration for one product or service (the *tying product*) on the condition that a customer purchase another product or service offered by the bank or by any of its affiliates (the *tied product*).

Section 106 was adopted in 1970 when Congress expanded the authority of the Board to approve proposals by bank holding companies to engage in nonbanking activities. The provisions of section 106 were based on congressional concern that banks' unique role in the economy, in particular their power to extend credit, would allow them to create a competitive advantage for their affiliates in the new, nonbanking markets that they were being allowed to enter.[27]

26. 12 U.S.C. 1972.
27. See S. Rep. No. 1084, 91st Cong., 2d Sess. (1970).

Congress therefore imposed special limitations on tying by banks—restrictions beyond those imposed by the antitrust laws. Section 106 is a broader prohibition; unlike the antitrust laws, a plaintiff in action under section 106 need not show that (1) the seller has market power in the market for the tying product, (2) the tying arrangement has had an anticompetitive effect in the market for the tied product, or (3) the tying arrangement has had a substantial effect on interstate commerce.

Section 106 applies only when a *bank* offers the tying product.[28] The Board has authority to grant exceptions to section 106, which it has used to allow banking organizations to package their products when doing so would benefit the organization and its customers without anticompetitive effects.

3070.0.7.4.1 Section 225.7(d) of Regulation Y

The Board originally extended section 106, which covers tying arrangements by *banks* only, to cover nonbank affiliates and bank holding companies. The Board rescinded this extension of the statute effective April 21, 1997. Thus, unless subject to another exemption, section 106 *prohibits*—

- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from the bank; and
- a bank from telling a customer that it can only receive a loan (or a discount thereon) if it purchases another product from an affiliate of the bank.

Section 106 and the Board's regulation allow—

- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from an affiliated bank; and
- a broker-dealer affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from a nonbank affiliate.

These distinctions make sense if one keeps in mind the concern of the statute: banks (*not* nonbanks) have special power over credit and, thus, are able to induce or coerce their customers into purchasing products that they would otherwise prefer not to purchase or to purchase from someone else.[29]

28. See 1997 FRB 275.

3070.0.7.4.2 Interaffiliate Tying Arrangements Treated the Same as Intrabank Arrangements

Section 106 contains an explicit exception (the *statutory traditional bank product exception*) that permits a bank to tie any product or service to a loan, discount, deposit, or trust service offered by that bank.[30] For example, a bank could condition the use of its messenger service on a customer's maintaining a deposit account at the bank. Although the statutory traditional bank product exception appears to have been effective in preserving traditional relationships between a customer and bank, the exception is limited in an important way—it does not extend to transactions involving products offered by affiliates.

The Board has adopted a *regulatory traditional bank product exception* that extends the statutory exception to transactions involving affiliates.[31] Although the Board has previously limited the scope of this extension, interaffiliate arrangements are now exempt to the same extent as intrabank arrangements.[32]

3070.0.7.4.3 Foreign Transactions Under Section 106

The Board has adopted a "safe harbor" from the anti-tying rules for transactions with corporate customers that are incorporated or otherwise organized and that have their principal place of business outside the United States, or with individuals who are citizens of a foreign country and are not resident in the United States. However, the safe harbor would not protect tying arrangements in which the customer is a U.S.-incorporated division of a foreign company. Furthermore, the safe harbor would not

29. The Board's rule also includes a limited prohibition on tying arrangements involving electronic benefit transfer services (12 C.F.R. 225.7(d)).
30. 12 U.S.C. 1972(1)(A).
31. See 12 C.F.R. 225.7(b)(1).
32. A similar action was taken for interaffiliate reciprocity arrangements, in which section 106 permits a bank to condition the availability of a product or service on the customer's providing to the bank some product or service "related to and usually provided in connection with" a loan, discount, deposit, or trust service (12 U.S.C. 1972(1)(C)).

shelter a transaction from other antitrust laws if they were otherwise applicable.[33]

3070.0.7.4.4 Technical Change

The Board also has adopted a definition of "bank" for purposes of the anti-tying rules. The definition clarifies that any exemptions afforded to banks generally also would be applicable to credit card and other limited-purpose institutions and to U.S. branches and agencies of foreign banks.[34]

3070.0.7.5 Inspection Objective

1. To evaluate transactions between a mortgage banking company organized as a direct subsidiary of a bank holding company and affiliated banks for compliance with federal laws and regulations, and related policy guidance.

3070.0.7.6 Inspection Procedures

1. Review management's method for monitoring and identifying section 23A and 23B covered transactions and applying the quantitative limitations. Determine whether—

   a. all covered transactions have been identified;

   b. quantitative limits are calculated correctly;

   c. covered transactions, including any overdrafts and lines of credit, meet both the quantitative limits and collateral requirements of section 23A; and

   d. adequate collateral values have been maintained over the life of the covered transactions (For example, collateral is maintained for the full amount of any credit lines with the bank, and any depreciated or matured collateral has been replaced as required.).

2. Review purchase and funding contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine that—

   a. asset purchases by the bank are either within the quantitative limits of section 23A or meet the exemption requirements of C.F.R. section 250.250,

   b. all purchases are at fair market value and consistent with market terms as required by section 23B,

   c. no low-quality assets were transferred to the bank since the previous inspection,

   d. the method of compensating the bank for balances maintained and net interest income earned on warehouse loans or lines is reasonable and based on market terms.

3. Review servicing contracts between the mortgage banking company and the bank, as well as the substance of actual transactions, to determine—

   a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?);

   b. the nature of all services provided; and

   c. billing arrangements, the frequency of billing, the method of computation, and the basis for such fees.

4. Review the bank holding company's policy statement on the prohibition of tie-in arrangements, the adequacy of training provided to employees, and whether its respective subsidiaries are in full compliance with internal policy.

3070.0.8 REGULATION Y COMPLIANCE

During the course of the on-site inspection, the examiner is expected to conduct sufficient tests and inquiries to determine whether the company is in compliance with Regulation Y and the act. Such tests and inquiries would include a listing of company offices which can be compared with the approved offices, comparisons of credit-related insurance policies and rate schedules against stipulated public benefits cited in Board orders, and reviews of various activities for technical compliance.

While not specifically detailed in this guidance, the examiner may find it necessary to conduct a review of the company's ledgers and accounts that is sufficient to disclose possible impermissible activities and potential violations of law. The audit function, both internal and external, should not be solely relied on for this disclosure because the auditor's program may emphasize other areas of concern. As a nonbank subsidiary of a bank holding company, reference should be made to part 225 of the Code of Federal Regulations (such as section 225.28(b) of Regulation Y) and other relevant sections thereof.

Concurrent with the review of assets for credit quality, the examiner should undertake a review

33. See 12 C.F.R. 225.7(b)(3).
34. See 12 C.F.R. 225.7(e).

of asset-related activities for compliance with the subsidiary's approval orders. In mortgage banking firms, it is possible that the company is engaging unknowingly in certain impermissible activities, such as those described by 12 C.F.R. 225.126 (i.e., real estate brokerage, land development, real estate syndication, and property management) and those deemed impermissible by Board order (see sections 3000.0.4 and 3700.0 to 3700.12). The Board of Governors has ruled (1972 FRB 429) that the purchase and development of land for sale to third parties constitutes land development by a nonbank subsidiary. However, the completion of a foreclosed property to facilitate the recovery of funds advanced under the loan appears to be permissible, provided that the additional work brings the project underway at foreclosure up to a saleable condition. The Board has also ruled that property management for third parties is impermissible (1972 FRB 652). However, property management as a fiduciary, for operating premises of affiliates, or for properties acquired for debts previously contracted (DPC) is permissible. In addition to the other impermissible activities, engaging in real estate joint ventures has also been ruled impermissible. If such impermissible activities are found, they represent violations and should be appropriately treated. The servicing agreements should be reviewed to determine that no additional liabilities, real or contingent, are imposed on the company beyond its responsibilities as a servicing agent.

The usual source of growth in the servicing portfolio is the company's own origination activity. However, it is not uncommon for a company to supplement this growth with bulk purchases of serviced mortgages from other companies. Under certain circumstances, usually relating to the relative percentage of the seller's portfolio, these transactions may not comply with 12 C.F.R. 225.132. Since these transactions may represent the effective acquisition of a going concern subject to prior approval by the Federal Reserve System, "servicing portfolio" acquisitions should be reviewed for compliance.

Section 225.22(d)(1) of Regulation Y provides an exemption from required Board approval for DPC property acquired in good faith and divested within two years of acquisition. The Board may permit additional extensions that can result in the property being held by a bank holding company for a total of 10 years, if the property has value and marketability characteristics similar to real estate. In conjunction with the review of real estate owned, the examiner should determine if any subsidiary holds title to any property that should have been disposed of within the time limits of Regulation Y, the book value of which has been reduced to zero and the property is not disclosed on the balance sheet. See section 3030.0 "Acquisition of DPC Shares or Assets," for additional information on DPC property acquired.

Legal counsel representing a BHC requested an opinion as to whether certain proposed flood zone–determination activities, to be conducted through a majority-owed (50 percent) joint venture company, would be within the scope of activities related to extending credit as defined in section 225.28(b)(2) of Regulation Y. The BHC proposes to engage in a variety of lending-related activities, including providing real estate appraisals and flood zone determinations.

The Board has determined, in section 225.28(b)(2) of Regulation Y, that it is permissible for bank holding companies to engage in "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board."[35] (See 12 C.F.R. 225.28(b)(2).) The Board also determined by regulation that performing real estate appraisals is an activity that is usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit. (See 12 C.F.R. 225.28(b)(2)(i).) The Board had not specifically addressed whether providing flood zone determinations is an activity that is usual in connection with lending activities.

The proposed flood zone–determination services are considered to be a necessary aspect of mortgage lending in the United States. As noted, federal law prohibits a federally regulated lender from making, increasing, extending, or renewing a loan that is secured by improved real estate or a mobile home located in an area

35. The Gramm-Leach-Bliley Act (the GLB Act) amended the Bank Holding Company Act to limit bank holding companies that are not financial holding companies to engaging only in "activities which had been determined by the Board by regulation or order under this paragraph as of the day before the date of the enactment of the Gramm-Leach-Bliley Act on November 12, 1999, to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board)" (12 U.S.C. 1843(c)(8)). Before November 12, 1999, the Board had determined that "[a]ny activity usual in connection with making, acquiring, brokering, or servicing loans or other extensions of credit, as determined by the Board" was closely related to banking. Accordingly, the Board retains authority after the GLB Act to define the scope of this section 4(c)(8) activity and to modify the terms and conditions that apply to the activity.

designated by the Federal Emergency Management Agency (FEMA) as a special flood hazard area unless the borrower obtains flood insurance.[36] (See 12 C.F.R. 208.25(c).) Further, federal law also provides that if a federally regulated lender determines, at any time during the life of a loan, that the improved real estate or mobile home securing the loan is located in a special flood hazard area and is not covered by flood insurance, the lender must instruct the borrower to obtain flood insurance and must purchase flood insurance on the borrower's behalf if the borrower fails to promptly purchase the required insurance. (See 12 C.F.R. 208.25(g).)

In addition, federal law requires the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association (the government-sponsored enterprises or GSEs) to have procedures reasonably designed to ensure that flood insurance is in place where required at the initiation of, and during the lives of, the mortgage loans they purchase. (See 12 U.S.C. 4012a(b).) The GSEs meet this requirement by requiring lenders that sell loans to them, and companies that service loans for them, to monitor on an ongoing basis the flood zone status of any loans sold to, or serviced for, the GSEs. To comply with the requirements of federal law and the GSEs, mortgage lenders must obtain an initial flood zone determination before the origination of each mortgage loan and must take steps to monitor, throughout the life of the loan, the flood zone status of any improved real estate or mobile home collateral securing the loan.[37]

The joint venture company proposes to provide initial flood zone determinations to mortgage lenders and to provide mortgage lenders with ongoing flood zone–tracking services with respect to their mortgage loans. The company's activities would be limited to making determinations as to whether particular parcels of real estate are in designated flood zones, preparing the FEMA standard flood zone–determination form, and communicating flood zone determinations to customers. The company committed to not be involved in placing, underwriting, or issuing flood insurance or in the collection of flood insurance premiums. The proposed flood zone determinations would be provided in connection with providing real estate appraisals and as a separate service. In addition, the joint venture company may assist customers who wish to request that FEMA amend its flood maps to remove a property from a designated special flood hazard area.

The proposed flood zone–determination services were found to be an essential part of mortgage lending, designed to assist mortgage lenders in complying with the requirements of federal law and the GSEs. The services generally would be provided to mortgage lenders,[38] thus usual in connection with making mortgage loans. Board staff therefore issued the opinion on July 9, 2002, concluding that the proposed flood zone–determination services are within the scope of permissible activities related to extending credit under section 225.28(b)(2) of Regulation Y (12 C.F.R. 225.28(b)(2)).

3070.0.9 ON-SITE INSPECTION OF MORTGAGE BANKING SUBSIDIARIES

Scheduling of on-site inspections of mortgage banking nonbank subsidiaries of bank holding companies should be done in accordance with the Board policy for frequency and scope of inspections. (See section 5000.0.2.) After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by nonaccrual and delinquency reports, the level of risk exposure to the organization (see section 4030.2), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted.

36. Statutory authority to issue flood insurance policies under the National Flood Insurance Program (NFIP) expired on December 31, 2002, after Congress adjourned without extending the FEMA authority. On January 13, 2003, the National Flood Insurance Program Reauthorization Act was approved, extending the authorization of the NFIP to December 31, 2003; this authorization was also made retroactive to December 31, 2002.

37. Lenders are specifically permitted to charge a reasonable fee to borrowers for flood zone determinations and life-of-the-loan tracking. For example, see 12 C.F.R. 208.25(h).

38. It was represented that the joint venture company would only market its services to mortgage lenders and that it would rarely provide services to nonlenders.

Conversely, a deteriorating condition might be detected that would require a visit, even though a satisfactory condition had been determined during the previous inspection. Mortgage subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected. All significant mortgage banking subsidiaries should be fully inspected at least once every three years.

3070.0.10 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Loans to affiliates section 23A of the FRA	371c			
Restrictions on 371c transactions with affiliates	371c			
Purchase of affiliate's notes from a third party			3–1131	
Activities not closely related to banking		225.126	4–184	
Acquisition of assets		225.132	4–175.1	
Purchase by member bank of loans originated by a mortgage banking firm		250.250	3–1133	
Mortgage companies acquired under sections 4(c)(1) or 4(c)(8) of the act		225.122	4–196	
Activities closely related to banking		225.131	4–176	
Investments in community welfare projects		225.127	4–178	
Staff opinion on engaging in certain proposed flood zone–determination activities		225.28(b)(2)	4–318.4	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3070.0.11 APPENDIX A—FIRST DAY LETTER

FEDERAL RESERVE BANK
OF BOSTON

P. O. BOX 2076
BOSTON, MASSACHUSETTS 02106-2076

June 15, 19x9

Mr. John Doe
President
XYZ Mortgage Bank Corporation
Boston, Massachusetts 02107

Dear Mr. Doe:

In conjunction with the inspection of the XYZ Bank Holding Company, we plan to begin an inspection of XYZ Mortgage Bank Corporation on July 15, 19x9. To facilitate this inspection, please provide a copy of or make available the following information relative to your organization's mortgage banking activities. Information should be as of xx/xx/xx and should be delivered to the examiner-in-charge as soon as it is available. Whenever possible, standardized management reports should be provided. Please include the name and telephone extension of the appropriate persons to contact, by department, if additional information is necessary.

Board Oversight and Management

1. Provide a listing of the mortgage banking company's board of directors that includes each individual's name, place of employment, title and position, age, management responsibilities (if any), and the length of time he or she has served on the board.
2. List significant management and board committees and have minutes from these meetings available for examiner review. Provide a copy of standardized reports that are provided before each meeting.
3. Provide an organizational chart that highlights individuals who are responsible for the following functional areas: production, warehousing and funding, marketing, servicing, finance, mortgage-servicing asset (MSA) valuations, internal audit, quality control, loan review, compliance, and legal. Include biographies and salary information.
4. Describe any organizational changes that have taken place at the mortgage banking company since xx/xx/xx, including any mergers, acquisitions, or consolidation of mortgage banking activities. Describe any management changes at or above the senior vice president level and provide details on management's new responsibilities.
5. Provide a copy of standardized management reports that are used to monitor compliance with established policies, operating procedures, and controls within each functional area.
6. Provide a copy of the mortgage banking company's most recent operating budget and its long-term strategic plan. Evaluate how interest-rate movements, competition, and other external factors have affected product mix, staffing levels, and the allocation of capital.
7. Describe the internal control environment and the internal control programs that are in place within the mortgage banking company. Have available for examiner review the following reports that were conducted since xx/xx/xx:
   a. internal and external audits
   b. loan reviews

c. internal control and compliance audits completed by or on behalf of agencies such as HUD, FHA, GNMA, FannieMae, FHLMC, state agencies, and private investors

Also have available management's response to each report and the most recent copy of any management reports that monitor the status of outstanding issues or problems.

8. Provide an organization chart for the *internal audit* department. Indicate the scope and frequency of internal audits for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make internal audit workpapers available for examiner review.
9. Provide an organization chart for the *loan review* department. Indicate the scope and frequency of loan reviews for the mortgage banking company, highlighting any weaknesses or problem areas noted. Upon request, make loan review workpapers available for examiner review.
10. Provide details on the nature and scope of the quality control program for loans originated and/or serviced for investors. Include an organization chart for the unit(s) involved in such activities, details on any outsourcing programs used since the previous inspection, copies of quality control reports submitted to senior management, and management responses.
11. Describe the method for ensuring compliance with state and federal laws and regulations. Make available for examiner review the procedures manual, work programs, and workpapers compiled by the person/department responsible for compliance.
12. Describe the insurance coverage in effect for the mortgage banking company and its officers and the date it was last reviewed by the board of directors.
13. Recap all mortgage banking–related legal claims/lawsuits in excess of $1 million. Indicate the nature of any legal reserve that is maintained and the method used to assess reserve adequacy.
14. Describe the system for logging, tracking, and responding to customer complaints. The customer complaint file should be made available for examiner review while on-site.
15. Provide a copy of the disaster recovery plan and describe safeguards in place to protect loan documents and data processing input records.

Production and Correspondent Lending Data

16. Provide detailed organization charts for departments within the company which relate to the production function (i.e., retail originations, wholesale purchases, processing, underwriting, closing, shipping).
17. Provide information on the total number and dollar amount of loans generated by the following sources during the two most recent fiscal years and the interim year-to-date period. For purchased loans, please specify the method of purchase (i.e., bulk versus flow), program name, and amount subject to recourse back to either the seller or the investor):

    a. originated by the mortgage banking company

    b. purchased from affiliates

    c. purchased from nonaffiliated third parties
18. Provide written policies and procedures manuals that describe traditional and nontraditional mortgage products, underwriting standards, closing and funding procedures, exception reporting practices, management and employee compensation methods, and training programs for loan production personnel. State methods used to establish ongoing compliance with written policies and procedures and provide copies of relevant management exception reports.
19. Describe the credit approval process used for in-house originations. Include information on rate commitment options extended to the borrower, the average length of the commitment period,

controls that are in place to monitor fallout caused by processing backlogs, and procedures for expired commitments.

20. Provide details on the correspondent lending program, including a list of approved institutions and copies of the most recent loan-quality reports. Describe the credit review process before purchase and any controls that are in place to protect the mortgage banking company against future losses on loans purchased from affiliates and from correspondents.
21. Determine whether rate-locks are provided to correspondents on best effort production programs. What methods are used to verify reported loan fallout?
22. Provide information on the average income and cost per origination and compare with industry standards. Describe the method of accounting used for origination fees and other related noninterest income and expenses.
23. If the mortgage banking company is a subsidiary of a state member bank or sells loans to a bank affiliate that is subject to Regulation O, furnish a list of extensions of credit to "an executive officer, director, or principal shareholder" (as defined in section 215.2 of Regulation O) of—

    a. the state member bank;

    b. a bank holding company of which the state member bank is a subsidiary;

    c. any other subsidiary of that bank holding company;

    d. a company controlled by an insider, as defined by Regulation O; and

    e. a political or campaign committee that benefits or is controlled by an insider as defined by Regulation O.

    For all such extensions of credit, include the amount, date the loan(s) was originated or renewed, interest rate, collateral requirements, total amount of loans outstanding to that individual or company, and date of approval by the board of directors. Also include the aggregate amount of loans outstanding to all such insiders as of the inspection date in relation to the bank's unimpaired capital and unimpaired surplus as defined in Regulation O. (See subsection 2050.0.3.2.)

Marketing and Hedging Data

24. Provide detailed organization charts for departments within the company that relate to the marketing and hedging functions. Describe management's roles and responsibilities with respect to the sale of loans in the secondary market, asset securitization, funding, liquidity risk management, interest-rate risk management, and interaction with the asset/liability management function at the parent company.
25. Provide a copy of written policies and procedures used to hedge interest-rate risk associated with the pipeline and closed-loan warehouse. Describe any parameters and limits that are in place and provide a list of securities dealers with whom management is authorized to conduct business.
26. Provide management reports on pipeline and closed-loan (warehouse) inventory volume, mix, yield, age, and turnover as of the inspection date. Describe the method used to project fallout and any models that are used to determine the sensitivity of the pipeline to interest-rate fluctuations.
27. Indicate the methods used to securitize loans for sale in the secondary market, including the use of third-party guaranties and other forms of credit enhancement. Are securities generally sold or retained on the balance sheet?
28. Provide information on the number and volume of securities that lacked final pool certification as of the inspection date. State whether this volume is in compliance with investor guidelines. If

applicable, indicate whether the requirements for obtaining a letter of credit or other guaranty have been satisfied.

Servicing Data

29. Provide a detailed organization chart for the servicing department.
30. List subservicers and vendors who are employed to perform servicing functions. Briefly describe the nature of the services provided.
31. Indicate whether any contracts with subservicers and/or vendors have been terminated for cause since the prior inspection.
32. Provide the monthly servicing management reports since the prior inspection, including the number of loans serviced, dollar volume, and composition of the servicing portfolio in terms of product mix, average loan size, weighted average coupon rates, weighted average maturities, geographic location, and delinquencies and foreclosures.
33. Provide a list of investors for whom servicing was performed as of the most recent quarter-end. Identify any recourse or repurchase provisions and/or forbearance requirements.
34. State whether any investors have terminated servicing contracts with the mortgage company and/or its affiliates for cause since the prior inspection, or if any are likely to be terminated in the near future.
35. Provide a list of all major bulk purchases and sales of servicing since the prior inspection. Identify the terms of each sale and any resulting gains or losses.
36. Provide a list and aging of all outstanding advances to investors as of the date of inspection.
37. Provide access to the servicing policies and procedures manual. Indicate the frequency with which manuals are updated. How does management ensure that subservicers and vendors comply with these same policies and procedures?
38. Provide a servicing-fee schedule (in basis points) for conventional, government, and nontraditional loans serviced for third parties.
39. Provide copies of management reports used to track portfolio runoff.
40. Provide a loan delinquency report segmented into 30, 60, 90, 120, and 180 foreclosure categories. Indicate the volume and number of loans in each segment by loan type. Also include information on the number and dollar volume of delinquent loans that were purchased out of investor pools.
41. Detail the number and dollar volume of other real estate (ORE) parcels segregated by company-owned and investor-owned. Provide a list of loans in foreclosure for which action has been delayed, if applicable.
42. Provide access to the customers' complaint file so that examiners can review it while on-site.

Financial Data

43. Provide copies of the Report of Condition and Income and/or Y-series report that was filed by the mortgage banking company for the two previous fiscal years and the most recent interim period.
44. Provide an internally prepared balance sheet and income statement that reconcile with the most recent Report of Condition and Income and/or Federal Reserve Board Y-series report.

45. Provide the latest published financial statements, if applicable, including the annual report, SEC 10K, 10Qs, and any press releases.

46. Provide copies of the accounting policies pertaining to mortgage loans, securities, and other assets held for sale and held for investment. Also provide copies of management reports that monitor compliance with SFAS No. 115 (securities), the current SFAS No. 65 (loans), SFAS No. 125 (mortgage-servicing assets), and internal policies as of the close of business of the most recent quarter.

47. Provide details on all formal and informal funding mechanisms, including but not limited to repurchase agreements, commercial paper programs, and debt issuance facilities. Indicate the counterparties, where applicable; the amount uncommitted; and the amount outstanding under each facility as of the close of the most recent quarter. Provide copies of all formal and informal written agreements.

48. Provide copies of credit agreements for all funding lines from affiliated and nonaffiliated institutions. Describe methods used to monitor the credit quality of all funding sources. The following information should be included:

    a. lending bank (include copies of confirmation letters)

    b. total credit line

    c. amount in use as of the inspection date

    d. amount available for use and by whom

    e. expiration date

    f. compensating balance and/or fee arrangements

    g. purpose

    h. whether the credit lines are contractual obligations of the lenders

    i. reciprocity arrangements, if any

    j. collateral requirements

    k. legal opinions evidencing compliance with sections 23A and 23B of the Federal Reserve Act, as amended

49. Provide copies of any contingency planning documents that outline alternative courses of action should the condition of traditional funding sources deteriorate.

50. Provide a copy of any standardized financial presentations made to the executive management team and to the board of directors.

51. Provide a copy of standardized management reports used to measure and track the quality of originated, purchased, and serviced assets. Include an aging report that identifies loans that are past due 30, 60, 90, 120, and 180 or more days and indicate whether such loans are *held for sale, held for investment,* or *serviced for investors*.

52. Provide a copy of internal policies that apply to loans held for investment. Indicate the date each loan that was on the books as of the most recent quarter-end was transferred to this account, its amortized cost, market value, and any write-downs or adjustments to yield at the date of transfer. Indicate the person responsible for reviewing these loans for collectibility, the frequency of such reviews, and any adjustments or write-downs taken over the past year.

53. Provide detail pertaining to the transfer or sale of assets between the nonbank mortgage banking company and affiliated entities since the last inspection and that supports the FR Y-8 Reports. Also provide related documentation evidencing methods for asset valuation and credit-quality determination.

54. Provide detail on the allowance for loan and lease losses, contra asset valuation allowances, and

other reserve accounts as of xx/xx/xx (fiscal) and xx/xx/xx (interim). For each account in use, provide a copy of the most recent analysis and a description of the applicable loan and other losses provisions reserving methodology.

55. Provide a copy of the company's policy with respect to real estate appraisals.

56. Provide a copy of management reports that are used for liquidity, funding, and asset/liability management. If these activities are coordinated with affiliate bank or parent bank holding company personnel, provide copies of the information that is routinely provided.

57. Indicate the method for assessing capital adequacy at the mortgage company level. Provide a copy of the company's capital and dividend policies, as well as a list of dividends paid to shareholders during the two previous fiscal years and the most recent interim period. Are any changes in the level of dividends planned or anticipated?

Mortgage-Servicing Assets

58. Provide an organization chart highlighting those areas and individuals responsible for the recording, measurement, and impairment testing for originated and purchased mortgage-servicing rights (MSAs).

59. Provide an inventory listing of all MSAs as of the close of business of the most recent quarter.

60. Discuss the various loan-origination and -purchase programs that give rise to MSAs; the method for calculating and communicating the price paid to correspondents and brokers for service release premiums; whether MSAs are recorded on table-funded loans; and the details on any bulk purchases since the previous inspection, including the price paid and yield realized.

61. Discuss the various loan-sale programs that give rise to MSAs, the method for calculating and recording the initial value of MSAs.

62. Provide a copy of detailed written policies and procedures regarding the initial recording, amortization, and periodic revaluation and impairment testing for MSAs. Indicate the management and/or board committee responsible for approving such policies and the date of last approval.

63. Provide detailed information on any valuation models used for MSA revaluations and a copy of the output as of the most recent quarter-end. Indicate whether such revaluations are performed in-house or by an outside vendor and the frequency of such revaluations.

64. Reconcile fair market values of MSAs to their respective book values as of the most recent quarter-end. Provide a copy of management reports and related journal entries used to record amortization adjustments and/or write-downs.

65. Provide copies of worksheets used to calculate the amount of MSAs included in Tier 1 capital for regulatory reporting purposes as of the most recent quarter-end.

66. Furnish copies of any management reports or presentations to the board of directors or a committee thereof regarding the risk characteristics of MSAs, business risk analysis, and methods used to hedge the interest-rate and prepayment-rate risks associated with capitalized MSAs.

67. Provide an organization chart highlighting those areas and individuals responsible for hedging the interest-rate and prepayment-rate risk associated with MSAs.

68. Provide information on any financial instruments used to hedge interest-rate and prepayment-risk associated with MSAs. Include a detailed prospectus on any customized hedge products that are purchased from investment bankers and a statement from either internal or external accountants on whether such instruments qualify for hedge accounting treatment under SFAS No. 80.

69. Provide a copy of management reports that identify the number of contracts or instruments used, their current market value, and the degree of correlation between the hedge instrument and the underlying MSAs being hedged. Such reports should demonstrate the effectiveness of the hedge under varying market conditions.
70. Provide information on the number and dollar volume of servicing rights sold during the most recent fiscal year and interim period.
71. If mortgage-servicing assets are sold, provide information on the number and dollar volume sold during the most recent fiscal year and interim period.

Intercompany Transactions

72. Provide an organizational chart on a legal-entity basis that includes the bank holding company and all directly held bank and nonbank affiliates.
73. If the mortgage banking company is a direct nonbank subsidiary of the bank holding company, describe the method for identifying transactions that constitute "covered transactions" under sections 23A and 23B of the Federal Reserve Act, as well as the method for applying quantitative limits for section 23A and 23B purposes.
74. Provide a current listing of collateral that is maintained for covered transactions. Indicate whether collateral is maintained for the full amount of any credit lines with the bank and whether any depreciated or matured collateral has been replaced since the previous review.
75. Provide copies of any purchase and funding contracts between the mortgage banking company and affiliated bank(s). Please address whether any or all of the following conditions are met and/or provide written support, where applicable:
    a. asset purchases by the bank have been reviewed by management and are either within the quantitative limits of section 23A or meet the exemption requirements of section 250.250
    b. all purchases are at fair market value and consistent with market terms as required by section 23B
    c. no low-quality assets were transferred to a bank affiliate since the previous inspection
    d. the method of compensating bank affiliates for balances maintained by the parent company or its nonbank subsidiaries and the net interest income earned on warehouse loans or lines is reasonable and based on market terms
76. Provide copies of any servicing contracts between the mortgage banking company and affiliate bank(s). If not so stated, indicate the following information:
    a. the capacity in which the affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?)
    b. the nature of all services provided
    c. billing arrangements, the frequency of billing, the method of computation and the basis for such fees
    d. the date of last review and approval by the mortgage banking company's board of directors
77. Provide a copy of the bank holding company's policy statement on the prohibition of tie-in arrangements, a description of training that is provided to employees in this area, and an attestation as to whether the nonbank subsidiary is in full compliance with internal policy.
78. If the mortgage banking company charges management or other fees, describe the nature of the

fees, the method of computation for such fees, and the settlement procedures. Include a listing of fees charged for the prior two fiscal years and the most recent interim period.

79. Provide a copy of the bank holding company's intercompany tax allocation policy. Indicate the amount and timing of intercompany tax payments and credits received during the two previous fiscal years and the most recent interim period. If credits are due, please indicate the amount owed to the subsidiary and the date the intercompany receivable originated.

Sincerely yours,

Vice President,
Federal Reserve Bank of Boston

3070.0.12 APPENDIX B—ACCOUNTING LITERATURE

The following is a list of generally accepted accounting principles (GAAP) governing the mortgage banking industry that are in the form of accounting standards and interpretations. Accounting standards may change over time. Current accounting literature should be reviewed with management during each inspection.

Statements of Financial Accounting Standards (SFAS)

SFAS No. 5, "Accounting for Contingencies"

SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," as amended

SFAS No. 77, "Reporting by Transferors for Transfers of Receivables with Recourse"

SFAS No. 80, "Accounting for Futures Transactions"

SFAS No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases"

SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities"

SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"

FASB Technical Bulletin

Technical Bulletin No. 87-3, "Accounting for Mortgage Servicing Fees and Rights"

Emerging Issues Task Force (EITF)

Issue No. 85-13, "Sale of Mortgage Service Rights on Mortgages Owned by Others"

Issue No. 85-26, "Measurement of Servicing Fee under FASB Statement No. 65—When a Loan Is Sold with Servicing Retained"

Issue No. 85-28, "Consolidation Issues Relating to Collateralized Mortgage Obligations"

Issue No. 86-38, "Implications of Mortgage Prepayments on Amortization of Servicing Rights"

Issue No. 86-39, "Gains from the Sale of Mortgage Loans with Servicing Rights Retained"

Issue No. 87-25, "Sale of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement"

Issue No. 87-34, "Sale of Mortgage Servicing Rights with a Subservicing Agreement"

Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold"

Issue No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate"

Issue No. 89-5, "Sale of Mortgage Loan Servicing Rights"

Issue No. 90-21, "Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement"

Issue No. 92-10, "Loan Acquisitions Involving Table Funding Arrangements"

3070.0.13 APPENDIX C—REGULATORY GUIDANCE

The following is a list of sections in this manual that examiners may find particularly useful in the review of mortgage banking activities. Regulatory guidance also evolves over time. This list is not all inclusive.

2010.0.1	Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks
2020.0–.7	Intercompany Transactions
2050.0	Extensions of Credit to BHC Officials
2060.0–.6	Management Information Systems
2065.2	Determining an Adequate Level for the Allowance for Loan and Lease Losses
2080.05	Bank Holding Company Funding and Liquidity
2080.0–.3	BHC Funding Practices
2125.0	Trading Activities of Banking Organizations
2126.0	Nontrading Activities of Banking Organizations
2126.1	Investment Securities and End-User Derivatives Activities
2128.02	Asset Securitization
2130.0	Futures, Forward, and Option Contracts
2150.0	Repurchase Transactions
3070.0	Section 4(c)(8)—Mortgage Banking
3080.0	Section 4(c)(8)—Servicing Loans
4000 sections	Financial Analysis
4030.0.2	Nonbanks (Analysis of Financial Condition and Risk Assessment)
4070.0	BHC Rating System

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2015, this section is revised to delete a footnote reference to SR letter 02-16, "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" and its attachment, superseded by SR letter 15-6 "Interagency Frequently Asked Questions on the Regulatory Capital Rule." Refer to subsection 3070.3.2.5., "Secondary Market Activity."

The Federal Reserve and the other federal banking and thrift regulatory agencies (the agencies)[1] issued the Interagency Guidance on Nontraditional Mortgage Product Risks on September 29, 2006. The guidance addresses both risk-management and consumer disclosure practices that institutions[2] should employ to effectively manage the risks associated with closed-end residential mortgage products that allow borrowers to defer repayment of principal and, sometimes, interest (referred to as nontraditional mortgage loans). (See SR-06-15.)

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. However, during the past few years consumer demand has been growing, particularly in high-priced real estate markets, for nontraditional mortgage loans. These mortgage products include such products as "interest-only" mortgages, where a borrower pays no loan principal for the first few years of the loan, and "payment-option" adjustable-rate mortgages (ARMs), where a borrower has flexible payment options with the potential for negative amortization.[3]

1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

2. The term *institution(s)*, as used in this interagency guidance, applies to Federal Reserve-supervised state member banks and their subsidiaries, bank holding companies, and the nonbank subsidiaries of bank holding companies. It also refers to all other *federally supervised* banks and their subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

3. Interest-only and payment-option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed-rate products. Refer to the appendix at 3060.3.4 for additional information on interest-only and payment-option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (HELOCs), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers; these borrowers may not otherwise qualify for more traditional mortgage loans and may not fully understand the risks associated with nontraditional mortgage loans.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (reduced documentation) and are increasingly combined with simultaneous second-lien loans.[4] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should—

- ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- ensure that consumers have sufficient information to clearly understand loan terms and associated; and
- recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio.

The Federal Reserve expects institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.[5]

Institutions should use the guidance to ensure that risk-management practices adequately

4. Refer to the appendix for additional information on reduced documentation and simultaneous second-lien loans.

5. Refer to the Interagency Guidelines Establishing Standards for Safety and Soundness in 12 C.F.R. 208, appendix D-1.

address these risks. Risk-management processes, policies, and procedures in this area will be carefully scrutinized. Institutions that do not adequately manage these risks will be asked to take remedial action.

This guidance focuses on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

3070.3.1 NONTRADITIONAL LOAN TERMS AND UNDERWRITING STANDARDS

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.[6]

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure that risk levels remain manageable.

3070.3.1.1 Qualifying Borrowers for Nontraditional Loans

Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as *payment shock*, this increase is of particular concern for payment-option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and potentially develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate,[7] assuming a fully amortizing repayment schedule.[8] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[9]

6. Refer to 12 C.F.R. 208.51 subpart E and appendix C and 12 C.F.R. 225 subpart G.

7. The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest-rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (for example, the MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

8. The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest-only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

9. The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether a loan balance has the potential to reach the negative amortization cap before the end of the initial payment-option period (usually five years). For example, a loan with a 115 percent negative amortization cap but only a small spread between the introductory rate and the accrual rate may reach a moderate 109 percent maximum loan balance before the end of the initial payment-option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

Furthermore, the analysis of repayment capacity should avoid overreliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

3070.3.1.2 Collateral-Dependent Loans

Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.[10] Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

3070.3.1.3 Risk Layering

Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest-only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance, and other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

3070.3.1.4 Reduced Documentation

Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Federal Reserve expects an institution to more diligently verify and document a borrower's income and debt-reduction capacity.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

3070.3.1.5 Simultaneous Second-Lien Loans

Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien HELOCs typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk-mitigating factors.

3070.3.1.6 Introductory Interest Rates

As a marketing tool for payment-option ARM products, many institutions offer introductory interest rates set well below the fully indexed rate. When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

3070.3.1.7 Lending to Subprime Borrowers

Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the

10. A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

applicable interagency guidance on subprime lending.[11] Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for the institution and the borrower.

3070.3.1.8 Non-Owner-Occupied Investor Loans

Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.

3070.3.2 PORTFOLIO AND RISK-MANAGEMENT PRACTICES

Institutions should ensure that risk-management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk-management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should—

- develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk-management expectations;
- design enhanced performance measures and management reporting that provide early warning for increasing risk;
- establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

11. See SR-99-6, Subprime Lending and its attachment, Interagency Guidance on Subprime Lending, March 1, 1999, and SR-01-4, Subprime Lending and its attachment, interagency Expanded Guidance for Subprime Lending Programs, January 31, 2001.

3070.3.2.1 Policies

An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk-management tools for risk-mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

3070.3.2.2 Concentrations

Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk-management practices. Monitoring systems should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

3070.3.2.3 Controls

An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service, and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

3070.3.2.4 Third-Party Originations

Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If problems involving appraisals, loan documentation, credit problems, or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, and even termination of the third-party relationship.

3070.3.2.5 Secondary-Market Activity

The sophistication of an institution's secondary-market risk-management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary-market activities should have comprehensive, formal strategies for managing risks. Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets.

3070.3.2.6 Management Information and Reporting

Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by (1) loan type (for example, interest-only mortgage loans and payment-option ARMs); (2) risk-layering features (for example, payment-option ARMs with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); (3) underwriting characteristics (for example, LTV, DTI, and credit score); and (4) borrower performance (for example, payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards, and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from estab-

12. Reserved footnote.
13. Reserved footnote.

lished policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk-tolerance levels.

3070.3.2.7 Stress Testing

Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring, and managing risk, as well as developing appropriate and cost-effective loss-mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

3070.3.2.8 Capital and Allowance for Loan and Lease Losses

Institutions should establish an appropriate ALLL for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit-risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. The valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.[14]

3070.3.3 CONSUMER PROTECTION ISSUES

While nontraditional mortgage loans provide flexibility for consumers, the Federal Reserve is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

3070.3.3.1 Concerns and Objectives

More than traditional ARMs, mortgage products such as payment-option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization, neither of which may be fully understood by consumers. For example, consumer payment obliga-

14. See SR-03-4, dated February 25, 2003, Interagency Advisory on Mortgage Banking and its attachment, which has the same title.

tions may increase substantially at the end of an interest-only period or upon the "recast" of a payment-option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest-rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared with a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in the property—even when the property has appreciated. The concern that consumers may not fully understand these products is exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risks of payment shock and of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

3070.3.3.2 Legal Risks

Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z
- Section 5 of the Federal Trade Commission Act (FTC Act)

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages (1) in advertisements, (2) with an application,[15] (3) before loan consummation, and (4) when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[16]

Other federal laws, including the fair-lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Federal Reserve notes that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

3070.3.3.3 Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[17]

3070.3.3.4 Communications with Consumers

When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when (1) a consumer is shopping for a mortgage (such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products) or (2) market-

15. These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

16. The Board of Governors enforces this provision under the FTC Act and section 8 of the Federal Deposit Insurance Act. See the joint Board and FDIC guidance titled Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004.

17. Institutions should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

ing relating to nontraditional mortgage products is provided by the institution to the consumer. Clear and balanced information should not be offered by the institution only upon the submission of an application or at consummation.[18] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z, as well as other laws.[19]

3070.3.3.4.1 Promotional Materials and Product Descriptions

To assist consumers in their product selection decisions, promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages (including information about the matters discussed below).

Payment Shock. Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[20] Such information also could describe when structural payment changes will occur (for example, when introductory rates expire or when amortizing payments are required) and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest-rate index.

Negative Amortization. When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

Prepayment Penalties. If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.

Cost of Reduced Documentation Loans. If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

3070.3.3.4.2 Monthly Statements on Payment-Option ARMs

Monthly statements that are provided to consumers on payment-option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment-option ARM borrowers to select a non-amortizing or negatively amortizing payment (for example, through the format or content of monthly statements).

18. Institutions also should strive to (1) focus on information important to consumer decision making; (2) highlight key information to make it more prominent; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers who are considering the nontraditional mortgage products and other loan features described in this guidance.

19. Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

20. Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

3070.3.3.4.3 Practices to Avoid

Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.[21] Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as (1) giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); (2) making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; (3) suggesting that initial minimum payments in a payment-option ARM will cover accrued interest (or principal and interest) charges; and (4) making misleading claims that interest rates or payment obligations for these products are "fixed."

3070.3.3.5 Control Systems

Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

3070.3.4 APPENDIX (TERMS USED IN THIS DOCUMENT)

Interest-Only Mortgage Loan. An interest-only mortgage loan refers to a nontraditional mortgage in which, for a specified number of years (for example, three or five years), the borrower is required to pay only the interest due on the loan, during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or it may fluctuate based on the prescribed index and payments, including both principal and interest.

Payment-Option ARM. A payment-option ARM is a nontraditional adjustable-rate mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option

21. For example, marketing materials for payment-option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15- or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation. Reduced documentation is a loan feature that is commonly referred to as ''low doc/no doc,'' ''no income/no asset,'' ''stated income,'' or ''stated assets.'' For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan. A simultaneous second-lien loan is a lending arrangement where either a closed-end second lien or a home equity line of credit (HELOC) is originated simultaneously with the first-lien mortgage loan, typically in lieu of a higher down payment. 3070.3.5

3070.3.5 INSPECTION OBJECTIVES

1. To ascertain if the banking organization[22] has adequate risk-management processes, policies, and procedures to address the risk associated with its nontraditional mortgage loans.
2. To evaluate whether the banking organization's nontraditional mortgage loan terms are supported by a disciplined analysis of its potential exposures versus the mitigating factors that ensure that risk levels are adequately managed.
3. To determine if the underwriting standards for nontraditional mortgage loans comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.
4. To evaluate whether the banking organization's management carefully considers and appropriately assesses and mitigates the risk exposures created by the nontraditional mortgage loans by ensuring that—
   a. its loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
   b. its nontraditional mortgage loan products have strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
   c. its consumers have sufficient information to clearly understand the loan terms and associated risks prior to making a nontraditional mortgage loan product choice.
5. To determine if the banking organization has borrower qualification criteria that include an evaluation of a borrower's repayment capacity and ability to repay the debt—the full amount of the credit extended, including any balance increase that may accrue from negative amortization—by the final maturity date at the fully indexed rate.

22. Going forward in this section (for bank holding company inspection purposes) ''banking organization'' refers to the bank holding company and its nonbank subsidiaries that are supervised by the Federal Reserve System.

3070.3.6 INSPECTION PROCEDURES

Risk Mitigation

1. Assess the banking organization's management procedures to mitigate the risk created by nontraditional mortgage products. Determine that—
   a. underwriting standards and terms are consistent with prudent lending practices, including consideration of each borrower's repayment capacity;
   b. products are supported by strong risk-management standards, capital levels that are commensurate with their risk, and an allowance for loan and lease losses that reflects the collectiblity of the portfolio; and
   c. borrowers have sufficient information to clearly understand the terms of their loans and their associated risks.

Underwriting Standards

1. Determine if the banking organization's underwriting standards—
   a. address the effect of a substantial pay-

ment increase in the borrower's capacity to repay when loan amortization begins,
   b. comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines, and
   c. require that loan terms are based on a disciplined analysis of potential exposures and mitigating factors, which will ensure that risk levels remain manageable.
2. Verify that the banking organization's nontraditional mortgage loan qualification standards recognize the potential impact of payment shock (particularly for borrowers with high loan-to-value ratios, high debt-to-income ratios, and low credit scores).
3. Ascertain that the analysis of a borrower's repayment capacity include—
   a. an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule;
   b. a repayment schedule that is based on the initial loan amount plus any balance increase that may accrue from a negative amortization provision; and
   c. avoiding an overreliance on credit scores as a substitute for income verification or reliance on the sale or refinancing of the property (pledged as collateral) when amortization begins.
4. Determine whether originated or purchased mortgage loans that combine nontraditional features (such as interest-only loans with reduced documentation and second-lien loans) have mitigating factors (that is, higher credit scores, lower LTVs and DTI repayment ratios, significant liquid assets, mortgage insurance, or other credit enhancements) that support the underwriting decisions and the borrower's repayment capacities.
5. Verify that the banking organization has clear loan underwriting policies governing the use of—
   a. reduced documentation of the borrower's financial capacity (for example, nonverification of reported income when the borrower's income can be documented based on recent W-2 statements, pay stubs, or tax returns),
   b. minimal or no owner's equity for second-lien home equity lines of credit (such loans generally should not have a payment structure allowing for delayed or negative amortization without other significant risk-mitigating factors),
   c. introductory interest rates (banking organizations should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates),
   d. subprime lending (adherence to the interagency guidance on subprime lending),[23] and
   e. non-owner-occupied investor loans (qualifications should be based on the borrower's ability to service the debt over the life of the loan, which would include a combined LTV ratio that considers negative amortization and sufficient borrower equity, and continuing cash reserves).

Portfolio and Risk-Management Practices

1. If the banking organization originates or invests in nontraditional mortgage loans, determine if more robust risk-management practices have been adopted to manage the exposures.
   a. Verify that there are appropriate written lending policies that have been adopted and are being used and monitored, specifying acceptable product attributes, production and portfolio limits (growth and volume limits by loan type), sales and securitization practices, and risk-management expectations (acceptable levels of risk).
   b. Determine if enhanced performance measures have been designed and if there is management reporting that provides an early warning for increasing risk.
   c. Find out if the appropriate ALLL levels have been established that consider the credit quality of the portfolio and the conditions that affect collectibility.
   d. Evaluate whether adequate capital is maintained at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility.
   e. Determine if capital is held commensurate with the risk characteristics of the banking organization's nontraditional mortgage loan portfolios.
2. If the banking organization has concentrations in nontraditional mortgage products, determine if there are—
   a. well-developed monitoring systems and risk-management practices, which monitor and keep track of concentrations in

23. See SR-01-4 and SR-99-6.

key portfolio segments, such as by loan type, third-party originations, geographic area, and property occupancy status, and
  b. systems that also monitor key portfolio characteristics: non-owner-occupied investor loan and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features.
3. Determine if the banking organization has adequate quality controls and compliance and audit procedures that focus on mortgage lending activities posing high risk.
   a. Determine if the banking organization has strong internal controls over accruals, customer service, and collections.
   b. Verify that policy exceptions made by servicing and collections personnel are carefully monitored and that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk.
   c. Find out if the quality control function regularly reviews (1) a sample of nontraditional mortgage loans from all origination channels and (2) a representative sample of underwriters confirming that underwriting policies are followed.
4. Bank oversight of third-party originators—
   a. determine if the banking organization has strong systems and controls in place for establishing and maintaining relationships with third-party nontraditional mortgage loan originators, including procedures for due diligence, and
   b. find out if the oversight of third-party mortgage loan origination lending practices includes monitoring the quality of originations (that is, the quality of origination sources, key borrower characteristics, appraisals, loan documentations, and credit repayment histories) so that they are reflective of the banking organization's lending standards and in compliance with applicable laws and regulations.
5. Determine if the banking organization's risk-management practices are commensurate with the nature, volume, and risk of its secondary-market activities.
   a. Find out if there are comprehensive formal strategies for managing the risks arising from significant secondary-market activities.
   b. Ascertain if contingency planning includes how the banking organization will respond to a decline in loan demand in the secondary market.
   c. Determine if there were any repurchases of defaulted mortgages and if the banking organization complies with its risk-based capital guidelines.
6. Evaluate the appropriateness of management information and reporting systems for the level and nature of the banking organization's mortgage lending activity.
   a. Verify that the reporting allows management to detect changes in the risk profile, or deteriorating performance, of its nontraditional mortgage loan portfolio.
   b. Determine if management information is reported and available by loan type, risk-layering features, underwriting characteristics, and borrower performance.
   c. Find out if—
      1) portfolio volume and performance are tracked against expectations, internal lending standards, and policy limits;
      2) volume and performance expectations are established at the subportfolio and aggregate portfolio levels;
      3) variance analyses are regularly performed to identify exceptions to policies and prescribed thresholds; and
      4) qualitative analyses are performed when actual performance deviates from established policies and thresholds.
7. Determine if the banking organization, based on the size and complexity of its lending operations, performs sensitivity analysis on its key portfolio segments to identify and quantify events that may increase its risks in a segment or the entire portfolio.
8. Verify that the scope of the sensitivity analysis includes stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the banking organization's immediate control.
9. Find out if the stress testing results provide direct feedback for determining underwriting standards, product terms, portfolio concentration limits, and capital levels.
10. Determine if the banking organization has established an appropriate ALLL for the estimated credit losses and commensurate capital levels for the risk inherent in its nontraditional mortgage loan portfolios (considering the higher risk of loss posed by the layered risks).
11. If the banking organization has material

mortgage banking activities and mortgage servicing assets—

a. evaluate whether sound practices were applied in valuing the mortgage servicing rights for its nontraditional mortgages and
b. ascertain if the valuation process followed the nontraditional mortgage and other interagency guidance and generally accepted accounting principles, and whether reasonable and supportable assumptions were used.

3071.0.1 INTERAGENCY ADVISORY ON ACCOUNTING AND REPORTING FOR COMMITMENTS TO ORIGINATE AND SELL MORTGAGE LOANS

On May 3, 2005, the Federal Reserve and the other federal financial institution regulatory agencies[1] (the agencies) issued an Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans.[2] (See SR-05-10.)

The advisory provides guidance on the appropriate accounting and reporting for commitments to—

- originate mortgage loans that will be *held for resale,* and
- sell mortgage loans under mandatory-delivery and best-efforts contracts.

Commitments to originate mortgage loans that will be held for resale are derivatives and must be accounted for at fair value on the balance sheet by the issuer. All loan-sales agreements, including both mandatory-delivery and best-efforts contracts, must be evaluated to determine whether the agreements meet the definition of a derivative under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by Statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" (collectively, FAS 133). A financial institution should also account for loan-sales agreements that meet the definition of a derivative at fair value on the balance sheet.

The advisory discusses the characteristics that should be considered in determining whether mandatory-delivery and best-efforts contracts are derivatives and the accounting and regulatory reporting treatment for both commitments to originate mortgage loans that will be held for resale and those loan-sales agreements that meet the definition of a derivative. The advisory also addresses the guidance that should be considered in determining the fair value of derivatives.

The advisory provides additional guidance on the application of FAS 133. Financial institutions, including those that are *not* required to file reports with the Securities and Exchange Commission (SEC), are expected to follow the guidance in SEC Staff Accounting Bulletin No. 105, "Application of Accounting Principles to Loan Commitments" (SAB 105).[3]

A financial institution is expected to account for and report derivative loan commitments and forward loan-sales commitments as derivatives in accordance with generally accepted accounting principles (GAAP), which include the use of valuation techniques that are reasonable and supportable in the determination of fair value. An institution's failure to account for and report derivative loan commitments and forward loan-sales commitments in regulatory reports in accordance with GAAP may be an unsafe and unsound practice.

3071.0.1.1 Accounting and Reporting

3071.0.1.1.1 Accounting Policies

Well-managed financial institutions have written and consistently applied accounting policies for commitments to originate mortgage loans that will be held for resale and to sell mortgage loans under mandatory-delivery and best-efforts contracts, including approved valuation methodologies and procedures to formally approve changes to those methodologies. The methodologies should be reasonable, objectively supported, and fully documented. Procedural discipline and consistency are key concepts in any valuation-measurement technique. Institutions should ensure that internal controls, including effective independent review or audit, are in place to provide integrity to the valuation process. Institutions' practices should, therefore, reflect these concepts to ensure the reliability of their valuations of derivative loan commitments and forward loan-sales commitments.

3071.0.1.1.2 Derivative Loan Commitments

A financial institution should account for deriva-

1. The agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

2. The guidance in the interagency advisory is also intended to apply to financial-statement reporting by bank holding companies.

3. Staff accounting bulletins (SABs) summarize the views of the SEC's staff regarding the application of generally accepted accounting principles.

tive loan commitments at fair value on the balance sheet, regardless of the manner in which the intended sale of the mortgage loans will be executed (e.g., under a best-efforts contract, a mandatory-delivery contract, or the institution's own securitization). An institution should report each fixed, adjustable, and floating derivative loan commitment as an "other asset" or an "other liability" in their regulatory reports based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.[4]

With respect to floating derivative loan commitments, because the interest rate on such a commitment "floats" on a daily basis with market interest rates, the fair value of a floating derivative loan commitment approximates zero as long as the creditworthiness of the borrower has not changed. However, as with other derivative loan commitments, an institution must report the entire gross notional amount of floating derivative loan commitments in its regulatory reports.

Commitments to originate mortgage loans that will be held for investment purposes and commitments to originate other types of loans are not within the scope of FAS 133 and, therefore, are not accounted for as derivatives.[5] An institution should report the unused portion of these types of commitments, which are *not* considered derivatives, as "unused commitments" in its regulatory reports.

3071.0.1.1.3 Forward Loan-Sales Commitments

A financial institution should account for forward loan-sales commitments for mortgage loans as derivatives at fair value on the balance sheet. Each forward loan-sales commitment should be reported as an "other asset" or an "other liability" based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.[6]

3071.0.1.1.4 Netting of Contracts

For balance-sheet-presentation purposes, FAS 133 does not provide specific guidance on financial-statement presentation.[7] A financial institution may not offset derivatives with negative fair values (liabilities) against those with positive fair values (assets), unless the criteria for "netting" under GAAP have been satisfied.[8] In addition, an institution may not offset the fair value of forward loan-sales commitments against the fair value of derivative loan commitments (the pipeline) or mortgage loans held for sale (warehouse loans). Rather, forward loan-sales commitments must be accounted for separately at fair value, and warehouse loans must be accounted for at the lower of cost or fair value (commonly referred to as "LOCOM")[9] with certain adjustments to the cost basis of the loans if hedge accounting is applied.

3071.0.1.1.5 Hedge Accounting

A financial institution should follow the guidance in FAS 133 when applying hedge accounting to its mortgage banking activities. If the FAS 133 qualifying criteria are met, an institution may apply—

- fair-value hedge accounting in a hedging relationship between forward loan-sales commitments (the hedging instrument) and fixed-rate warehouse loans (the hedged item), or
- cash-flow hedge accounting in a hedging relationship between forward loan-sales com-

4. When preparing Reports of Condition and Income (Call Reports) and the Consolidated Financial Statements for Bank Holding Companies (BHC reports), fixed, adjustable, and floating derivative loan commitments should not be reported as unused commitments in Schedule RC-L, Derivatives and Off-Balance Sheet Items (Schedule HC-1 for bank holding companies), because such commitments are to be reported as derivatives in this schedule.

5. See FAS 133, paragraph 10(i).

6. Regardless of whether the underlying mortgage loans will be held for investment or for resale, commitments to purchase mortgage loans from third parties under either mandatory-delivery contracts or best-efforts contracts are derivatives if, upon evaluation, the contracts meet the definition of a derivative under FAS 133. An institution should report its loan-purchase commitments that meet the definition of a derivative at fair value on the balance sheet.

7. That is, FAS 133 does not provide specific guidance where, in the financial statements, the fair value of derivatives or the changes in the fair value of derivatives should be classified and presented on the financial statement.

8. When an institution has two (or more) derivatives with the same counterparty, contracts with positive fair values and negative fair values may be netted if the conditions set forth in FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts" (FIN 39), are met. Those conditions are as follows: (1) each of the parties owes the other determinable amounts; (2) the reporting party has the right to set off the amount owed with the amount owed by the other party; (3) the reporting party intends to set off; and (4) the right of setoff is enforceable at law. In addition, without regard to the third condition, fair-value amounts recognized for derivative contracts executed with the same counterparty under a master netting arrangement may be offset.

9. See Statement of Financial Accounting Standards No. 65, "Accounting for Certain Mortgage Banking Activities" (FAS 65), paragraph 4.

mitments (the hedging instrument) and the forecasted sale of the warehouse loans and/or the loans to be originated under derivative loan commitments (the forecasted transaction).[10]

If a financial institution does not apply hedge accounting, either because the FAS 133 hedge criteria are not met or the institution chooses not to apply hedge accounting, forward loan-sales commitments should be treated as nonhedging derivatives. If hedge accounting is not applied, an institution will account for its warehouse loans at the lower of cost or fair value. Because nonhedging forward loan-sales commitments are accounted for at fair value through earnings, such an approach causes volatility in reported earnings if the fair value of the warehouse loans increases above their cost basis. In this situation, the volatility is a result of recognizing the full amount of any decline in the fair value of the forward loan-sales commitments in earnings while not adjusting the carrying amount of the warehouse loans above their cost basis.

3071.0.1.1.6 Income-Statement Effect

Unless cash-flow hedge accounting is applied, a financial institution should include the periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments in current-period earnings. An institution should report these changes in fair value in either "other non-interest income" or "other non-interest expense," but not as trading revenue, in their regulatory reports. However, an institution's decision as to whether to report the changes in fair value in its regulatory reports in an income or expense line item should be consistent with its presentation of these changes in its general-purpose external financial statements (including audited financial statements)[11] and should be consistent from period to period.

3071.0.1.2 Valuation

3071.0.1.2.1 Fair Value

FAS 133 indicates that the guidance in Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments" (FAS 107), should be followed in determining the fair value of derivatives.[12] That guidance provides that quoted market prices are the best evidence of the fair value of financial instruments. However, when quoted market prices are not available, which is typically the case for derivative loan commitments and forward loan-sales commitments, estimates of fair value should be based on the best information available in the circumstances (e.g., valuation techniques based on estimated expected future cash flows). When expected future cash flows are used, they should be the institution's best estimate based on reasonable and supportable assumptions and projections.

Estimates of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. In the absence of (1) quoted market prices in an active market, (2) observable prices of other current market transactions, or (3) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of an arrangement.

A financial institution should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data.[13] Based on this guidance, derivative loan commitments generally would have a zero fair value at inception.[14] However, subsequent changes in the fair value of a derivative loan commitment must be recognized in financial statements and regulatory reports (e.g., changes in fair value attributable to changes in market interest rates).

When estimating the fair value of derivative loan commitments and those best-efforts contracts that meet the definition of a derivative, a

10. See FAS 133, paragraphs 20–21, and related FAS 133 guidance for hedging instruments, hedged items, and forecasted transactions that qualify for fair-value and cash-flow hedge accounting.

11. See footnote 7.

12. See FAS 133, paragraph 17.

13. See footnote 3 in Emerging Issues Task Force Issue No. 02-3 (EITF 02-3), "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

14. If a potential borrower pays the lender a fee upon entering into a derivative loan commitment (e.g., a rate-lock fee), there is a transaction price, and the lender should recognize the derivative loan commitment as a liability at inception using an amount equal to the fee charged to the potential borrower.

financial institution should consider predicted "pull-through" (or, conversely, "fallout") rates. A pull-through rate is the probability that a derivative loan commitment will ultimately result in an originated loan. Some factors that may be considered in arriving at appropriate pull-through rates include (but are not limited to) the origination channel (which may be either internal [retail] or external [wholesale or correspondent, to the extent the institution rather than the correspondent closes the loan]),[15] current mortgage interest rates in the market versus the interest rate incorporated in the derivative loan commitment, the purpose of the mortgage (purchase versus refinancing), the stage of completion of the underlying application and underwriting process, and the time remaining until the expiration of the derivative loan commitment. Estimates of pull-through rates should be based on historical information for each type of loan product adjusted for potential changes in market interest rates that may affect the percentage of loans that will close. An institution should not consider the pull-through rate when reporting the notional amount of derivative loan commitments in regulatory reports but, rather, must report the entire gross notional amount.

3071.0.1.2.2 SAB 105

In March 2004, the SEC issued SAB 105 to provide guidance on the proper accounting and disclosures for derivative loan commitments. SAB 105 is effective for derivative loan commitments entered into after March 31, 2004. SAB 105 indicates that the expected future cash flows related to the associated servicing of loans should not be considered in recognizing derivative loan commitments. Incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. Servicing assets should only be recognized when the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.[16] Further, no other internally developed intangible assets (such as customer-relationship intangible assets) should be recognized as part of derivative loan commitments. Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a derivative loan commitment either individually, in a portfolio, or in a business combination).

15. If an institution commits to purchase a loan that will be closed by a correspondent in the correspondent's name, the institution would have a loan-purchase commitment rather than a derivative loan commitment. See footnote 6.

16. See Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," paragraph 61.

3071.0.1.3 Standard-Setter Activities

Financial institutions should be aware that the SEC or the Financial Accounting Standards Board (FASB) may issue additional fair-value, measurement, or recognition guidance in the future (e.g., a fair-value measurement statement). To the extent that additional guidance is issued, institutions must also consider the guidance in developing fair-value-estimate methodologies for derivative loan commitments and forward loan-sales commitments as well as measuring and recognizing such derivatives.

3071.0.1.4 Changes in Accounting for Derivative Loan Commitments and Loan-Sales Agreements

Financial institutions should follow Accounting Principles Board Opinion No. 20 (APB 20), "Accounting Changes,"[17] if a change in their accounting for derivative loan commitments, best-efforts contracts, or mandatory-delivery contracts is necessary. APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states, "Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

For regulatory reporting purposes, a financial institution must determine whether the reason for a change in its accounting meets the APB 20 definition of an accounting error. If the reason for the change meets this definition, the error should be reported as a prior-period adjustment if the amount is material. Otherwise, the effect of the correction of the error should be reported in current earnings.

If the effect of the correction of the error is

17. Effective December 15, 2005, APB 20 will be replaced by FASB Statement No. 154, "Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3."

material, a financial institution should also consult with its primary federal regulatory agency to determine whether any of its prior regulatory reports should be amended. If amended regulatory reports are not required, the institution should report the effect of the correction of the error on prior years' earnings, net of applicable taxes, as an adjustment to the previously reported beginning balance of equity capital. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," with an explanation in Schedule RI-E, item 4.

The effect of the correction of the error on income and expenses since the beginning of the year in which the error is corrected should be reflected in each affected income and expense account on a year-to-date basis beginning in the next quarterly income statement (Call Report) to be filed and not as a direct adjustment to retained earnings.

3071.0.1.5 Definitions of Terms Used in the Advisory

3071.0.1.5.1 Derivative Loan Commitment

The term *derivative loan commitment* refers to a lender's commitment to originate a mortgage loan that will be held for resale. Notwithstanding the characteristics of a derivative set forth in FAS 133, these commitments to originate mortgage loans *must* be accounted for as derivatives by the issuer under FAS 133 and include, but are not limited to, those commonly referred to as *interest-rate-lock commitments.*

In a derivative loan commitment, the lender agrees to extend credit to a borrower under certain specified terms and conditions in which the interest rate and the maximum amount of the loan[18] are set prior to or at funding. Under the agreement, the lender commits to lend funds to a potential borrower (subject to the lender's approval of the loan) on a fixed- or adjustable-rate basis, regardless of whether interest rates change in the market, or on a floating-rate basis. In a typical derivative loan commitment, the borrower can choose to—

- "lock in" the current market rate for a fixed-rate loan (i.e., a fixed derivative loan commitment),
- "lock in" the current market rate for an adjustable-rate loan that has a specified formula for determining when and how the interest rate will adjust (i.e., an adjustable derivative loan commitment), or
- wait until a future date to set the interest rate and allow the interest rate to "float" with market interest rates until the rate is set (i.e., a floating derivative loan commitment).

Derivative loan commitments vary in term and expire after a specified time period (e.g., 60 days after the commitment date). Additionally, derivative loan commitments generally do not bind the potential borrower to obtain the loan, nor do they guarantee that the lender will approve the loan once the creditworthiness of the potential borrower has been determined.

3071.0.1.5.2 Forward Loan-Sales Commitment

The term *forward loan-sales commitment* refers to either (1) a mandatory-delivery contract or (2) a best-efforts contract that, upon evaluation under FAS 133, meets the definition of a derivative.

3071.0.1.5.3 Mandatory-Delivery Contract

A *mandatory-delivery contract* is a loan-sales agreement in which a financial institution commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the institution fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a "pair-off" fee, based on then-current market prices, to the investor to compensate the investor for the shortfall. Variance from the originally committed principal amount is usually permitted, but typically may not exceed 10 percent of the committed amount.

All loan-sales agreements must be evaluated to determine whether they meet the definition of a derivative under FAS 133.[19] A mandatory-

18. In accordance with the "Background Information and Basis for Conclusions" in Statement of Financial Accounting Standards No. 149 (FAS 149), the notional amount of a derivative loan commitment is the maximum amount of the borrowing. See FAS 149, paragraph A27.

19. See FAS 133, paragraph 6, for the characteristics of a financial instrument or other contract that meets the definition of a derivative.

delivery contract has a specified underlying (the contractually specified price for the loans) and notional amount (the committed loan-principal amount), and requires little or no initial net investment. Additionally, a mandatory-delivery contract requires or permits net settlement or the equivalent thereof as the institution is obligated under the contract to either deliver mortgage loans or pay a pair-off fee (based on the then-current market prices) on any shortfall on the delivery of the committed loan-principal amount. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the mortgage loans to be delivered are considered readily convertible to cash.[20] Based on these characteristics, a mandatory-delivery contract meets the definition of a derivative at the time an institution enters into the commitment.

3071.0.1.5.4 Best-Efforts Contract

The term *best-efforts contract* refers to a loan-sales agreement in which a financial institution commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. Generally, the price the investor will pay the seller for an individual loan is specified prior to the loan being funded (e.g., on the same day the lender commits to lend funds to a potential borrower). A best-efforts contract that has all of the following characteristics would meet the definition of a derivative:

- an underlying (e.g., the price the investor will pay the seller for an individual loan is specified in the contract)
- a notional amount (e.g., the contract specifies the principal amount of the loan as an exact dollar amount or as a principal range with a determinable maximum amount)[21]
- requires little or no initial net investment (e.g., no fees are exchanged between the seller and investor upon entering into the agreement, or a fee that is similar to a premium on other option-type contracts is exchanged)
- requires or permits net settlement or the equivalent thereof (for example, the seller is contractually obligated to either (1) deliver the loan to the investor if the loan closes or (2) pay a pair-off fee, based on then-current market prices, to the investor to compensate the investor if the loan closes and is not delivered. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the loan to be delivered is considered readily convertible to cash.).

3071.0.1.5.5 Master Agreement

A financial institution may enter into one of several types of arrangements with an investor to govern the relationship between the institution and the investor and set the parameters under which the institution will deliver individual mortgage loans through separate best-efforts contracts. Such an arrangement might include, for example, a *master agreement* or an *umbrella contract.* These arrangements may specify an overall maximum principal amount of mortgage loans that the institution may deliver to the investor during a specified time period, but generally they do not specify the price the investor will pay for individual loans. Further, while these arrangements may include pair-off-fee provisions for loans to be sold under individual best-efforts contracts covered by the arrangements, the seller is neither contractually obligated to deliver the amount of mortgages necessary to fulfill the maximum principal amount specified in the arrangement nor required to pay a pair-off fee on any shortfall. Because these arrangements generally either do not have a specified underlying or determinable notional amount or do not require or permit net settlement or the equivalent thereof, the arrangements typically do not meet the definition of a derivative. As discussed above, an individual best-efforts contract governed by one of these arrangements may, however, meet the definition of a derivative.

As the terms of individual best-efforts contracts and master agreements or umbrella contracts vary, a financial institution must carefully evaluate such contracts to determine whether the contracts meet the definition of a derivative in FAS 133.

20. See FAS 133, paragraph 57(c)(1), for a description of contracts that have terms that implicitly or explicitly require or permit net settlement.

21. The use of a maximum amount as the notional amount of a best-efforts contract is consistent with the loan-commitment discussion in the "Background Information and Basis for Conclusions" in FAS 149. See FAS 149, paragraph A27.

3071.0.1.6 Example of the Accounting for Commitments to Originate and Sell Mortgage Loans[22]

3071.0.1.6.1 ABC Mortgage Financial Institution (Best-Efforts Contracts and No Application of Fair-Value Hedge Accounting)

The following simplified example was developed to provide a financial institution that has a limited number of derivative loan commitments general guidance on one approach that may be used to value such commitments.[23] This example also illustrates the regulatory reporting requirements for derivative loan commitments and forward loan-sales commitments.

The guidance in this example is for illustrative purposes only, as there are several ways that a financial institution might estimate the fair value of its derivative loan commitments. A second approach to valuing derivative loan commitments is described in *Derivative Loan Commitments Task Force Illustrative Disclosures on Derivative Loan Commitments,* a practice aid developed by staff of the American Institute of Certified Public Accountants (AICPA) and a task force comprising representatives from the financial services, mortgage banking, and public accounting communities.[24] As indicated in the body of the interagency advisory, a financial institution must consider the guidance in FAS 133, FAS 107, EITF 02-3, and SAB 105 in measuring and recognizing derivative loan commitments and forward loan-sales commitments. In addition, an institution should be aware that the SEC or FASB may issue additional guidance in the future that may alter certain aspects of this example.

3071.0.1.6.1.1 Background

ABC Mortgage Financial Institution (ABC) enters into fixed, adjustable, and floating derivative loan commitments to originate mortgage loans that it intends to sell. The institution accounts for the commitments as derivative financial instruments as required under FAS 133.

ABC enters into best-efforts contracts with a mortgage investor under which it commits to deliver certain loans that it expects to originate under derivative loan commitments (i.e., the pipeline) and loans that it has already originated and currently holds for sale (i.e., warehouse loans). ABC and the mortgage investor agree on the price that the investor will pay ABC for an individual loan with a specified principal amount prior to the loan being funded. Once the price that the mortgage investor will pay ABC for an individual loan and the notional amount of the loan are specified, and ABC is obligated to deliver the loan to the investor if the loan closes, the contract represents a forward loan-sales commitment. Under FAS 133, ABC accounts for these forward loan-sales commitments as derivative financial instruments.

On December 31 of a given year, the notional amounts of ABC's mortgage banking derivative loan commitments and forward loan-sales commitments are as follows:

Table 1—Notional Amounts of Derivative Loan Commitments and Forward Loan-Sales Commitments

	Notional amount
Derivative loan commitments	
Fixed-rate commitments	$ 8,500,000
Adjustable-rate commitments	1,500,000
Floating-rate commitments	2,000,000
Total derivative loan commitments	$12,000,000 [A][25]

22. This example uses the definitions and concepts presented in the body of the Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (the interagency advisory). Refer to the interagency advisory for clarification of the terms and concepts used in this example.

23. Estimating fair values when quoted market prices are unavailable requires considerable judgment. Valuation techniques using simplified assumptions may sometimes be used (with appropriate disclosure in the financial statements) to provide a reliable estimate of fair value at a reasonable cost. See FAS 107, paragraphs 60–61.

24. The practice aid is available at www.aicpa.org/download/members/div/acctstd/Illustrative_Disclosure_on_Derivative_Loan_Commitments.pdf.

25. Alpha references in table 1 and the text of this example refer to the "Reference" column in table 3.

Table 1—continued

	Notional amount	
Forward loan-sales commitments		
Pipeline loan commitments	$12,000,000	
Warehouse loan commitments	8,000,000	
Total forward loan-sales commitments	$20,000,000	[B]

Market interest rates have changed throughout the time period that ABC's derivative loan commitments and forward loan-sales commitments have been outstanding. Some of the fixed-rate commitments are at rates above current market rates while others are at rates at or below current market rates. All of ABC's adjustable-rate commitments are at rates below current market rates.

Based on its past experience, ABC estimates a pull-through rate of 70 percent on its fixed-rate commitments for which the locked-in rate is above current market rates (i.e., 70 percent of the commitments will actually result in loan originations) and a pull-through rate of 85 percent for its fixed-rate commitments for which the locked-in rate is at or below current market rates. ABC also estimates a pull-through rate of 85 percent for all of its adjustable-rate commitments that are below market rates.

The pull-through-rate assumptions in this example have been simplified for illustrative purposes. In determining appropriate pull-through rates, a financial institution must consider all factors that affect the probability that derivative loan commitments will ultimately result in originated loans. Therefore, an institution is expected to have more granularity (i.e., stratification) in its application of pull-through-rate assumptions to its derivative loan commitments.

3071.0.1.6.1.2 Discussion of ABC's Approach to Valuing Derivative Loan Commitments and Forward Loan-Sales Commitments

ABC estimates the fair value of its derivative loan commitments using the best information available in the circumstances because quoted market prices are not available. In this case, ABC uses valuation techniques that take into account current secondary-market loan pricing information.[26] ABC had noted the appropriate reference price for the underlying loans on the day that each derivative loan commitment was given to a borrower, and assigned an initial fair value of zero to each loan commitment consistent with the guidance in SAB 105 and EITF 02-3. At the end of the month, ABC compares the current reference price of each underlying loan with its initial reference price and calculates the price difference. ABC then calculates the fair value of these derivatives by multiplying the price difference by the estimated pull-through rate. This approach is illustrated in table 2.

As illustrated in table 2, ABC excludes time value from its fair-value-estimate methodology due to the short-term nature of the derivative loan commitments. As the exclusion of time value is not appropriate for all fair-value estimates, an institution must consider the terms of its specific agreements in determining an appropriate estimation methodology.

In the example in table 2, ABC estimated the initial reference price of the underlying loan to be originated under the commitment, excluding the value of the associated servicing rights, to be $100,000. That is, at the date it entered into the fixed derivative loan commitment with the borrower, ABC estimated it would receive $100,000, excluding the value of the associated servicing rights, if the underlying loan was funded and sold in the secondary market on that day. Because this amount is equal to the notional amount of the loan, ABC would not experience a gain or loss on the sale of the underlying loan (before considering the effect of the loan-origination fees and costs associated with the loan). As such, the fair value of this derivative loan commitment would be zero, and there would not be any unrealized gain or loss at the inception of the derivative loan commitment. This may not be true for all derivative loan commitments.

ABC defers all unrealized gains and losses at the inception of its derivative loan commitments until the underlying loans are sold. ABC's policy is based on the short-term nature of its

26. In general, source data for secondary-market loan-pricing information may include, for example, quotations from rate sheets; brokers; or electronic systems such as those provided by third-party vendors, market makers, or mortgage loan investors. When secondary-market loan-pricing information that includes the value of servicing rights is used, the fair value of the derivative loan commitments ultimately must exclude any value attributable to servicing rights.

Table 2—ABC's Calculation of the Fair Value of Derivative Loan Commitments: An Example of a Fixed Derivative Loan Commitment for Which the Locked-In Rate Is Above the Current Market Rate*

Notional amount of loan	*Initial reference price of loan to be originated under commitment—excluding servicing rights*	*Current reference price of loan to be originated under commitment—excluding servicing rights*	*Price difference*	*Pull-through rate*	*Fair value of derivative loan commitment*
(1)	(2)	(3)	[(3) - (2)]	(4)	[(3) - (2)] × (4)
$100,000	$100,000	$100,500	$500	70%	$350

* The example in this table presents the fair-value calculation for one derivative loan commitment. The fair value of this derivative, which is positive, would be added to all the other derivative loan commitments with positive fair values. Netting derivatives with positive fair values (assets) against derivatives with negative fair values (liabilities) is not permitted unless the conditions stipulated in FIN 39 are met. Refer to footnote 8.

derivative loan commitments and was adopted in order to not accelerate the timing of gain recognition. As this practice may not be appropriate for all derivative loan commitments or other derivatives initially accounted for under EITF 02-3, and due to the lack of authoritative guidance in this area, an institution should consult with its accounting advisers concerning the appropriate accounting for its specific agreements.

After applying the methodology described above to individual derivative loan commitments, ABC aggregates the fair values of the derivative loan commitments by type (i.e., fixed, adjustable, and floating) and by whether the commitments have above-, at-, or below-market rates. The fair values of the fixed derivative loan commitments with above-market rates, adjusted for the appropriate pull-through rate, total $21,000 [C], which represents an asset. The aggregate fair value of the fixed derivative loan commitments that have at- or below-market rates, adjusted for the appropriate pull-through rate, sums to ($31,000) [D], which represents a liability. For the adjustable derivative loan commitments, the aggregate fair value, adjusted for the pull-through rate, is approximately ($2,000) [E], which is also a liability. The fair value of the floating derivative loan commitments approximates zero.

ABC also estimates the fair value of its forward loan-sales commitments outstanding at the end of the month using a similar methodology as that described above. Based upon this information, ABC determines that the estimated fair value of the forward loan-sales commitments related to its derivative loan commitments and warehouse loans with above-market rates is approximately ($45,000) [F], which represents a liability, because current market interest rates for comparable mortgage loans are lower than the rates in effect when the derivative loan commitments were initiated. (Consequently, current offered delivery prices for similar commitments are greater than the delivery prices of ABC's existing forward loan-sales commitments. Therefore, the change in the fair value of ABC's forward loan-sales commitments since they were entered into represents a loss.) The fair value of ABC's forward loan-sales commitments related to its derivative loan commitments and warehouse loans with at- or below-market rates is estimated to be $50,000, which is an asset.[27]

3071.0.1.6.1.3 Regulatory Reporting

The following table illustrates the regulatory reporting requirements for the derivative-related dollar amounts cited in the example.

As illustrated in table 3, depending upon particular market circumstances, individual derivative loan commitments and forward loan-sales

27. The absolute value of the fair value of the forward loan-sales commitments is greater than the absolute value of the fair value of the related derivative loan commitments because the forward loan-sales commitments also apply to, and act as an economic hedge of, ABC's warehouse loans. ABC accounts for its warehouse loans at the lower of cost or fair value in accordance with FAS 65. In this example, ABC does not apply hedge accounting to its warehouse loans.

Table 3—Regulatory Reporting Implications for Derivative Loan Commitments and Forward Loan-Sales Commitments

	Amount	*Reference*
Derivative loan commitments		
Notional amount of "over-the-counter written options"[28]	$12,000,000	[A]
Derivatives with a *positive* fair value held for purposes other than trading (asset)	$21,000	[C]
Derivatives with a *negative* fair value held for purposes other than trading (liability)	$33,000	[D + E]
Forward loan-sales commitments		
Notional amount of "forward contracts"	$20,000,000	[B]
Derivatives with a *positive* fair value held for purposes other than trading (asset)	$50,000	[G]
Derivatives with a *negative* fair value held for purposes other than trading (liability)	$45,000	[F]
Derivative loan commitments and forward loan-sales commitments		
Total notional amount of derivative contracts held for purposes other than trading	$32,000,000	[A + B]

commitments may have either positive or negative fair values, which ABC properly reports gross as assets or liabilities on its balance sheet. In addition, for regulatory reporting purposes, ABC consistently reports the periodic *changes* in the fair value of its derivative contracts in "other non-interest expense" in its income statement. Alternatively, ABC could have chosen to consistently report these fair-value changes in "other non-interest income" in its regulatory reports.

3071.0.2 INSPECTION OBJECTIVE

1. To find out if the bank holding company accounted for and reported the following transactions at their fair value: (1) its commitments to originate mortgage loans that were held for resale (derivatives) and (2) its loan-sales agreements that are derivatives. If so, ascertain if these transactions were accounted for and reported—
   a. in accordance with the instructions for the BHC reports (for example, the FR Y-9C); GAAP; and SR-05-10 and its attached May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and
   b. based on reasonable and supportable valuation techniques as prescribed by the May 3, 2005, interagency advisory.

3071.0.3 INSPECTION PROCEDURES

1. Determine whether the bank holding company has written and consistently applied accounting policies to its commitments to (1) originate mortgage loans that were held for resale and (2) sell mortgage loans under mandatory-delivery and best-efforts contracts.
2. Find out if the bank holding company has developed and uses approved valuation methodologies and procedures to obtain formal approval for changes to those methodologies.
   a. Ascertain whether the valuation methodologies are reasonable, objectively supported, and fully documented.

28. Because derivative loan commitments are in certain respects similar to options, they are reported with "over-the-counter written options" for regulatory reporting purposes.

b. Determine if the bank holding company has internal controls, including an effective independent review or audit, in place that give integrity to the valuation process.
3. If the bank holding company issues fixed-, adjustable-, and floating-rate derivative loan commitments or forward loan-sales commitments, review an adequate sample that evidences the full coverage of these types of transactions.
   a. Ascertain if these transactions were properly reported on the balance sheet as an ''other asset'' or an ''other liability,'' based on whether the individual commitment has a positive (asset) or negative (liability) fair value in accordance with the instructions for the BHC reports.
   b. Determine if the floating-rate derivative loan commitments and other derivative loan commitments were reported at their entire gross notional amount in the BHC's reports (such as the FR Y-9C).
   c. Find out if the balance sheet correctly presents accounts for all such transactions, including the netting of contracts, the application of hedge accounting to mortgage banking activities, the valuation of derivatives, and any material or other accounting changes for derivative loan commitments and loan-sales agreements. Also determine if the bank holding company complies with the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and with GAAP.
   d. Ascertain if periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments are reported in current-period earnings as either ''other non-interest income or ''non-interest expense, as appropriate.
4. Report to the central point of contact or examiner-in-charge any failure by the bank holding company's management to follow (1) the bank holding company's accounting and valuation policies for its commitments to originate mortgage loans that are held for resale and its commitments to sell mortgage loans, (2) the instructions for the Consolidated Financial Statement for Bank Holding Companies, (3) the May 3, 2005, interagency advisory, or (4) GAAP.
5. When additional inspection scrutiny is needed—based on the examination's findings; the supervisory concerns discussed in section 3071.0; the February 23, 2003, Interagency Advisory on Mortgage Banking (see SR-03-4 and its attachment); and the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (see SR-05-10 and its attachment)—consider using the comprehensive mortgage banking examination procedures in the appendix section A.2040.3 of the *Commercial Bank Examination Manual.*

In 1997, the Board amended Regulation Y to include "activities related to extending credit" in section 225.28(b)(2), which includes the following permissible nonbanking activities:

	Section No.
1. real estate and personal property appraising	3270.0
2. arranging commercial real estate equity financing	3220.0
3. check-guaranty services	3320.0
4. collection agency services	3330.0
5. credit bureau services	3340.0
6. asset-management, servicing, and collection activities	3084.0
7. acquiring debt in default	3104.0
8. real estate settlement services[1]	3072.8

1. Real estate settlement services do not include providing title insurance as principal, agent, or broker.

In 1997, the Board incorporated real estate servicing into section 225.28(b)(2) as one of the activities related to extending credit. (See 12 C.F.R. 225.28(b)(2)(viii).) Real estate settlement services do not include providing title insurance as principal, agent, or broker. Previously, the Board had approved the activity by Board order. In the order, the Board found that real estate settlement services consist of—

1. reviewing the status of the title in the title commitment, resolving any exceptions to the title, and reviewing the purchase agreement to identify any requirements that need to be complied with;
2. verifying payoffs on existing loans secured by the real estate and verifying the amount of and then calculating the prorating of special assessments and taxes on the property;
3. obtaining an updated title insurance commitment to the date of closing; preparing the required checks, deeds, and affidavits; and obtaining any authorization letters needed;
4. establishing a time and place for the closing, conducting the closing, and ensuring that all parties properly execute all appropriate documents and meet all commitments;
5. collecting and disbursing funds for the parties, holding funds in escrow pending satisfaction of certain commitments, and preparing the HUD settlement statement, the deed of trust, mortgage notes, the Truth-in-Lending statement, and purchaser's affidavits; and
6. recording all of the documents required under law. (See 1990 FRB 1058.)

3072.8.1 REAL PROPERTY EXCHANGE TRANSACTIONS UNDER SECTION 1031 OF THE INTERNAL REVENUE CODE

A request submitted to the Board on behalf of a bank holding company (BHC) requested an advisory opinion pursuant to section 225.27 of Regulation Y (12 C.F.R. 225.27). The BHC was proposing the acquisition of a subsidiary (the 1031 exchange subsidiary) that provided services to customers seeking to make exchanges of real property pursuant to section 1031 of the Internal Revenue Code (1031 exchange transactions).

Section 1031 of the Internal Revenue Code provides a U.S. taxpayer with deferral of gain when the taxpayer exchanges his or her property for another property of a "like kind." In a "forward" 1031 exchange transaction, the taxpayer first sells his or her existing property and later purchases a replacement property.[1] In order to complete a forward 1031 exchange transaction successfully, a taxpayer must satisfy certain conditions in section 1031 of the Internal Revenue Code and the U.S. Treasury regulations that implement section 1031. For example, in a forward 1031 exchange transaction, at the closing of the sale of the initial property, the proceeds of the sale must be held by an individual or entity otherwise unrelated to the transaction (the qualified intermediary). In addition, the taxpayer engaging in the forward 1031 exchange transaction may not receive the sale proceeds during the period in which a replacement property is identified (up to 45 days) and acquired (up to 180 days). In this request, the BHC was proposing to acquire a subsidiary that would act as a qualified intermediary in forward 1031 exchange transactions involving real property.

The 1031 exchange subsidiary would engage in several activities in order to facilitate forward 1031 exchange transactions. First, the subsidiary would provide its customer with documents related to the exchange to ensure that the exchange qualified as a valid forward 1031 exchange transaction. Specifically, the subsidiary would provide an exchange agreement, an assignment agreement, and a notice. The exchange agreement is a contract between the customer and the subsidiary that, among other features, notes the requirements for the successful completion of the transaction. The assignment agreement transfers from the customer to the subsidiary certain responsibilities for the sale of the initial property and the receipt of sales proceeds in order to ensure that the customer does not "constructively receive" the proceeds of the initial property sale for tax purposes. These responsibilities may include taking the transitory title to the initial property and replacement property as they are transferred from seller to buyer. The notice informs the purchaser of the initial property that the transaction is part of a forward 1031 exchange transaction; it helps establish that the mecha-

1. In a "reverse" 1031 exchange transaction, the taxpayer first purchases a replacement property and later sells his or her property. The proposal did not include the provision of services to customers seeking to make reverse 1031 exchange transactions.

nism for the forward 1031 exchange transaction is in place at the time of the sale.

Second, the 1031 exchange subsidiary would invest the proceeds of the sale of the initial property on behalf of the customer until the customer acquired the replacement property. The proceeds would be invested at the discretion of the subsidiary but would typically be deposited into deposit accounts at the BHC's subsidiary state-chartered commercial bank.[2] The subsidiary would also transfer the necessary funds to the appropriate party to effect the customer's purchase of the replacement property. If the customer does not identify a replacement property or purchase the replacement property within the required time periods set forth in section 1031 of the Internal Revenue Code or U.S. Treasury regulations implementing section 1031, the proceeds of the sale of the initial property would be transferred to the customer. It was represented that the subsidiary would act in a fiduciary capacity in holding, investing, and disbursing the customer's funds and that a state-chartered nondepository trust company would be allowed to engage in the activities of the subsidiary.

The 1031 exchange subsidiary (1) would not participate in negotiating the terms of the real property sale and purchase transactions that constitute the forward 1031 exchange transaction and (2) would not assist the customer in locating a buyer of the initial property or a seller of the replacement property. The requestor also asserted that the proposed services are permissible nonbanking activities for BHCs under section 225.28(b) of Regulation Y (12 C.F.R. 225.28(b)).

In view of all the facts of the record, Board staff opined that the proposed activities of the 1031 exchange subsidiary would be permissible real estate settlement services under section 225.28(b)(2)(viii) of Regulation Y (12 C.F.R. 225.28(b)(2)(viii)); would be trust company functions under section 225.28(b)(5) of Regulation Y (12 C.F.R. 225.28(b)(5)); and would be financial advisory services, including tax-planning and tax-preparation services, under section 225.28(b)(6) of Regulation Y (12 C.F.R. 225.28(b)(6)).[3]

The opinion is limited to the activities relating to the 1031 exchange transaction described in the opinion and in the correspondence exchanged between the requestor and Board staff. See the Board staff's February 9, 2006, legal interpretation.

2. The BHC's commercial bank subsidiary also may be a lender with respect to real properties involved in the 1031 exchange transaction. Any lending relationship between the bank and the customer would depend on the ability of the customer and the loan transaction to meet the bank's standard underwriting terms and conditions.

3. The Office of the Comptroller of the Currency (OCC) authorized national banks to provide a wide range of services to facilitate their customers' 1031 exchange transactions. See OCC Interpretive Letter No. 880 (December 16, 1999) and OCC Corporate Decision No. 2001–30 (October 10, 2001).

3073.0.1 EXPANDED STUDENT-LOAN-SERVICING ACTIVITIES

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of Regulation Y to expand the student-loan-servicing activities of its nonbank subsidiary. The activities would consist of—

1. providing student-loan authorities (the authority) with regular reports that include information in the aggregate and by individual lenders concerning the volume of loans being serviced for the authority and the volume of loans outstanding;
2. preparing projections for approval by the authority of student loans to be purchased and commitments to be issued in the future, based on the volume of loans being serviced and commitments outstanding, consistent with the amount of funds available to the authority as the result of its sale of bonds;
3. advising eligible lenders, borrowers, and other interested parties of the authority's student-loan-purchase program, including the criteria used by the authority in purchasing student loans and the extent to which the authority will be purchasing loans in the future based on the availability of funds; and
4. meeting regularly with the authority to advise it of the nonbank subsidiary's efforts in connection with the student-loan activities.

Under no circumstances would the nonbank subsidiary be authorized to bind the authority or its bank trustee to commit to purchase or actually to purchase student loans from eligible lenders.

The proposed activities were regarded as being equivalent to the activities of a mortgage banking subsidiary of a bank holding company, authorized under section 225.28(b)(1) of Regulation Y, with respect to acquiring and servicing mortgage loans for institutional investors or in connection with the secondary-mortgage market. The activities proposed and currently conducted by the applicant, to the extent that they were different from the services performed by any institution that services loans for others, were perceived as being different only in that they related to servicing student loans for a governmental authority. Banks and their nonbank subsidiaries generally provide comprehensive loan-acquisition and -servicing "packages" for investors in mortgage and other loans. The bank holding company's nonbank subsidiary was the nation's largest servicer of student loans, and was thus particularly well equipped to perform the proposed expanded services.

In addition to determining that the proposed activities were closely related to banking to approve the application, the Board had to conclude that the proposed activities would produce benefits to the public that would outweigh any possible adverse effects, such as unsound banking practices, unfair competition, conflicts of interests, or undue concentration of resources. The Board made that conclusion in addition to determining that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act was favorable. Accordingly, the application was approved on July 1, 1985 (1985 FRB 725).

Section 4(c)(8) of the BHC Act (Servicing Loans)

A bank holding company or its subsidiary may engage in the activity of servicing loans or other extensions of credit for either affiliated companies or for persons or institutions not affiliated with the holding company. The service will often be carried on as an additional activity of a credit-extending subsidiary, such as a mortgage company, where the loan serviced was originated by the subsidiary and subsequently sold to an investor. A servicing company provides the collection vehicle through receipt and disbursement of funds for investors who may not possess the resources to accomplish the activity. The purpose of servicing is to keep a sound loan in good standing for a passive investor. The servicing company's remuneration is usually based upon a percentage of the outstanding balance of the loan.

The traditional servicing arrangement arises from the normal business of a mortgage company. The company grants extensions of credit to qualified borrowers and subsequently packages and sells these loans, normally without recourse, to individuals or institutional investors who contract the collection of the credit to the mortgage company. The company may also purchase mortgages or other extensions of credit in the open market with the intention of reselling the credit and retaining the servicing or can simply purchase servicing portfolios (12 C.F.R. 225.132). The collection itself is basically a bookkeeping function.

Servicing loans for others is relatively risk-free to the company when the credits are sold without recourse to investors. A credit which has been sold with recourse represents an unusual circumstance and should, therefore, be reviewed in detail. The serviced loans will generally be high quality mortgages which are in turn purchased from the company by passive investors desiring a fixed rate of return on their funds. The risk to a servicing company lies in its portfolio of unsold loans, or its "warehouse." The risk is two-fold: (1) the loan may not be of high enough quality to attract an investor so that the servicing company will have to continue to carry the credit for its own account, and (2) the loan was made at an interest rate which is below current market rates. In the latter case, the servicing company must either sell the loan at a discount or continue to hold the credit for its own account. In either case, the loan is treated as an asset of the company and involves credit risk.

The inspection of a servicing company, or a servicing department of a credit-extending subsidiary, should focus on adequacy of documentation and controls, and on the quality and marketability of the warehoused loans. The examiner should obtain a past due report for the portfolio and note in the inspection report significant credits which are past due together with the period of delinquency, the type of loan, and the asset classification, if any. The nature of the servicing business is such that the number of past dues should be small because loans are only warehoused for a short period of time until they can be sold to an investor. As a rule, a past due loan or a current loan which has been warehoused for more than several months is indicative of some problem with the credit. Each loan should be evaluated to determine the reason it has not been sold.

During periods of rising long-term interest rates, the warehouse portfolio becomes subject to the risk that a loan may not be marketable, except at a discount, because of its relatively low yield. This affects both the servicer's income and liquidity.

In the case of the parent company acting as a servicer, the inspection should also determine whether the activity is being carried on under the proper exemption. A bank holding company may act as a servicer under section 4(c)(8) of the Act or under the provisions of sections 4(a)(2) and/or 4(c)(1) of the Act. If carried on under Section 4(a)(2) of the BHC Act, the holding company is limited to servicing loans only for its own account or its banking and nonbanking subsidiaries. If carried under Section 4(c)(1)(C) of the BHC Act, the bank holding company is limited to servicing loans only for its own account or its banking subsidiaries.

Finally, the income of the company should be subject to scrutiny. A servicing company should be a profitable business. The servicer receives a fee based upon a percentage of the outstanding balance of the loan. In the early years of the payback period, the fee should significantly exceed the cost of the service, and because much of the portfolio will be refinanced either prior to its maturity or prepaid, the fee income should be sufficient to cover the servicer's cost plus profit. The reason for poor earnings in this activity is generally either inefficiency in the collection area, failure to attain the breakeven point of servicing volume, or the inability to turnover the warehouse portfolio often enough to maintain new fee generation. In the event that the servicer is unprofitable, the examiner should determine the reasons and clearly set them forth in the inspection report.

The servicing arrangement is of a fiduciary nature and as such it gives rise to certain contingent liabilities. In the situation where the servicer is not fully and properly discharging its servicing responsibilities in accordance with the servicing agreement, the holder of the serviced notes might bring legal claims against the servicer. The inspection process should direct attention to this area including a review of the servicing agreement and verification that the servicer is fulfilling its obligations. Management should be reminded of the significant loss exposure which can result from improper attention to its fiduciary responsibilities.

3080.0.1 INSPECTION OBJECTIVES

1. To determine that internal controls are adequate to administer effectively the servicing of the loan portfolio.

2. To determine the level of exposure to credit risk of loans held for the firm's own account.

3. To determine if the firm's earnings are sufficient so as not to be a burden on the parent or subsidiary bank.

3080.0.2 INSPECTION PROCEDURES

1. Review the balance sheet to determine the volume of credits held for the firm's own account and evaluate their asset quality.

2. Review internal controls and evaluate their adequacy.

3. Review earnings and appraise the impact on the parent and bank subsidiaries.

4. Review servicing agreements and evaluate the potential or contingent risks to which the firm is exposed in the event of failure by a borrower to service its loan properly.

5. Determine whether mortgage servicing rights are recorded as an asset and whether they are being amortized over the average life of the loans being serviced.

A bank holding company may engage under contract with a third party in the management, servicing, and collection[1] of the types of assets that an insured depository institution may originate and own. The company cannot engage in real property management or real estate brokerage services as part of these services. See Regulation Y, section 225.28(b)(2)(vi). Provided below are some initial historical examples of Board orders that involve asset-management services related to this nonbanking activity. The commitments and conditions provided for within the Board orders should not be considered to be currently applicable.

3084.0.1 ASSET-MANAGEMENT SERVICES TO CERTAIN GOVERNMENTAL AGENCIES AND UNAFFILIATED FINANCIAL INSTITUTIONS WITH TROUBLED ASSETS

Three bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in providing asset-management services to the Resolution Trust Corporation and the Federal Deposit Insurance Corporation, and generally to unaffiliated financial institutions with troubled assets. The applicants committed to conduct these activities under the same terms and conditions as set out in 1988 FRB 771.

The commitments and conditions of this order required that (1) the asset-management activities would be provided to the banks and savings associations, (2) the applicant would obtain the Board's approval before providing asset-management services for pools of assets that were not originated or held by financial institutions and their affiliates, (3) the applicant would cause its asset-management subsidiary to establish procedures to preserve the confidentiality of information obtained in the course of providing asset-management services, and (4) neither the applicant nor its management subsidiary would take title to the assets managed by the asset-management subsidiary.

The applications of these holding companies were approved by a Board order on December 24, 1990 (1991 FRB 124). Two additional orders about providing asset-management services were approved on March 25, 1991 (1991 FRB 331 and 334).

3084.0.2 ASSET-MANAGEMENT SERVICES FOR ASSETS ORIGINATED BY NONFINANCIAL INSTITUTIONS

Two bank holding companies (the applicants) applied jointly for the Board's approval under section 4(c)(8) of the BHC Act to engage de novo in collection-agency activities pursuant to Regulation Y through a joint venture. The Board concluded that the collection activities were permissible.

The bank holding companies also applied for the Board's approval to engage in asset-management, asset-servicing, and collection activities through a nonbank of the joint venture located in New Jersey. The subsidiary would provide asset-management services to the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). It would also provide these services to unaffiliated third-party investors that purchase pools of assets assembled by the RTC or the FDIC. Under the proposal, neither the applicants nor this nonbank subsidiary would acquire an ownership interest in the assets that they manage or in the institutions for which they provide the asset-management services. The applicants further committed that they would not provide real property management or real estate brokerage services as part of the proposed activities.

The Board previously determined that, within certain parameters, providing asset-management services for assets originated by financial institutions (banks, savings associations, and credit unions) and their bank holding company affiliates is an activity closely related to banking (see 1991 FRB 331, 334 and section 3600.15.3). The applicants proposed to conduct all asset-management activities subject to the same conditions as in the Board orders previously cited.

The applicants proposed to engage in asset-management activities for assets originated by nonfinancial institutions as well as by financial institutions. These assets include real estate, consumer, and other loans; equipment leases; and extensions of credit. Assets of nonfinancial institutions include pension funds, leasing com-

1. Asset-management services include acting as agent in the liquidation or sale of loans and collateral for loans, including real estate and other assets acquired through foreclosure or in satisfaction of debts previously contracted.

panies, finance companies, and investment companies formed to engage in asset-management activities. The managed assets would be limited to the types of assets that financial institutions have the authority to originate. The Board concluded that the applicants would have the expertise to engage in managing these types of assets, regardless of the originating entity. The Board also determined that the proposal was consistent with the asset-management proposals approved in its prior orders. The Board concluded that the applicants' proposed activities are closely related to banking and approved the order on December 21, 1992. (1993 FRB 131)

Section 4(c)(8) of the BHC Act (Receivables) Section 3090.0

Two nonbanking activities authorized under section 4(c)(8) of the BHC Act, per Regulation Y in section 225.28(b)(1), are the discount purchasing of a client's accounts receivables (factoring) and the establishment of a revolving credit facility secured by an assignment of accounts receivable (accounts receivable financing). These activities date back to Board orders issued in 1951. See sections 3090.1 and 3090.2.

3090.1.1 INTRODUCTION

Factoring is the discount purchasing of the client's accounts receivable invoices for goods that have been manufactured and shipped. Factoring differs from accounts receivable financing in that the factor assumes the credit risk of collecting payment from the recipient of the goods. The principal advantage of factoring is that the client is assured of the collection of the proceeds of its sales, regardless of whether the factor is paid.

A factor generally offers four basic services: (1) credit investigation and approval; (2) buying the client's accounts receivable at a discount (generally between .75 and 1.5 percent) after shipment of the goods to which there is no subsequent claim, just a claim against the invoices; (3) bookkeeping in the form of posting accounts; and (4) advancing funds in the form of an "open account" when there could be 30 days between shipment and payment. The later allows the client to replenish inventory loans for working capital or expansion.

Maturity factoring and advance factoring are the basic techniques of the industry. In maturity factoring, an average maturity due date is computed for the receivables purchased during a period and the client receives payment on that date. Advance factoring uses the same computations, however, the client has the option of taking advance payments equal to a percentage of the balance due at any time *prior* to the computed average maturity due date. The unadvanced balance, sometimes called the "client's equity," is payable on demand at the due date.

The factor's balance sheet reflects the purchases as "factored receivables" and the liabilities as "due to clients." Usually the due to clients balance will be significantly less than the factored receivables balance because of payments and advances to the clients. The income statement will show factoring commissions, which represent the discount on the receivables purchased. Interest income for advances on the due to client balances may or may not be a separate line item.

The factor is a pivoting point between the buyer and the seller. The buyer must pay or all parties lose. Also the seller must have a reputation for delivering quality merchandise. The factor must know the business well enough to account for sudden increases in returns for out-of-specification merchandise or for merchandise of low quality. If the seller does not perform adequately, payment for the goods may not be forthcoming, and if bankruptcy threatens the seller, buyers may hold back their future purchases.

3090.1.2 FUNDING

Since factors traditionally provide financing to industries with seasonal borrowing requirements, such as textiles, shoes, clothing, and other consumer goods, their own funding programs will usually reflect this volatility. It may be expected that factors generally will have greater access to short-term unsecured credit facilities than would be expected for other nonbank activities. This would hold true for factors funded solely from internal sources as well as external sources.

Because of a factor's inherent funding volatility, a major portion of a factor's liabilities will be short-term debt. For the internally funded company, this source will be predominantly commercial paper proceeds from the parent company, with perhaps some bank line proceeds intermixed. The externally funded company will probably rely on bank lines for its short-term needs, usually with the parent company's guaranty of the debt.

Longer term funding may be provided through bank term loans and subordinated debt, although the volume of this type of debt appears to be low relative to other financing industries. The terms and covenants of long-term debt appear to allow for relatively more flexibility in operations and more highly leveraged positions than similar debt for other financing industries in recognition of the volatility of factoring operations and the liquidity of factoring assets.

The principal suppliers of senior and subordinated funds to factors and accounts receivable financers appear to be limited to a few insurance companies that specialize in this field, although a few banks also provide senior term funding. These lenders have incorporated their perceptions of acceptable balance sheet ratios and earnings performance into their debt agreements as restrictive covenants. Since comparative industry data is limited, these restrictive covenants may be the examiner's primary means of evaluating leverage, loss reserves, and capital adequacy. The "due to clients" account is another significant measure of a factor's liabilities. As noted before, the account represents the accumulation of the amounts payable to the clients upon the maturity of their factored receivables. This liability is, to a large extent, self-liquidating through the collection of those receivables.

An analysis of the changes in the relative proportions of the "due to clients" account should provide valuable input into the analysis of a factor's earnings. Since factoring is a highly competitive industry, price cutting has reduced factoring commissions to a point where they provide minimal support to earnings; therefore, the interest margins on factoring advances have a significant impact on net income. The implication of the analysis of proportional changes is that as more clients take advances (reducing "due to clients"), profit margins should widen, and conversely, as the "due to clients" proportion of total liabilities rises, profit margins may be expected to narrow.

3090.1.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios, and whether lending, monitoring and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going-concern, and whether its affiliate status represents a potential or actual adverse influence upon the condition of the consolidated corporation.

3090.1.4 INSPECTION PROCEDURES

The inspection procedures for a factor have been divided into two phases, preliminary and on-site, when considered necessary.

The preliminary phase entails the gathering and analysis of information at the parent company in order to determine the scope of the field work to be performed on-site. The on-site segment of the procedures expresses some of the typical practices and considerations in this form of financing.

During the preliminary phase, the following information should be reviewed:

1. System approvals for offices and activities, including stipulated public benefits;
2. Financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns;
3. All management reports which should indicate problem loans, loan volume, new accounts and other reports regarding loan portfolio and company status;
4. External debt instruments to determine material restrictive covenants;
5. Internal audit reports and workpapers;
6. Minutes of the board of directors, executive committee and loan committee, if available at the parent company;
7. The results of a parent company loan review, if any.
8. To be requested:
   a. Schedules of past due loans, intercompany participations, and large loans;
   b. Schedules of problem accounts, liquidating accounts, and repossessed assets;
   c. General ledger trial balance;
   d. Loan trial balance, including overadvances;
   e. Statements of company lending, accrual, and other policies;
   f. Reconcilement of the loan loss reserve for the period between inspections;
   g. Listing of common borrowers between affiliates.

3090.1.4.1 On-Site Procedures

After reviewing the material available at the parent company, including the audit review, a decision whether to go on-site is in order. Some of the determinants of this decision are relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by internal loan review reports and problem loan reports, and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The following comments provide a general outline of the factor's basic operation. This outline will provide a background for the comments in the inspection procedures.

While the typical factoring agreement stipulates that all accounts receivable of a client are assigned to the factor, not all are purchased without recourse. The agreement between the factor and the client will usually state that receivables subject to shipping disputes and errors, returns, and adjustments are chargeable to the client because they do not represent bona fide sales. In addition, sales made without the factor's approval are considered *client risk* receivables, with full recourse to the client if the customer fails to pay.

The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department will research its files, determine the credit worthiness of the customer, and approve or reject the sale. As stated before, if the credit department rejects the sale, the client may complete the sale, but at its own risk. The most common reasons for rejection are sales to affiliates, sales to known bad risks, sales to customers whose credit cannot be verified, and sales to customers whose outstanding payables exceed the factor's credit line.

Once a sale has been made and the receivable assigned to the factor, approved or not, the client's account will be credited for the net invoice amount of the sale. That is, any trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's "availability" to be paid in advance or at the computed due date, depending upon the basis of the factoring arrangement.

Each month the client will receive an "accounts current" statement from the factor which details the transactions on a daily basis. This statement will reflect the daily assignments of receivables, remittances made, deductions for term loans, and interest charges and factoring commissions. Credit memos, client risk, charge backs, and other adjustments will also be shown. Client risk charge backs are the amounts deducted from the balance due to the client upon the failure of customers to pay receivables factored at client risk.

The accounts current statement and the availability sheets will be necessary for the asset analysis process. Considering the volume of transactions, the accounting system that develops this data will probably be automated, which may allow the factor to obtain comparison and monitoring data on the client. If a monitoring system is in place, the data provided will be valuable in the asset analysis process.

The evaluation of a factor includes a review of its systems and controls as well as an analysis of the quality of its assets, both of which may be accomplished by a two segment analytical approach. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of the assets will be the client loans and credit accommodations, for which the account officers are responsible. The procedures for each area will be dealt with separately.

3090.1.4.2 Credit Department

Because of its integral function in the credit and collection process, the credit department is the heart of a factor. The department maintains credit files, which are continually updated as purchases are made and paid for by the customers. These files will include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Usually, each customer will have an assigned credit line, which is the credit department's estimate of the customer's credit capacity.

The evaluation of this department should take the form of a review of a sample of the customer files. The sample may be drawn from lists of large volume customers and closely monitored customers, or it may be a random sample. The examiner should have either a copy of departmental policies and procedures or a verbal understanding of them prior to the review. It should be kept in mind that the objective of the review is to critique the credit and collection process and to verify departmental effectiveness, and not to obtain classifications.

3090.1.4.3 Asset Evaluation

Prior to the review of asset quality, the examiner should receive the lists of problem clients, client over-advances, term loans, and credit accommodations; as well as the aging schedule of factored receivables including client risk receivables. These will be used as the basis for selecting the clients to be reviewed. It is recommended that the selection be made from the list of clients with term loans, largest first, in addition to the acknowledged problems. Clients with high dilution rates and those with client risk receivables equal to 20 percent or more of factored volume may also be included.

It should be noted that a factor usually collects principal and interest payments directly from the client's availability, which means that the expected delinquency rate is minimal. Past due factored volume is not an effective measure of client quality.

A maturity client's availability is the sum of all factored receivables, less trade and other discounts, factoring commissions, credit memos, and client risk charge-backs. There may also be other deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed upon ''advance'' percentage. This reciprocal, 20 percent in the case of an 80 percent advance client, is sometimes referred to as the client's ''equity'' in the factored receivables. Availability may be increased by liens on additional collateral such as inventory, machinery and equipment, real estate, and other marketable assets.

The review and analysis of asset quality will be procedurally similar to that used in accounts receivable financing. However, certain aspects of the financial statements may need elaboration. The client's balance sheet will have a ''due from factor'' account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, which would affect turnover ratios and other short-term ratios. The difference relates to the client's ability to convert sales to cash faster with a factor than if the receivables were to be collected normally. In addition, the analysis of the statements should incorporate an assessment of the client's ability to absorb normal dilution and the potential losses associated with client risk receivables, particularly when these factors are higher than usual for the portfolio.

As a factor's systems and controls for client loans are somewhat similar to those for accounts receivable financing, the evaluation of asset quality must consider these factors before the classification of a client is made. While the typical client may have less than satisfactory financial statements, the factor's working knowledge of the client's operations and industry tends to mitigate the risk factors present.

For classification purposes, ''client risk receivables'' is the only portion of factored volume that is appropriate for use in the amount classified. Because of the recourse aspect the balance is considered as an indirect obligation rather than a direct obligation.

As a further step in the evaluation of the lending area and its controls, the evaluation of the steps taken and the results of at least one recent client liquidation should be made. By reviewing the chronology of events along with the loan and collateral balances, the effectiveness of systems and controls under extended circumstances may be assessed. The type of liquidation will have a bearing on the losses taken. Losses tend to be higher when client fraud is involved.

In the process of evaluating a factor's condition, the adequacy of systems and controls and the capability of management are considered significant measures. Asset quality, as measured by classifications, may be influenced by seasonal aspects and should be carefully analyzed to allow for such influences. Because of a lack of regular and consistent comparative data for the industry, earnings and capital adequacy are evaluated in terms of the company's own performance.

The review of the company's internal systems and controls should be continuous during the inspection. Considering the large volume of daily transactions that flows through a factor, any internal control that can be easily negated represents a potential problem and should be brought to management's attention. In the broad context, this review would include the credit controls for both clients and customers. Since credit problems can develop rapidly in factoring, credit controls and systems must be responsive to the identification of these problems. Deficiencies noted should be discussed with management and, if significant, cited in the report. The company's earnings trends may be evaluated by using a comparative yield on assets approach. By analyzing yields on asset categories from period to period the examiner will be able to make a judgment as to the efficiency of the systems. Factors are subject to the same price competition in the commercial finance market as accounts receivable financers. Declining portfolio yields may reflect the inroads made by competition and may indicate a decline in future profitability.

The subject of capital adequacy is influenced by the aforementioned seasonal characteristics. Over the period of a year, the comparisons of equity to assets and equity to liabilities will vary significantly. It is suggested that an average balance sheet be used to stabilize the variations.

In addition to balance-sheet ratio analysis, the effects of dividends and fees paid to the parent company on the capital accounts may be analyzed to determine the rate of internal capital generation. If the company is in a growth profile, or attempting to gain market share, the comparisons between fiscal periods may reflect a declining trend. Such a trend should be discussed with parent company management.

The report comments should summarize these considerations in a clear, concise presentation.

3090.1.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans to affiliates	23A FRA 371c			
Purchase of affiliate's notes from a third party	23A FRA 371c		3–1131	1951 FRB 960
Activities not closely related to banking	4(c)(8) BHC Act 1843(c)(8)	225.126	4–184	
Acquisition of assets	4(c)(8) BHC Act 1843(c)(8)	225.132	4–175.1	1974 FRB 725 1984 FRB 370
Real estate mortgages as eligible collateral under section 23A	23A FRA 371c			1933 FRB 566
Indebtedness of affiliate on assets acquired from member bank	23A FRA 371c		3–1125	1936 FRB 324
Marketability of collateral under section 23A	23A FRA 371c		3–1121	1935 FRB 395
Activities closely related to banking	4(c)(8) BHC Act 1843(c)(8)	225.123 225.28(b)(1)	4–176	1971 FRB 514 1975 FRB 245 1984 FRB 50 1984 FRB 370 1984 FRB 376 1984 FRB 452 1984 FRB 736 1986 FRB 143 1988 FRB 177 1988 FRB 330 1989 FRB 79 1992 FRB 74
Community development activities	4(c)(8) BHC Act 1843(c)(8)	225.127 225.28(b)(12)	4–178	1972 FRB 572

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3090.2.1 INTRODUCTION

Accounts receivable financing is a revolving credit facility secured by an assignment of accounts receivable. As a financing technique, it allows the client (the financed company) to obtain working capital without waiting for customer payments. This form of financing is frequently used by companies with working-capital shortages, companies in seasonal industries, and companies with weak financial conditions. Typically, the funding requirements of these companies are in excess of any amounts that would be available through unsecured bank financing.

The financing process begins with a bona fide credit sale by the client and the assignment of the resulting receivable to the financer. Upon assignment, the financer advances a specific percentage of the receivable to the client. The loan is repaid by customers' direct payments or, in the case of a lockbox, by the remittance of the customer's payment to the financer, who returns the amount in excess of the loan to the client. While a simple concept for a single transaction, the operations of an accounts receivable financer become a complex process when many clients and perhaps thousands of receivables are involved.

Companies engaged in accounts receivable financing usually incorporate the full range of commercial financing activities into their operation. These activities would include inventory financing, loans secured by machinery and equipment, some forms of real estate loans, and loans secured by other assets. As a general statement, these companies will provide working-capital financing using almost any form of viable collateral to secure the loans. These additional activities are facilitated by the financer's in-depth knowledge of the borrowers' financial conditions and cash flows. This knowledge comes from the controls placed on the borrowers, such as periodic field audits, the flow of the borrower's cash through the company, and an internal staff that specializes in the financed industries.

3090.2.2 FUNDING

Accounts receivable financing companies, like factors, traditionally provide working-capital financing to seasonal industries. Consequently, the funding programs of these financing companies will reflect these variations in their increased use of short-term funds relative to other nonbanking activities.

Since many accounts receivable clients have seasonal businesses, a large portion of the financer's liabilities will be short-term debt. For internally funded financers, this debt will be predominantly commercial paper proceeds from the parent company, with perhaps some bank lines intermixed. The externally funded company will probably rely on bank lines for its short-term needs, usually with the parent company's guaranty of the debt.

Longer term funding may be provided through bank term loans and subordinated debt, although the volume of this type of debt appears to be low relative to other financing industries, another parallel to factoring. The terms and covenants of long-term debt appear to allow for more flexibility in operations and somewhat more highly leveraged positions than similar debt for other financing industries. This practice is apparently in recognition of the volatility of this form of financing and the liquidity of the assets supporting the financer's loans.

The principal suppliers of senior and subordinated funds to collateral lenders (factors and accounts receivable financers) appear to be limited to a few insurance companies that specialize in this field, although a few banks also provide senior term funding. These lenders have incorporated their perceptions of acceptable balance-sheet ratios and earnings performance into their debt agreements as restrictive covenants. Since comparative industry data are limited, these restrictive covenants may be the examiner's primary means of evaluating leverage, loss reserves, and capital adequacy.

3090.2.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios and whether lending, monitoring, and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going concern, and whether its affiliate

status represents a potential or actual adverse influence upon the condition of the consolidated corporation.

3090.2.4 INSPECTION PROCEDURES

The inspection procedures for an accounts receivable company have been divided into two phases, preliminary and on-site.

The preliminary phase entails the gathering and analysis of information at the parent company in order to determine the scope of the field work to be performed on-site, if required. The on-site segment of the procedures expresses some of the typical practices and considerations in this form of financing.

During the preliminary phase, the following information should be reviewed:

1. system approvals for offices and activities, including stipulated public benefits
2. financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns
3. all management reports which should indicate problem loans, loan volume, new accounts and other reports regarding loan portfolio and company status
4. external debt instruments to determine material restrictive covenants
5. internal audit reports and workpapers—
    a. internal control exception report to determine weaknesses and corrective actions,
    b. flow charts in the workpapers which will enable the examiner to become familiar with company systems, and
    c. additional internal reports may be identified which may assist the inspection on-site
6. minutes of the board of directors, executive committee and loan committee, if available at the parent company
7. the results of a parent company loan review, if completed
8. To be requested:
    a. schedules of past-due loans, intercompany participations, and large loans
    b. schedules of problem accounts, liquidating accounts, and repossessed assets
    c. general ledger trial balance
    d. loan trial balance
    e. statements of company lending, accrual, and other policies
    f. reconcilement of the loan-loss reserve for the period between inspections
    g. listing of common borrowers between affiliates

3090.2.4.1 On-Site Procedures

After reviewing the material available at the parent company level, including the audit review, a decision whether to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by internal loan review reports and problem loan reports, and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The on-site inspection procedure will be similar to that used in a commercial department of a bank. Selection and evaluation of the assets, review of internal controls, identification of lending policies, and credit review procedures are all familiar areas to the examiner and do not need further explanation. However, the accounting and reporting systems are somewhat different and will require the examiner to become familiar with systems and policies before proceeding with the asset evaluation process.

3090.2.4.2 Accounting and Controls

There are two basic systems within the accounting and control environment of an accounts receivable company. The first system provides accounting and control for client loans and collateral balances and is frequently automated to handle the large flows of data generated in the operation. It is also common to find lockbox arrangements with banks that tie into the client system for the receipt of customer remittances. Such lockbox arrangements provide a greater degree of control over remittances.

The mechanics of the client system will be detailed in the internal audit file, which should also indicate the adequacy and efficiency of the system's controls. The audit file may also indicate the accounting techniques used and the client-monitoring reports that are generated by the system, such as dilution rates and trends, and year-to-year volume and operating comparisons. The client system provides the basic data for the company's accounting and control system. While the basic accounting considerations are outlined in the AICPA *Industry Audit Guide: Audits of Finance Companies*, there are certain accounting aspects which deserve additional treatment. In some cases where a group of related companies are clients, the financing arrangements may include cross-guarantees and cross-collateralization agreements. In these cases, the financer might utilize excess availability for some of the related entities to offset the over-advance of another entity. Another treatment that may be applied is the use of a "reserve for liquidating accounts," which in some instances is a specific reserve for a problem account that reverses at least current period earnings for the account. This reserve is in addition to the allowance for bad debts and may not be an explicit balance sheet account, but an offset to gross loans outstanding.

3090.2.4.3 Definitions

While many of the following comments define certain routine accounting and control considerations for accounts receivable financing, certain of the concepts are necessary for proper evaluation of client quality (i.e., availability, dilution, over-advances, and advances on other collateral). These definitions are general in nature as is the terminology, however, the processes will be similar in almost every company.

Loans to the client are based upon a contractual percentage of the client's eligible receivables against which the financer has agreed to advance funds. Eligible receivables include all assigned receivables, less trade discounts, early payment discounts, contra-accounts (reciprocal sales between the client and customers), receivables past due beyond the eligibility period specified in the contract, and other adjustments. The advance percentage is determined by a number of factors which include the expected average dilution rate (disputed invoices, misshipped goods, returns and allowances, etc.) and the client's expected gross profit margin. As a general rule, lenders in this field try to finance only the cost of sales and not the client's profits.

Because this form of financing involves rapidly changing collateral balances, a high volume of customer payments, and frequent loan requests, the financer has to determine the client's "availability" (loanable funds) before advancing the loan. Availability is the total of eligible receivables times the advance percentage less credit memos and the current loan balance. Credit memos are adjustments to the customer's account for errors in the client's shipments (i.e., the quantity shipped was less than that ordered). It is the client's responsibility to provide this information to the financer on a daily basis. If there is sufficient availability, the requested amount is usually advanced. On occasion, the availability computation will show the client to be "over-advanced," that is the loan balance exceeds the agreed percentage advance against collateral. This situation may have occurred because some receivables have become past due, or the financer may have authorized additional funds to meet some valid client requirement. As a rule, over- advance positions are usually subject to a quick paydown to reduce the loan balance to the original contractual terms.

At times, the availability computation will reflect additional collateral value in the form of inventories, machinery and equipment, and other assets, shown net of an advance percentage. These categories usually indicate term loans, secured by liens against the respective assets, which expand the collateral base and provide additional support to the client's working capital requirements. These term loans should not be confused with loans for the acquisition of such assets which might appear only in the client's monthly statement.

The accounts receivable financer charges interest on the daily cash borrowings of the client and accumulates these charges on the client's monthly statement. The total interest charge for advances on receivables and other loans is deducted directly from remittances received by the financer. Accordingly, the expected delinquency rate for an accounts receivable operation is low except for the rare loan which is paid directly by the client and other assets which formerly belonged to a defunct client.

3090.2.4.4 Over-Advances and Other Loans

It was indicated earlier that an over-advance represented funds advanced in excess of available loanable funds and that there are two basic causes for over-advances. Some over-advances occur because a portion of eligible receivables becomes past due and ineligible for advances. This condition is usually corrected by the assignment of additional receivables or receipt of customer payments, and therefore may exist only for a few days.

The other basic over-advance occurs when a client requires additional funds for valid business purposes, such as an inventory buildup at the beginning of a season. In such cases, the over-advance is set up as a very short-term loan and paid down rapidly out of the client's availability. While the policy for over-advances varies between financers, when they are permitted they are usually carefully analyzed by the internal credit committee and closely monitored until paid off.

If a client is involved only in receivables financing and has made an over-advance request, the financer generally will prefer to take a lien against inventory rather than make an unsecured over-advance. Regardless of the purpose of the inventory loan, the financer will advance only a small percentage of the inventory value (40 to 50 percent) to allow for shrinkage, spoilage and obsolescence of the collateral. While inventory liens are in effect, the field audit staff will partially verify the inventory during each audit.

While machinery and equipment may be pledged as additional collateral to support working capital loans during the business period, most client companies will also finance equipment purchases on a secured basis. In either case, the financer usually advances a percentage of the quick sale or auction value of the equipment as determined by an appraisal. During field audits, the presence of the equipment and appropriate lien tagging are verified by the field auditors.

On occasion, a lien on real estate is part of the pledged collateral. The real estate may be operating premises, land, or the property of the principal of the client. Such liens may occur when the client is acquiring new, or expanding old, operating facilities and is using the financing relationship to fund the project. However, in many cases the lien was taken to provide additional collateral for working capital loans. In either case, appropriate documentation and appraisals should be on file.

It should be noted that loans on real estate collateral are limited to those providing support to the primary business of the client. Loans to finance speculative real estate acquisitions, and unrelated commercial property are not considered to be the usual practice of this industry, and would be considered as not complying with the general activities of a commercial finance company, unless specifically approved.

3090.2.4.5 Asset Evaluation

In selecting the loans to be reviewed, the first group to be considered is the acknowledged problem accounts. The next sample should be drawn from accounts with high dilution rates, those with frequent or large over-advances, and those which constantly take down all of their availability. Participations, purchased or sold, between affiliates should also be included in the examiner's sample. While this approach may exclude some of the larger accounts, it is intended to include those accounts which are potential problems in the primary review group. Should the company have a monitoring system for potential problem accounts, the system should be used for drawing the review sample.

The principal tools for the review process should include: the credit file, the field audit file, the monthly statement for the inspection date, the availability sheet for the inspection date, and updated information for the interim period ending with the on-site inspection date. Within the credit file, the copies of the financing agreements will indicate the specific terms of the borrowing relationship: the pledged collateral; advance percentage; interest rate; guarantees; appraisals; and the required communications, such as monthly receivables agings, inventory and machinery and equipment certification, etc. The usual file information will also include management's analysis of the client's operations.

The field audit file will contain the audit reports originated by the financer's field audit staff. These reports are usually quite comprehensive, with a primary focus upon critical financial areas. As a minimum, the auditors will analyze trade payables, State and federal taxes, cash flows, inventories, and receivables. Particular attention is paid to the client's sales and shipping procedures in order to ascertain that valid invoices are being assigned to the financer. The client's accounting procedures are also analyzed to determine their effectiveness and accuracy. These reports represent a primary source of information regarding the general financial condition of the client.

The client's monthly statement and availability sheets represent spot information on the client's activity. Many clients operate in seasonal industries such as clothing and textiles. In such industries, a client will tend to use all of its availability, as well as seasonal over-advances, during its inventory buildup period, and will pay off the over-advances and may have excess availability during the sales and collection period. The examiner will have to analyze the client's current position with regard to its particular operating cycle. Over-advances granted to a client for valid reasons do not necessarily represent undue exposure or a substandard asset for the financer.

The financial statements of a client quite frequently reflect a "relatively unsatisfactory or weak" financial condition, with minimal working capital, high leverage, and uncertain earnings as prime ingredients. There have been cases where both deficit working capital and deficit net worth were in evidence, however, the financing relationship has continued to function properly. The financer can continue these relationships if the short-term factors (sales volume, receivables and inventory turnover, and current liabilities) are appropriate and the character of the principals warrants the exposure. Analysis of a financed client should emphasize the short-term analytical factors and the related trends in the evaluation of asset quality.

Such factors as the success of the selling season, availability of materials, and fad merchandising will have direct impact on the client's financial condition. While the loan may be adequately protected by pledged collateral, the ability of the client to continue operations may be affected by these short-term factors.

For classification purposes, the financer's controls will have to be considered in addition to weighing the degree and quality of collateral protection, short-term factors, and the client's ability to withstand any financial reverses that are evident. Clients with deficit net worth, past-due trade obligations, and delinquent taxes should be considered to be problems and appropriately classified. The ability of the financer to control the risk exposure in the portfolio will be an important consideration in determining whether to classify a specific loan.

3090.2.4.6 DPC Assets

In some companies, assets acquired from defunct clients remain in the loan account instead of being reclassified to another balance-sheet category. Usually, these assets are uncollected accounts receivable, inventory, and machinery and equipment which have not been liquidated. However, these assets may include securities, as well as business and personal real estate, which had been pledged as collateral. By retaining these assets in the loan category, effective liquidation of the respective assets may be delayed because they usually represent small dollar amounts. Apart from this consideration, classification as loans may disguise the fact that certain of the assets may be subject to provisions of Regulation Y and the act, such as control and retention considerations. Separate control of these assets is recommended.

It is common practice in the accounts receivable and factoring industry for the lender to require a pledge of client company stock by the principals, particularly in overextended situations. Additional pledges of securities owned by the principals may also provide added collateral. While such pledges are not precluded by Regulation Y and the act, once they become company assets they should be reviewed for control and retention purposes.

3090.2.4.7 Financial Condition

Secured lending relies upon the four C's of credit: the traditional Capital, Character, Capacity, and Collateral. Pragmatically, these lenders practice a fifth C, Control. In this context, control implies the continuous monitoring of the client's financial condition, continued evaluation of the collateral, constant contact with the client, and the adjusting of the credit accommodation to conform to the client's current situation. This control is the reason that the secured lender can maintain a proper and mutually profitable financing arrangement with the client.

It is to be expected that the typical portfolio may include clients with less than satisfactory financial conditions. Considering the controls imposed upon the borrowing relationships, the secured lender has compensated for some of the additional risk in the loans. The combination of field audits, collateral controls, and account officer contact can be expected to reduce the exposure to unsatisfactory clients to a minimum. However, clients do fail and losses may be taken in liquidating the account. The incidence rate of liquidations and the extent of losses taken may be an indicator of the effectiveness of company controls.

The earnings of an accounts receivable company are based upon loans carrying interest rates above prime, which means that loan volume is a major determinant of revenues. Because this industry is very competitive, loan pricing is frequently used to obtain new clients from other lenders in order to promote growth in loan volume. Increases in loan volume combined with declining interest margins may be an indicator of price competition that is yielding negative results. Analysis of client turnover may verify this possibility.

In summary, management's ability to control risk and achieve profitability is essential to the soundness of an accounts receivable operation.

The effectiveness of company policies, the expertise of the lending staff and field audit staff, and the adequacy of systems and controls are the expressions of this ability to control risk. Company profitability is a measure of management's ability to obtain satisfactory client quality and terms in a price-competitive environment. The examiner will have to balance these factors in assessing the condition of the company.

3090.2.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Loans to affiliates	23A FR Act 371c			
Purchase of affiliate's notes from a third party			3–1131	1951 FRB 960
Acquisition of assets		225.132	4–175.1	1974 FRB 725 1984 FRB 370
Activities closely related to banking		225.123	4–176	1971 FRB 514 1975 FRB 245
Investments in community welfare projects		225.127	4–178	1972 FRB 572

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3100.0.1 INTRODUCTION

The basic activity of a consumer finance company is making installment loans to individuals and is permissible pursuant to section 225.28(b)(1) of Regulation Y and section 4(c)(8) of the BHC Act (the act). In most areas, a company may make these loans under one or more of the following licenses: consumer discount, small loan, sales finance, or second mortgage. Most of a company's activity will probably be direct cash lending, in which the borrower and the lender come into direct contact with one another in the credit-extension process. However, a significant volume of lending is done through third-party contact. This is sales finance lending in which the company purchases, or discounts, the loans originated by a durable goods dealer in daily retail sales activity. Second mortgage lending may be originated from either direct contact or through home-improvement contractors.

Most consumer finance companies offer credit-related insurance as part of their services, and may have a captive insurance subsidiary if they are large enough. Inspection considerations and procedures for reviewing credit-related insurance activities are covered in section 3170.0.

3100.0.2 FUNDING

In some holding companies, management has elected to use a conventional industry funding pattern to support its consumer finance company operations. This pattern makes use of long-term subordinated debt in a specific proportion to equity capital. The further addition of senior long-term and short-term debt is then limited by restrictive covenants incorporated into the subordinated debt agreements. These covenants also provide operating limits for management in such areas as the proportions of specific classes of assets, minimum levels of net worth to be maintained, and the maximum dividend payout allowable. Since the wording and limits of these covenants are negotiated between the borrower and the subordinated debt holder, generalizations regarding the usual terms are not practicable.

It appears that certain life insurance companies supply most of this subordinated debt to the consumer finance industry. Along with their general knowledge of the industry, these insurance companies police their loans by requiring periodic reports from the borrower and by sending teams of their people to review the borrower's operations. In a sense, this approach to funding represents regulation and control by market forces rather than by governmental intervention.

In other holding companies, management has elected to support these operations using holding company funding sources such as commercial paper and lines of credit. In using this approach, operating management is generally free from market restrictions on operations.

It is likely that most affiliated consumer finance companies will have a funding plan that falls somewhere between these two extremes. Since commercial paper generally carries a lower total cost than bank lines of credit, the examiner may find that the senior short-term debt component is almost completely supplied by the parent company. On the other hand, long-term debt may have been obtained directly, or with the parent company's guaranty, or it may have been borrowed from the parent company's sources—that is, the parent borrows from a third party and re-lends the proceeds to the subsidiary.

Since a large volume of consumer installment paper carries maturities of three years or more, the use of commercial paper proceeds with maximum maturities of 270 days warrants some comment. Securities Act Release No. 401 specifically recognizes this use of commercial paper as appropriate. Further information may be found in the Code of Federal Regulations, 17 C.F.R. 231.4412. Also see sections 2080.1 and 5010.16 for information on commercial paper.

3100.0.3 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the act and Regulation Y.
2. To determine whether transactions with affiliates, including banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolio, and whether lending, monitoring, and collection policies are adequate to maintain sound asset conditions.
4. To determine the adequacy of the reserve for loan losses and whether the asset charge-off policy is appropriate.
5. To determine the viability of the company as a going concern, and whether its affiliate

status represents a potential or actual adverse influence on the condition of the consolidated corporation or the subsidiary bank(s).

3100.0.4 INSPECTION PROCEDURES

After reviewing the material available at the parent company level, including the audit review, a decision whether or not to go on-site is in order. Some of the determinants of this decision would include relative size, current earnings performance, overall contribution to the corporation's condition, asset quality as indicated by delinquency reports and industry comparisons (detailed later in this section), and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in apparently sound condition. In such a case, an on-site inspection may not be warranted, providing that a fairly recent on-site inspection had been conducted. Conversely, a deteriorating condition might be detected which would require a visit, even though a satisfactory condition had been determined during the previous inspection. Subsidiaries in unsatisfactory condition should be inspected each time the parent company is inspected.

The inspection procedures for a consumer finance company have been divided into two phases: preliminary and on-site. The preliminary phase entails the gathering and analysis of information at the parent company to determine the scope of the field work to be performed on-site. The on-site phase establishes a minimum scope of the inspection at the main office, and includes considerations to be incorporated into a visit to field offices if the inspection scope is expanded to that degree.

During the preliminary phase, the following information should be reviewed:

1. system approvals for offices and activities, including stipulated public benefits
2. financial statements, both interim and fiscal, for a sufficient period to determine trends and operating patterns
3. all management reports which should indicate problem loans, loan volume, delinquencies, and other reports regarding loan portfolio and company status including the Robert Morris Associates' *Direct Cash Lending Questionnaire* and similar reports
4. external debt instruments to determine material restrictive covenants
5. internal audit reports and workpapers:
   a. internal control exception reports to determine weaknesses and corrective actions
   b. flow charts in the workpapers to become familiar with company systems
   c. additional internal reports may be identified which may assist the inspection on-site
6. examination reports of any state regulatory agencies having jurisdiction over the company's offices
7. minutes of the board of directors, executive committee, and any other such committee, if available at the parent company
8. the results of a parent company loan review or operations review, if conducted and available
9. the following items to be requested from management:
   a. detailed past-due schedules and intercompany participations
   b. schedule of problem accounts, liquidating accounts, and repossessed assets
   c. general-ledger trial balance
   d. loan trial balance
   e. policy statements on lending, accrual, and charge-offs
   f. reconcilement of the loan-loss reserve for the period between inspections
   g. organization chart
   h. listing of company offices with addresses and operating licenses

3100.0.4.1 On-Site Phase

The procedures of the on-site inspection are intended to evaluate management and its supervisory efforts, to determine the soundness and compliance with the company's operating policies, and to analyze the impact of these policies on the company's financial condition using ratio analysis. A thorough understanding of the policies and systems of the company is necessary for the examiner to accurately determine the company's condition.

During the initial period on-site, the examiner may obtain an overview of the company's systems by interviewing the key staff officers. These individuals can provide the examiner with the detailed reports, policy manuals, and other information necessary for the inspection.

3100.0.4.2 Policy Evaluation

Because of its large volume of transactions and the number of offices involved, the typical consumer company will maintain an extensive set of policy and procedure manuals which are intended to guide company personnel in their daily activities. During the review of these manuals, the examiner should bear in mind that liberal policies and procedures may allow the company to mask portfolio problems and reflect other than an accurate condition in its financial statements.

The principal policies to be considered cover such areas as:

1. extensions of credit;
2. treatment of delinquent accounts and partial payments;
3. loan renewals;
4. loan charge-offs;
5. provisions for loan losses;
6. bulk purchases of loans, for both credit and account purposes; and
7. treatment of deferred income.

After assessing the soundness of company policies, the next step is to test their implementation through a review of the company's supervisory structure.

3100.0.4.3 Evaluation of the Supervisory Structure

The effectiveness of the supervisory structure is a key element in the condition of a consumer finance operation. This system serves two functions: it communicates the policies to the field personnel, and it enforces those policies. Assuming that management's policies are valid, the effectiveness of this system will be partially reflected in the ratio analysis of the company. However, it may take close analysis to determine whether any poor ratios are due to inadequate policies or ineffective enforcement.

In order to evaluate the supervisory effort, the examiner may review a sample of the various supervisor's reports which are prepared after visits to the loan offices. The sample should represent a cross-section of the offices and supervisors in order to obtain a balanced view of the company.

A further evaluative step may be undertaken if there are sufficient resources available to the examiner. The on-site visits to selected loan offices may provide considerable input to the examiner in assessing supervisory effort. In selecting the offices to be visited, well-performing as well as poor-performing offices should be selected. Concentration on poor offices will result in a biased assessment of the supervisory effort and may result in an invalid evaluation of company policies. The selection of the offices may be made by using the number of policy exceptions cited, poor performance records, or local economic conditions as criteria.

3100.0.4.4 Detailed Procedures for an Office Visit

The following steps outline a general procedure for determining field compliance with company policies and assessing the effectiveness of the supervisory effort. The examiner may modify, eliminate, or expand any of these steps or may devise any procedure deemed appropriate under the circumstances present.

The review of loans on-site should be oriented toward confirming the implementation of company policies for delinquency, balance renewals, charge-offs, extensions, partial payments, collection, and loan approvals. This review is intended to be a test of compliance and not a review of specific assets for classification purposes.

1. Review the detailed delinquency report for the selected office for a short period before the inspection date, generally two or three months. Trace the well overdue loans through to resolution, pay-off, charge-off, or reinstatement. Check these loans against the loan register to determine whether new loans have been granted to these customers and if so, determine if they are in accordance with company policy.
2. Review the controls for charging off loans and determine the effectiveness of the collection and recovery effort.
3. Review the loans to present borrowers. While renewals are usually granted to the better customers, the examiner will find a volume of renewals (''under 10 percent new money advanced'' loans). In some companies, these ''under 10 percent new money'' loans represent efforts to rehabilitate borrowers with poor payment records due to ill health, unemployment, etc. However, the examiner may find that management is using this approach to adjust and control delinquency and loss rates. There should be sufficient internal controls present to prevent the continuous renewal of such loans to poor borrowers.

The examiner may find that some office personnel are circumventing these controls, for example, by advancing 11 percent new money to the borrower. If found, such circumvention raises serious questions regarding portfolio quality, the adequacy of internal controls, and the effectiveness of the supervisory effort. A high volume of "under 10 percent" loans or evidence of circumvention of controls may warrant separate treatment in the report.

4. Review partial-payment, interest-only, and extension accounts. Significant numbers of these accounts may indicate potential problems for the loan portfolio and the office.
5. Review credit-extension and loan documentation procedures, especially if the office's portfolio has a high level of losses or frequent litigation. Proper credit controls and documentation are essential for sound operations. If the office extends second mortgage financing, appraisals and lien searches should be included with the documentation.
6. Test the office's delinquency reporting. There are two methods for computing delinquencies, a contractual basis and the recency basis. On a contractual basis, principal reductions are applied to the most overdue payment under the contract and the loan is considered past due from the date of the oldest unsatisfied payment. On a recency basis, delinquency is computed from the date of last payment regardless of contract terms.

   As an example, assume a loan was granted with payments beginning the first of March. The borrower makes the first payment on time and the second payment on the first of June. On the first of April, the loan is a 30-day recency account and current contractually. On the first of May, the loan is a 60-day recency account and a 30-day contractual account. Upon receipt of payment in June, the loan is current on a recency basis and a 60-day (two-payment) contractual account. Notice the difference in computations between the banking industry and the consumer finance industry.

   The consumer finance industry has begun to institute contractual delinquency reporting standards. As these standards are developed and refined, changes in the computation of delinquent accounts may be expected.
7. Review the collection effort. The past-due accounts will be under the control of the collection manager, whose objective is to return these accounts to current status. The manager's collection efforts must begin early in the delinquency pattern if the loans are to be salvaged from charge-off. Consistent, persistent, frequent effort is expected.

The foregoing steps should provide the examiner opportunity to evaluate the company's policies, procedures, and supervisory systems.

3100.0.4.5 Additional Procedures

While field visits are a desirable aspect of the inspection procedure, the examiner may have to rely on other procedures to be satisfied with certain aspects of company operations, particularly when the company reports past-due receivables on a recency rather than a contractual basis. The additional procedures may be necessary when the examiner has other reasons to question portfolio quality or the adequacy of internal controls.

The examiner may perform an extensive review of the most recent audit of the company, including the workpapers and programs of the internal and independent auditors, when available. In this review, the examiner should be able to determine whether internal controls are adequate, and portfolio characteristics are properly reported.

3100.0.4.6 Compliance

Certain aspects of the company are subject to review for compliance with the requirements of the act and Regulation Y. These include public benefits, office activities and locations, and bulk purchases of assets.

1. Public benefits stipulated in approval orders frequently require continuing reduced interest rates or insurance charges as part of the approval to operate. It is expected that these relative public benefits continue in effect despite changes in state-mandated rates.
2. Office locations and activities are subject to approval by the Board before opening for business. The operating licenses and activities of the offices should also be reviewed for compliance with the respective approvals.
3. On occasion, a consumer finance company may make a bulk purchase of loans or other assets of another finance company. Under certain circumstances, these purchases require the prior approval of the Board (12 C.F.R. 225.132). These bulk purchases should not be confused with the bulk purchase of sales finance contracts from a retailer recently signed to a dealer agreement.

4. While most consumer finance activity relates to consumer installment loans, some companies also extend credit under the "large loan" provisions of the consumer lending statutes of certain states. While the limitations vary from state to state, these provisions allow loans of many times the size of normal consumer loans. A review of these large loans may indicate that there are extensions of credit to local businesses which may constitute commercial installment lending. Unless specifically approved by the System, this activity may not be permissible for the company being inspected. Review for compliance with various consumer regulations is the responsibility of the Federal Trade Commission.

3100.0.4.7 Asset Classification Policy

As previously discussed, companies use one of two different methods of delinquency computation. In general, classifications should be based on the *contractual* reporting basis whenever possible. Since much of the industry utilizes *recency* reporting, which tends to reduce classifications comparatively, the classification approach enumerated above may unduly penalize an affiliated company using the contractual basis. This is particularly true when such important measures of portfolio quality as the liquidation ratios are in line with industry averages. Therefore, formula classification may result in more severe classifications for companies using the contractual method than those reporting on a recency basis. Examiners should indicate the reporting method used when calculating classifications.

Classification information is used to evaluate the adequacy of the loss reserve. In assessing the adequacy of the loss reserves, the examiner should take into consideration the charge-off frequency, the period of delinquency which would require charge-off under company policy, and the controls regarding renewal of severely past-due accounts. A shorter charge-off cycle prevents the accumulation of poor-quality assets; in this respect, monthly charge-offs are preferable to annual charge-offs. An unlimited "when deemed uncollectible" charge-off policy is considered lax and inadequate. The delinquency period to required charge-offs refers to the period of time a loan is past due before it is charged to the reserve; a six-month period is understandably preferred to a nine-month or one-year period. Management should have sufficient controls in place to prevent the continued renewal of loans to avoid charge-off. Adequate controls might include special coding of such loans, with supervisory review of the renewals. Inadequate controls over these assets represent poor management practices deserving special comment.

Most subordinated debt agreements provide for an adjustment (reduction) to net worth when calculating compliance with leverage limits for any loans past due 60 days on a recency basis that exceed loss reserves. As there are some seasonal characteristics to the loan portfolio, it may be of benefit to compare the delinquency statistics on inspection date to the company's seasonal pattern as revealed in both the subordinated debt calculations and monthly past-due reports. It is possible that a currently adverse portfolio condition may be due to local economic conditions which correct themselves over a period of time. Such conditions may relate to a tourist economy, an agricultural community, or a strike at a major local employer's plant. Consumer finance companies are very sensitive to these local factors; therefore, these factors may temper the examiner's evaluation of the loss reserves.

3100.0.4.8 Ratio Analysis

In order to assess the condition of a company using ratio analysis, the examiner will have to be familiar with the company's accounting policies and systems. It will become obvious from the data used in the ratios that, under certain accounting treatments, the data can be misinterpreted. The following analysis has been structured around the *Direct Cash Lending Questionnaire,* published by the Robert Morris Associates and endorsed by the National Consumer Finance Association, in an effort to provide both a format for developing the information and a means of minimizing the possibility of misinterpretation. While some consumer companies do not prepare the questionnaire, much of the information is required for management purposes and should be available from company systems.

The analytical factors presented have been derived from two principal sources: *A Lender's Approach to a Realistic Analysis of Consumer Finance Companies* by Richard E. Edwards (Philadelphia: The Philadelphia National Bank, 1970) and the *Industry Audit Guide: Audits of Finance Companies* by the Committee on Finance Companies (New York: American Institute of

Certified Public Accountants, 1988). These sources provide basic information on certain accounting and management policies and are recommended as references for the examiner. While the Federal Reserve System stipulates no specific accounting policies, the examiner may choose to criticize those policies which result in a misleading presentation of the company's financial condition.

Each year the *Annual Statement Studies,* published by Robert Morris Associates, includes sets of consumer finance company operating ratios. This information will provide a background against which the performance of the company under inspection can be measured. Such compiled ratios should be used only as background as they represent the "average company" in the respective sample. Attention should be directed toward the company's trends as they compare to the industry's trends and the changes in the company that are indicated by those trends.

3100.0.4.9 Delinquency

As shown in the *Annual Statement Studies,* the delinquency rates are on a recency-of-payment basis. *While past-due statistics based on contractual payments are preferred,* companies continue to report on a recency basis. It is important to have full knowledge of the company's reporting, lending, and renewal policies in order to fully understand the implications of this data. The trends for "interest-only" accounts and "partial-payment" accounts will provide some measure of the adherence of the operating personnel to company policy regarding these loan categories.

3100.0.4.10 Liquidation

Liquidation ratios provide two types of information. First, they indicate the amount of principal cash flowing back to the company for liquidity purposes. Secondly, they indicate the amount required to pay senior debt and the period of time required to do so. Several ratios follow:

1. Average monthly cash principal collection to average net monthly outstanding.

   The higher this percentage, the more liquid the portfolio. A company following conservative policies such as requiring full payments and a contractual aging of receivables will tend to show a higher principal collection percentage and, accordingly, a higher liquidity. This ratio can be used to estimate near term collections as compared to current outstandings.

   Monthly cash collections should not include loan renewals or rebates during the period. On an industry-wide basis, there appears to be a pattern of increased loan renewals during November and December, which would be reflected in a seasonal decrease in principal cash collections. Lower than expected collections may be indications of changes in local economic patterns or of increased market effort by a competitor which has resulted in loan payoff. In any event, adverse change in the collection pattern should be reviewed for the underlying causes.
2. The ratio of unsubordinated liabilities less cash and near cash to estimated monthly principal collections results in the number of months it would take to pay senior debt.
3. The ratio of senior debt to gross receivables reflects the proportion of gross receivables which would have to be liquidated to repay senior debt. The higher the percentage, the more senior lenders are relying on the assets for protection.

3100.0.4.11 Loss Reserves

Analysis of the loss reserve for a specific entity has to include company policy regarding loan charge-offs, delinquencies, payments, and charge-off frequency. In addition, if charge-offs are made gross of deferred income, the reserve account may be slightly larger than if charge-offs were net of deferred income. Ratios used to evaluate loss reserves include—

1. Reserve for loan losses to total receivables, net of deferred income,
2. Loans charged off less recoveries to average outstandings (net or gross of deferred income, depending on policy).

   Unless the company's charge-off and delinquency policies are realistic, this ratio will not depict true losses over the periods, and
3. Recoveries to loans charged off tends to be higher in companies with conservative charge-off policies than those with liberal policies. This ratio is indicative of the effectiveness of a company's collection and follow-up policy.

3100.0.4.12 Volume

Analyzing aspects of a company's loan volume can provide the examiner with some information regarding the company's renewal and credit policies.

Lengthening of loan maturities during the current period will be reflected in the future average monthly principal collections and in the company's liquidity. While loans of longer maturity are not necessarily indicative of an adverse trend, the reasons behind a longer maturity portfolio should be analyzed. Ratios used to evaluate loan volume include:

1. *New money advanced to present borrowers to total loan volume.*

   This ratio is somewhat indicative of whether the company's renewal policy is conservative or liberal. A high percentage may indicate that a volume of new money is being advanced along with the renewal of the previous balance.

2. *Loans to present borrowers with less than 10 percent new money advanced to loan volume.*

   A high ratio can indicate the possibility of disguised delinquencies and potential charge-offs. The examiner may take a random sample of loans in the new money advanced to present borrowers category and review them to determine whether or not the company's "balance renewal" policy is being followed.

The preceding ratios were presented because they represent a means of measuring the effect of certain company policies. The analysis of company operations may be expanded to include other ratios such as return on equity, return on assets, interest margins, and other conventional measurements. The particular format utilized will, of course, vary to some degree between companies, however, the analysis should be broad enough in scope to determine the company's trends and the causes of those trends.

3100.0.4.13 Evaluation of the Company's Condition

Ratio analysis of a consumer finance company is a feasible technique for evaluating its condition because of the "portfolio effect" of its assets. However, the examiner must look beyond the ratios and analyze the effects of company policies on the elements of the ratios. As an example, if a company only charges off loans once a year, the losses determined by a formula classification would be less just after the charge-off date than just before.

In comparing classifications from one inspection to another, there might be a difference in the loss classifications which may be interpreted as an apparent improvement or decline in asset quality should the inspections bracket the charge-off date. Similar misinterpretations can occur from a change in charge-off frequency, a change to an automatic charge-off policy, or a shortening in the past-due period required for charge-off.

Certain accounting and reporting techniques may also be misleading in ratio analysis. For example, an artificial improvement in earnings would be reported when a company changes from a collection basis to an accrual basis of income recognition, if the collection and follow-up policy had been poor or deteriorating. Only a thorough review of the accounting policies and an understanding of their interplay with operating policies will prevent this type of misinterpretation. In some cases, the company's accounting system may yield results that inadvertently distort the ratios. A company recognizing income on a straight-line basis would, during a period of low loan volume, reflect improving gross interest income as a percentage of loans outstanding. While the importance of realistic accounting policies cannot be overstated, neither can the proper interpretation of reported results be overstressed.

One of the key elements in the evaluation of the company's performance is reflected in the ratios, but not quantified by the analysis. The company's internal controls and management information systems are the primary means of controlling asset quality and communicating management's policies. The supervisory effort is not only reflected by the ratios, but also in such areas as personnel turnover, citations in state supervisory reports, audit exceptions, and litigation. The systems relied on by management should be responsive not only to the changing needs of the company, but also to the changing climate of consumer regulations.

In the inspection report commentary, the examiner should maintain an objective view of the company under inspection. Management's corrective actions for exceptions and plans to reverse adverse trends are a necessary ingredient in the commentary. Report comments should give the reader an accurate picture of the condition of the company and its relationship with, and impact on, the financial condition of the consolidated corporation and the subsidiary bank(s).

3100.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activities not closely related to banking		225.126	4–184	
Marketability of collateral under section 23A			3–1121	1935 FRB 395
Activities closely related to banking		225.123	4–176	1971 FRB 514 1975 FRB 245
Expansion of activities of a trust company, or acquisition of a de novo bank, to include consumer lending		225.28(b)(1)		1984 FRB 371 1985 FRB 51 1985 FRB 55 1985 FRB 61 1985 FRB 253

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The Board amended Regulation Y, effective April 21, 1997, to include the acquiring of debt in default as an authorized nonbanking activity for bank holding companies (see Regulation Y, section 225.28(b)(2)(vii)). A bank holding may acquire debt that is in default at the time of acquisition if the company—

1. divests shares or assets securing debt in default that are not permissible investments for bank holding companies, within the time period required for divestiture of property acquired in satisfaction of a debt previously contracted under section 225.12(b) of Regulation Y;
2. stands only in the position of a creditor and does not purchase equity of obligors of debt in default (other than equity that may be collateral for such debt); and
3. does not acquire debt in default secured by shares of a bank or bank holding company.

The Board held that these restrictions were necessary to define the scope of the activity and to ensure that the activity remains the acquisition of debt instead of an impermissible nonbanking activity involving the acquisition of securities or other assets. As for calculating the time period for disposing of the underlying shares or assets, the time period is the same as that applied under the BHC Act to disposing of shares or assets acquired in satisfaction of a debt previously contracted. During this period, a bank holding company can divest the property or, in the case of any debt that has been previously contracted, restructure the debt.

The initial Board order that was issued to permit the acquisition of defaulted debt is summarized here as a historical example of the nonbanking activity. Provisions or commitments made in the Board order should not be relied upon. The current requirements are found in section 225.28(b)(2)(vii) of Regulation Y.

3104.0.1 ACQUISITION OF DEFAULTED DEBT—BOARD ORDER

A bank holding company (the applicant) within the meaning of the BHC Act gave notice under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and the Board's Regulation Y that it proposed to acquire a company (the company) and engage nationwide in asset-based commercial lending and management of assets.

The applicant proposed to engage through the company in managing certain assets as the corporate general partner in two limited partnerships (the partnerships).[1] The applicant committed to conduct the activities, which the Board previously determined to be permissible, through the partnerships, subject to the limitations previously established by the Board.[2]

One nonbanking activity proposed by the partnerships, acquisition of defaulted debt, was an activity that the Board had not previously approved. The partnerships are engaged primarily in making, servicing, and investing in discounted bank loans and other debt securities.[3] The partnerships acquire debt that has been or is in the process of being restructured, including secured and unsecured debt in the form of bank loans, privately placed and publicly traded debt instruments, bonds, notes, debentures, and discounted receivables.[4] The applicant stated that the partnerships will take an active role in the restructuring of the defaulted debt they acquire, including participating on creditors' committees. The applicant indicates that such discounted debt would be acquired for the purpose of restructuring the debt to achieve a higher yield and greater collateral protection.

Some of the debt the partnerships would acquire may be in default at the time of acquisition and may be secured by voting shares or

1. The first partnership group (in which the company owned more than a 50 percent interest) was to terminate by December 31, 1995. The company owned less than 50 percent of the second partnership group, which would terminate by December 31, 1999.

2. See 1994 FRB 736. The partnerships, together with the applicant and its affiliates, would hold not more than 5 percent of any class of voting securities of any issuer and not more than 25 percent of the total equity, including subordinated debt, of any issuer. In addition, the applicant committed that no directors, officers, or employees of the applicant or its affiliates will serve as directors, officers, or employees of any issuer of which the applicant and its affiliates hold more than 10 percent of the total equity. The applicant also committed that future limited partnerships would be structured in the same manner as the current partnerships.

3. The partnerships are not leveraged, and the applicant stated that the partnerships will not be leveraged. The applicant has committed that neither the applicant nor any of its subsidiaries would be permitted to make loans to the partnerships.

4. The debt investments may include investments in companies that may be contemplating, be involved in, or recently have completed a negotiated restructuring of their outstanding debt or a reorganization under chapter 11 of the Federal Bankruptcy Code.

other assets that would be impermissible for a bank holding company to hold without Board approval.[5] Because the partnerships would have the right in some cases to take title immediately to shares or assets securing defaulted debt that they acquire, the applicant committed that the partnerships would treat this collateral, as well as any other assets acquired in renegotiating this debt, as assets acquired in satisfaction of a debt previously contracted (DPC). Under the BHC Act, a bank holding company must divest any shares or assets acquired as DPC within two years from the date the asset is acquired. For this purpose, the applicant has committed that it will consider shares or assets acquired in satisfaction of defaulted debt to have been acquired on the date the defaulted debt is acquired.[6]

The Board stated that the acquisition of defaulted debt under the circumstances and conditions proposed by the applicant is an activity that is closely related to banking. The applicant stated that it will only purchase debt, not equity, and will stand in the position of a creditor.

Based on all the facts of record, the Board concluded that the proposed activities are closely related to banking. The Board approved the notice on October 17, 1995 (see 1995 FRB 1128). Approval was specifically conditioned on the applicant's compliance with the commitments made in connection with the notice.

5. The applicant has committed that the partnerships will not acquire debt in default that is secured by shares of banks or bank holding companies.

6. The applicant could apply for up to a three-year extension. See 12 C.F.R. 225.22(d)(1). The Board notes that the divestiture requirement would be satisfied if, during the divestiture period, the partnerships renegotiate the debt into a performing obligation and release the collateral to the borrower as part of the renegotiation. To the extent that defaulted debt acquired by the partnerships is secured by assets or shares that would be permissible investments for a bank holding company, this divestiture commitment would not apply.

A bank holding company applied for the Board's approval, pursuant to section 4(c)(8) of the BHC Act, to engage de novo, through its existing nonbank subsidiary, in credit card authorization services and lost/stolen credit card reporting services. The credit card authorization activity would consist of providing, for a fee, a service to issuers of credit cards that would enable merchants to determine the validity and credit limits of cards tendered to them. In addition, the applicant was to provide, for a fee, a reporting service to credit card holders, that would enable them to report the loss or theft of any of their credit cards via a single toll-free telephone call to the nonbank subsidiary.

A number of banks indirectly offer the service of reporting lost cards that are issued by other institutions by arranging with independent companies to provide the service under a trade name associated with the bank. With respect to credit card authorization services, banks have a financial interest in the security of the credit cards and the availability of credit. Based on the foregoing, the Board believed that banks generally have, in fact, provided the services proposed by the applicant and are particularly well suited to provide the proposed services. On that basis, the Board concluded that the proposed services were closely related to banking.

Since the proposed credit card reporting service would create more competition and provide greater conveniences by allowing an individual who loses more than one card to report all lost cards at once to one source rather than having to make separate notifications to each card issuer, and there was no evidence of adverse effects as a result of the proposal, the application was approved by the Board on January 5, 1985 (1985 FRB 648). See Regulation Y, section 225.28(b)(2).

A domestic bank holding company (the applicant) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of the Board's Regulation Y to engage de novo, through a wholly owned subsidiary, in the following services to customers who make loans secured by inventory:

1. identifying inventory and deciding its general condition, level of protection, and amount of use, as appropriate
2. identifying inventory subject to a purchase-money security interest under the Uniform Commercial Code
3. identifying missing inventory and any credit exposure that could result
4. supporting the proper allocation of loan payments that are related to the aging or sale of inventory[1]

The applicant would provide the above inventory-inspection services only in connection with an extension of credit either by the BHC (applicant) or a third pary. The service would be provided throughout the United States, but only in connection with inventory pledged as collateral for a loan.

Bank holding companies currently inspect and survey collateral for loans made or services provided by them. Banks inspect collateral for loans originated in direct lending activities. The applicant suggested that its proposed collateral-inspection services to third-party lenders are identical to the collateral-inspection services performed for its own extensions of credit.

In accordance with section 225.28(b)(1) of Regulation Y, the Board authorized bank holding companies to make, acquire, and service loans for the company's own account or for the account of others. The Board believes that these activities include collateral-inspection services provided to third parties in connection with third-party extensions of credit. The Board also believes that bank holding companies have the necessary expertise to provide this service for other lenders (on a stand-alone basis).

The Board found that public benefits would result from a potential increase in the availability of inventory financing. It noted that there was no evidence suggesting that the proposal would result in significant adverse effects. The financial and managerial resources of the applicant were believed to be consistent with previous approvals. The Board, based on the facts of record, and the commitments and conditions made by the applicant, approved the request on September 13, 1993 (1993 FRB 1053).

1. For example, a loan may be secured by a pool of inventory collateral, but there may be an agreement to apply loan proceeds to specific items of collateral in a specified order. Equipment used beyond a stated number of hours might be of limited value, and the lender might agree to release its security interest in such items. The inspection of inventory collateral would verify the equipment's proceeds to pay off the oldest (or the youngest) items of collateral first (or last), rather than applying the proceeds pro rata to all items.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2015, this section was revised to amend the beginning discussion and to include statutory and regulatory citations and a current Board order reference within section 3110.0.4.

A bank holding company may acquire or retain an industrial bank to the extent authorized by state law, under section 225.28(b)(4) of Regulation Y only if the industrial bank acquired by the holding company is not a "bank" within the meaning of the Bank Holding Company Act. Industrial loan companies, industrial banks, and Morris Plan banks are state-chartered financial institutions that engage primarily in the business of furnishing consumer loans and small- business loans. The distinction between these institution and consumer finance companies lies in the ability of the industrial loan company to generate funds through the acceptance of deposits or issuance of certificates of indebtedness (thrift notes). Although some of these institutions have the same charters as banks (in some states), they traditionally have not been considered to be banks for purposes of the Bank Holding Company Act as they cannot both make commercial loans and accept demand deposits, although in some states they have been empowered to offer NOW accounts. Under a decision of the Supreme Court, NOW accounts are not demand deposits for the purposes of defining what a bank is. Thus, industrial loan companies and similar institutions may offer NOW accounts and make commercial loans without being treated as banks for purposes of the Bank Holding Company Act. These institutions may be insured by the Federal Deposit Insurance Corporation and are eligible for membership in the Federal Reserve System.

3110.0.1 NONBANKING ACQUISITIONS NOT REQUIRING PRIOR BOARD APPROVAL

In accordance with 12 C.F.R. 225.22(d)(8) of Regulation Y, the Board's prior approval is not required for certain asset acquisitions by a lending company or industrial bank. This refers to the assets of an office(s) of a company of which all, or substantially all, the assets relate to making, acquiring, or servicing loans for personal, family, or household purposes, if—

- the acquiring company has previously received Board approval to engage in lending or industrial banking activities under Regulation Y;
- the assets acquired during any 12-month period do not represent more than 50 percent of the risk-weighted assets (on a consolidated basis) of the acquiring lending company or industrial bank, or more than $100 million, whichever amount is less;
- the assets acquired do not represent more than 50 percent of the selling company's consolidated assets that are devoted to lending activities or industrial banking business;
- the acquiring company notifies the Reserve Bank of the acquisition within 30 days after the acquisition; and
- the acquiring company, after giving effect to the transaction, meets the Board's capital adequacy guidelines and the Board has not previously notified the acquiring company that it may not acquire the assets under the exemption.

3110.0.2 INSPECTION OBJECTIVES

1. To determine the quality of the loan portfolio and the overall condition of the company.
2. To determine what exposure the subsidiary presents to the holding company and subsidiary bank(s).
3. To determine compliance with applicable laws and regulations.

3110.0.3 INSPECTION PROCEDURES

1. Contact the applicable state regulatory agency to determine the legal parameters within which the company operates and to assess the degree to which the company is supervised. Each of the institutional structures under this exemption is state chartered, and the laws and regulations vary widely from state to state. The company may be directly supervised by its state department of banking or may be subject to virtually no supervision or regulation. If the company is insured by the Federal Deposit Insurance Corporation or is a member of the Federal Reserve System, the company is primarily subject to the primary supervision and regulation of that agency. In cases in which the

company is supervised by a banking agency, that agency's report of examination will generally suffice. However, when the company is not supervised or examined, or when the Reserve Bank finds the supervising agency's report inadequate, an on-site inspection is necessary.

2. Focus on an evaluation of the loan portfolio and securities account, a determination of the volatility of the deposits, an appraisal of the adequacy of the audit program, and a review of the company's internal policies.
3. Review the receivables representing lending activities. The company should provide a schedule of the aging of the consumer receivables. It is preferable that the aging be done on a contractual method. Classification of the consumer paper may be done on a formula basis. The larger credits must be given a complete evaluation.
4. Review the adequacy of the allowance for loan and lease losses in conjunction with the asset evaluation.
5. Price the securities portfolio, with particular emphasis placed upon determining its liquidity. Since the deposits of these institutions are not always insured, they are more susceptible to a deposit run off; therefore, the requirement of adequate liquidity is of paramount importance.

   The deposits may be insured by a guaranty corporation up to a certain limit in some states. These guaranty corporations have provided some stability to the industry. The guaranty corporations are independent of any government agency or municipality and therefore are limited in the amount of protection which can be offered depositors.
6. Review back-up lines of credit available to ensure secondary liquidity to the company.
7. Review the deposit accounts of the company. The deposits are evidenced by certificates of indebtedness, or thrift notes. Information regarding the number of deposits, the size of accounts, and maturity distribution should be obtained to assess the stability of the funding base.
8. Determine that the institution makes proper disclosure to the public as to the type of instrument the certificate represents. Some states require that a disclosure statement, or a prospectus, be filed with the public yearly, which sets forth the uses to which the funds are being put and states that the funds are not insured. This prospectus should be reviewed for proper disclosure of the required information to ensure against possible suits.
9. Check the company's policy concerning withdrawals, giving recognition to state law requirements, to ascertain whether funds are generally not allowed to be withdrawn without prior notice.
10. Review the scope of the internal or external audits.

3110.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Reference for authorized nonbanking activity—activity closely related to banking	4(c)(8) 4j(2)(A)	225.28(b)(4)		1982 FRB 253 1983 FRB 921 1984 FRB 231 1984 FRB 234 1984 FRB 371 1984 FRB 469 1984 FRB 741 1985 FRB 476
BHC indirect acquisition of an industrial bank	4(c)(8) 4j(2)(A)	225.24 225.28(b)(1) and (3)		2014 FRB 59, Q2
Nonbanking acquisition not requiring Board approval (conditions specified)		225.22 (d)(8)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, this section was revised to include in subsection 3111.03 additional Board orders that have authorized the acquisition of savings and loan holding companies.

3111.0.1 ACQUISITION OF A SAVINGS ASSOCIATION

Prior to 1989, the Board had determined that the operation of a savings association was closely related to banking but concluded, as a general rule, that the operation of a savings and loan association was not a proper incident to banking because the potential adverse effects, of allowing the affiliations of banks and thrift institutions outweighed the potential public benefits (1977 FRB 280). Upon consideration of some individual cases, the Board found that the adverse effects of the affiliation would be outweighed by the public benefits of preserving the failing thrift institution as a competitor in its market and of ensuring public confidence. (See 1985 FRB 462.) The 1982 Garn–St Germain Act recognized the Board's authority under section 4(c)(8) of the BHC Act to approve such acquisitions by authorizing the Board to dispense with the necessary notice and hearing requirements of this section under appropriate emergency circumstances.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) amended section 4 of the Bank Holding Company Act (BHC Act) to authorize, effective August 9, 1989, bank holding companies (BHCs) to acquire any savings association. The legislation lifted the previously existing "tandem operations" restrictions as they applied to savings associations owned by BHCs. (See 1989 FRB 716, appendix I.) These restrictions (1) provided that savings associations acquired by a BHC could not be operated in tandem with any other subsidiary of the BHC and (2) required approval by the appropriate Federal Reserve Bank before the savings association engaged in any transactions with the BHC or its other subsidiaries. The Board may not impose these restrictions on such transactions in the future, except for those restrictions required by sections 23A and 23B of the Federal Reserve Act.

With respect to previous Board approvals of the acquisition of problem thrifts by BHCs, FIRREA required the Board to modify those approvals by limiting any restrictions on transactions between the savings association and its holding company affiliates to those required under sections 23A and 23B of the Federal Reserve Act. In 1989, the Board removed the tandem restrictions imposed on the operations of savings association subsidiaries of a BHC. (See 1989 FRB 71b.)

The Board amended Regulation Y pursuant to FIRREA, effective October 10, 1989 (12 C.F.R. 225.28(b)(4)(ii)). The regulation allows BHCs to acquire healthy and failed or failing savings and loan associations in accordance with FIRREA. The regulation permits BHCs to acquire savings and loan associations in any state, regardless of whether the holding company may operate a bank in that state. It does not impose any operational or branching conditions on the operation of savings and loan associations. The regulation authorizes, as a permissible activity under section 4(c)(8) of the BHC Act, the owning, controlling, or operating of a savings association if the savings association engages only in deposit taking, lending, and other activities that are permissible for BHCs.[1] The Board has permitted a short divestiture period for impermissible investments and other activities. (See 1992 FRB 707.)

The Board requires that when a BHC acquires a savings association, the BHC must conform the acquired institution's direct and indirect activities to those permissible for BHCs under section 4 of the BHC Act.

In 2002, a foreign banking organization subject to the provisions of the BHC Act, and its wholly owned subsidiary, requested the Board's approval under section 4(c)(8) and section 4(j) of the BHC Act to acquire a savings association and thereby engage in operating a savings association, and to conduct certain nonbanking activities as a result of that acquisition. The foreign banking organization committed that it would conform all the activities of the acquired savings association to those permissible under

1. Section 225.2(m) of Regulation Y defines a savings association as (1) any federal savings association or federal savings bank; (2) any building and loan association, savings and loan association, homestead association, or cooperative bank if such association or cooperative bank is a member of the Savings Association Insurance Fund; and (3) any savings bank or cooperative deemed by the director of the Office of Thrift Supervision to be a savings association under section 10(*l*) of the Home Owners' Loan Act.

section 4(c)(8) of the BHC Act and Regulation Y. (See section 225.28(b)(4)(ii). See also 2002 FRB 385, 2002 FRB 485, 2003 FRB 439, 2004 FRB 503, and 2005 FRB 91.) The foreign banking organization was also treated as a financial holding company. Any other activities of the acquired savings association were, therefore, required to conform to those permissible for a financial holding company under section 4(k) of the BHC Act.

3111.0.2 APPROVAL TO BECOME A BHC BY ACQUIRING ANOTHER BHC

A savings and loan holding company (SLHC) requested the Board's approval, under section 3 of the BHC Act, to become a bank holding company (BHC), by merging with HN Corporation (a bank holding company) and thereby acquire HNB, a national bank. The SLHC requested the Board's approval to continue to operate SB, a subsidiary federal savings bank, until its conversion to a national bank. After the merger, SLHC would convert SB to a national bank and merge its subsidiary commercial bank (SCB) and HNB into SB, the survivor being SB.

SLHC also requested the Board's approval under section 3 of the BHC Act to acquire HN's minority interest in another BHC, BBI and its subsidiary bank, B Bank.

3111.0.2.1 Financial, Managerial, and Other Supervisory Considerations

Sections 3 and 4 of the BHC Act require the Board to consider the financial and managerial resources and future prospects of the companies, banks, and savings associations involved in a proposal and certain other supervisory factors.[2] These factors include supervisory and examination information received from the relevant federal and state supervisors of the organizations involved in the proposal, and other available financial information, including information provided by the SLHC. The Board is required to consider the managerial resources of the organizations involved and the proposed combined organization.[3]

3111.0.2.2 Nonbanking Activities

The SLHC filed a notice pursuant to sections 4(c)(8) and 4(j) of the BHC Act to (1) retain its ownership interest in SB and thereby operate a savings association and (2) engage in activities that are permissible for BHCs through its nonbanking subsidiaries, including lending, loans servicing and related activities, leasing, and selling credit-related insurance. The Board previously has determined by regulation that the operating of a savings association by a BHC and the other nonbanking activities for which SLHC has requested approval, are closely related to banking for the purposes of section 4(c)(8) of the BHC Act.[4]

With respect to the public interest factors under section 4(j) of the act, the Board must determine whether the operation of SB as a savings association by a BHC can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. The record indicated that consummation of the proposal would create a stronger and more diversified financial services organization and would provide current and future customers of HNB with expanded financial products and services.

2. 12 U.S.C. 1842(c)(2) and (3).

3. A comment received from the public expressed concern that SLHC acquired control over HN before obtaining the Board's approval of the application as the result of an extension of credit the SLHC made to HN. The extension of credit was made after the SLHC had filed its application with the Board to acquire HN. The SLHC loaned HN $50 million, secured by the shares of HNB. HN invested the loan proceeds in HNB to increase the bank's capital.

The Board noted its concern about a banking organization seeking to acquire another banking organization and making a loan to the acquiree in advance of the Board's approval of the acquisition. Such types of loans raise concern that the transactions would be, in substance, the acquisition of a controlling interest or would provide the acquirer with the ability to exercise a controlling influence over the management and policies of the BHC before receiving approval. The Board carefully reviewed the loan transaction, its supporting documentation, and the relationships of the organizations after the loan transaction. Based on all the facts of record, the Board concluded that the loan did not result in SLHC acquiring voting securities of, or a controlling equity interest in, HN, or in SLHC exercising, or having the ability to exercise, a controlling influence over HN. The Board noted that it continues to believe that when a loan is made by an acquirer to a target organization before it receives agency approval of its acquisition proposal, it raises important issues, and that it will review these arrangements critically and carefully.

4. See 12 C.F.R. 225.28(b)(1), (2), (3), (4), (8), and (11).

3111.0.2.3 Noncontrolling Investment

The SLHC proposed to acquire 17.5 percent of BBI's voting shares that HN currently owned and to increase up to 19.9 percent its total ownership of BBI's voting shares. The Board previously had approved HN's investment in BBI as a passive investment, and HN complied with certain commitments that were previously relied on by the Board in determining that an investing BHC would not exercise a controlling influence over another BHC or bank for the purposes of the BHC Act ("Passivity Commitments").[5] The SLHC indicated that it did not propose to control or exercise a controlling influence over BBI and that its indirect investment in B Bank also would be a passive investment. The SLHC provided the passivity commitments to the Board (see appendix A). Based on those commitments, the Board concluded that the SLHC would not acquire control of, or have the ability to exercise a controlling influence over, BBI or B Bank through the proposed acquisition of BBI's voting shares.

3111.0.2.4 Appendix A Passivity Commitments

The SLHC will not, without the prior approval of the Federal Reserve Board or its staff, directly or indirectly:

1. Exercise or attempt to exercise a controlling influence over the management or policies of BBI or any of its subsidiaries;
2. Have or seek to have a representative of SLHC serve on the board of directors of BBI or any of its subsidiaries;
3. Have or seek to have any employee or representative of SLHC serve as an officer, agent, or employee of BBI or any of its subsidiaries;
4. Take any action that would cause BBI or any of its subsidiaries to become a subsidiary of SLHC;
5. Acquire or retain shares that would cause the combined interests of SLHC and its officers, directors, and affiliates to equal or exceed 19.9 percent of the outstanding voting shares of BBI or any of its subsidiaries;
6. Propose a director or slate of directors in opposition to a nominee or slate of nominees proposed by the management or board of directors of BBI or any of its subsidiaries;
7. Solicit or participate in soliciting proxies with respect to any matter presented to the shareholders of BBI or any of its subsidiaries;
8. Attempt to influence the dividend policies; loan, credit, or investment decisions or policies; pricing of services; personnel decisions; operations activities, including the location of any offices or branches or their hours of operation, etc.; or any similar activities or decisions of BBI or any of its subsidiaries;
9. Dispose or threaten to dispose (explicitly or implicitly) of shares of BBI in any manner as a condition or inducement of specific action or non-action by BBI or any of its subsidiaries;
10. Enter into any other banking or nonbanking transactions with BBI or any of its subsidiaries, except that SLHC may establish and maintain deposit accounts with BBI, provided that the aggregate balance of all such deposit accounts does not exceed $500,000 and that the accounts are maintained on substantially the same terms as those prevailing for comparable accounts of persons unaffiliated with BBI.
11. Acquire or seek to acquire any nonpublic financial information of BBI or any of its subsidiaries, beyond the information already available to it as a shareholder of BBI. SLHC also confirms that there are no legal, contractual, or statutory provisions that would allow it or its subsidiaries to have any access to financial information of BBI or its subsidiaries beyond the information available to shareholders.

3111.0.2.5 Interstate Acquisition

Under the Dodd-Frank Act, the Board of Governors of the Federal Reserve System may not approve the acquisition of an insured depository institution (including a savings association) if the home state of the insured depository institution is a state other than the home state of the

5. The Board previously determined that the acquisition of less than a controlling interest in a bank or BHC is not a normal acquisition for a BHC. The requirement in section 3(a)(3) of the BHC Act that the Board's approval be obtained before a BHC acquires more than 5 percent of the voting shares of a bank seems to suggest, however, that Congress contemplated the acquisition by BHCs of between 5 and 25 percent of the voting shares of banks. See 12 U.S.C. 1843(a)(3). On this basis, the Board has previously approved the acquisition of a BHC of less than a controlling interest in a bank or BHC. See 2006 FRB C37 (acquisition of up to 24.89 percent of the voting shares of a BHC); 2005 FRB 74 (acquisition of 24.9 percent of the shares of a BHC); and 2000 FRB 52 (acquisition of up to 9.9 percent of the voting shares of a BHC).

bank holding company and the applicant controls, upon consummation, more than 10 percent of the total amount of insured deposits in the United States. (For the Dodd-Frank cite, see 12 USC 1843(c)(8). Pub. L. 111-203 124 stat 1547, 1634)

3111.0.3 LAWS, REGULATIONS, INTERPRETATIONS, ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Activity approval	1843(4)(i)	225.28(b)(4)(ii)		1997 FRB 275
Determination that the operation of a thrift institution is closely related to banking and a proper incident thereto		225.28(b)(1), (2), (3), (4), (8), and (11)		2010 FRB B7 1989 FRB 86 1986 FRB 724 1986 FRB 342 1985 FRB 340 1983 FRB 812 1982 FRB 660 1982 FRB 316 1977 FRB 280 1974 FRB 868
Bank holding companies acquiring savings associations must conform their direct and indirect nonbank activities to those permissible for bank holding companies		225.28(b)(4)(ii)		2014 FRB 13, Q3 (FRB Order No. 2014-16) 2010 FRB B7 2005 FRB 91 2004 FRB 503 2003 FRB 439 2002 FRB 485 2002 FRB 385
Acquisition of stock savings and loan associations				1985 FRB 462
Removal of tandem restrictions				1989 FRB 716
Establishing branches on an interstate basis after acquisition				1993 FRB 890
BHC's joint acquisition of a savings association, merged subsequently into a subsidiary bank		225.28(b)(4)(ii)		2014 FRB 23, Q4 (FRB Order No. 2014-22)
Minority investment (interest) in a savings bank				1995 FRB 509
Acquisition of a BHC of less than a controlling interest in a bank or BHC				2006 FRB C37 2005 FRB 74 2000 FRB 52

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Acquisition of a savings and loan holding company	1843(c)(8) and (j)	225.28(b)(4)(ii)		2015 FRB 61 (Board Order No. 2015-27 2015 FRB 37 (Board Order No. 2015-34

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Section 4(c)(8) of the BHC Act (Trust Services) Section 3120.0

The performance of trust services by a trust company subsidiary that is neither a ''bank'' nor a nonbank bank encompasses virtually any kind of fiduciary, agency, or custodial service commonly performed by a trust company so long as the subsidiary does not accept demand deposits or make loans, except as expressly permitted by section 225.28(b)(5) of Regulation Y. Generally, under Regulation Y, a trust company may only accept deposits arising out of trust funds not currently invested; perform escrow services, such as receiving, holding, and disbursing downpayments and other funds deposited by purchasers in real estate transactions; and act as an agent for an issuer of, or broker or dealer in, securities in a capacity of a paying agent, dividend-disbursing agent, or securities clearing agent, so long as the funds are not used by the customer as a general-purpose checking account and do not bear interest. The subsidiary's lending activities are restricted to making call loans to securities dealers and to purchasing money market instruments; however, such loans may not be used to provide funding for nonbank subsidiaries of the holding company.

Trust companies may be either state chartered or nationally chartered. Some nationally chartered trust companies have national bank charters but have agreed through limitations in their bylaws to engage only in those activities permitted for trust departments of national banks. To prevent the use of a trust company as a vehicle for evasion of section 3(d) of the Bank Holding Company Act, the Board has conditioned its approval of certain interstate acquisitions by requiring that (1) the trust company's demand deposit–taking activities not be operated in tandem with any other subsidiary, (2) demand deposit and commercial lending services of affiliates will not be linked in any way, and (3) the trust company will not engage in any transactions with affiliates, other than the payment of dividends or the infusion of capital, without the Board's approval (for example, see U.S. Trust Corporation, 1984 FRB 371). The scope of these conditions may be reviewed by the Board in connection with nonbank bank applications.

As part of normal administration of its trust accounts, a trust company will from time to time engage in an activity, such as property management or land development, that has been determined to be *not* closely related to banking by the Board. Any such service may only be performed incidentally to fiduciary-account administration and may not be offered or marketed as a separate service.

The board of directors and senior management of financial holding companies (FHCs) and bank holding companies (BHCs) are responsible for overseeing the operations of their fiduciary activities in a safe and sound manner. Such oversight (particularly for those BHCs and FHCs engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with financial activities as well as fiduciary activities can cut across legal entities and business lines. Federal Reserve examiners review and assess the internal policies, reports, and procedures and effectiveness of the BHC/FHC consolidated risk-management process.

The appropriate regulator of trust activities (including activities of a fiduciary, agency, or custodial nature) has the primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for any subsidiary or subsidiaries that the regulator supervises. Federal Reserve examiners should seek to use the examination findings of the appropriate regulators. (See SR-00-13.)

To determine the complete scope of fiduciary assets within an FHC/BHC, examiners should reference the Uniform Bank Performance Report (UBPR), which reflects the information gathered on Schedule RC-T. To further understand the scope of fiduciary assets within an FHC/BHC, an examiner should also look at information reported on Schedules Y-11 and Y-9C with respect to income derived from trust, fiduciary, and asset-management activities. (See also page 4 of the Bank Holding Company Performance Report (BHCPR) for the amount and percentages of income from fiduciary activities to adjusted operating income (tax-equivalent), including the BHC's corresponding peer-group ratios.)

Peer analysis is also available at the bank level. Examiners should refer to pages Trust 1 and Trust 1A of the UBPR. General comparison information is also available on a lagged basis in the FFIEC's electronic report ''Trust Assets of Financial Institutions'' (www2.fdic.gov/structur/trust/index.asp). Aggregate data are listed by year back to 1996.

3120.0.1 ON-SITE INSPECTIONS

Trust companies are normally engaged in activities such as management of funds for individuals. These activities are significant to the integrity of the banking system and involve significant potential liability to the bank holding company if not properly conducted. Therefore, periodic on-site inspections should be performed. If the trust company is examined by a state banking department, then alternate-year examination procedures may apply. If nationally chartered, a review of the periodic on-site examinations of the Comptroller of the Currency will generally suffice. If the trust company is not subject to a regular examination by another federal banking agency (i.e., if it is an uninsured, state-chartered nonmember trust company), the Reserve Bank should perform regular on-site inspections to include, at a minimum, full-scope reviews of the trust activity. The inspections would use procedures such as those used in the examinations of trust activities of state member banks. This portion of the inspection should be performed by examiners specially trained in trust examinations. Holding company inspectors should specifically review trust activities for compliance with any conditions imposed by the Board in connection with the approval of an application.

The main sections that follow (sections 3130.1 through 3130.9) address all financial and investment advisory activities under section 4(c)(8) of the BHC Act and section 225.28(b)(6) of Regulation Y that have been authorized by the Board. This section provides general inspection objectives and procedures that relate to such financial and investment advisory activities. These objectives and procedures can be applied to the BHC inspection of every advisory activity when advisory activities are not listed separately in any of this manual's individual advisory sections.

Any commitments that were made by the bank holding company or its nonbank subsidiaries to the Federal Reserve System pertaining to its financial and investment advisory nonbanking activities should be reviewed by the examiner for compliance and applicability, in accordance with the current statutory and regulatory provisions. Any existing commitments or conditions that relate to the financial resources of a bank holding company or its subsidiaries or to commitments or conditions that relate to the risk-management policies of the organization should remain intact and should be reviewed by an examiner for compliance during each inspection.

The Board's Regulation Y, effective April 1997, resulted in a structural reorganization of financial and investment advisory nonbanking activities. The provision of discretionary investment advice is no longer limited to institutional customers. Bank holding companies and their subsidiaries may engage in financial and investment advisory activities without restriction. Bank holding companies can manage retail customer accounts outside of the trust department of an affiliated bank (to the extent permitted by law). Further, bank holding companies may engage in any combination of permissible nonbanking activities listed in Regulation Y. Accordingly, bank holding companies may provide financial and investment advice jointly with permissible agency transactional service, investment or trading transactions as principal, or any other listed nonbanking activity.

The rules in Regulation Y provide examples of financial and investment advisory activities that are illustrative rather than exclusive. With regard to the examples, a bank holding company may act as an investment or financial adviser without restriction to any person, including

1. serving as an investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940) to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;
2. furnishing general economic information and advice, general economical statistical forecasting services, and industry studies;
3. providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar instruments, and conducting financial-feasibility studies;
4. providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instrument;
5. providing educational courses and instructional materials to consumers on individual financial-management matters; and
6. providing tax-planning and tax-preparation services to any person.

Sections 3130.1 through 3130.9 include many historical examples of various financial and investment advisory activities that have been approved by the Board. These examples are to be viewed as historical references. They should be considered as to their applicability to current statutory and regulatory provisions. Some examples include, but are not limited to, providing financial advice in rendering fairness opinions and providing valuation services in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, and capital structurings. Other examples include providing advice on financing and similar transactions with respect to private and public financings and loan syndications; conducting financial-feasibility studies; and providing financial advice to state and local governments with respect to the issuance of their securities.

3130.0.1 INSPECTION OBJECTIVES

1. To review the adviser's organizational structure and the qualifications of its management to conduct business, and to determine whether they are satisfactory.

2. To determine the status of the adviser's financial condition and the adequacy of internal controls, general accounting policies, and reporting procedures, and to determine if they reflect the guidelines established by management.
3. To determine whether fee income is accurately computed and reported on a consistent basis.
4. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
5. To review and evaluate investment practices considering the adviser's investment responsibilities for the selection and allocation of investments for various types of accounts to determine whether they are appropriate.
6. To evaluate funding sources, including indebtedness, and their management with respect to maturities and interest rates.
7. To determine the adequacy of internal and external audits.
8. To determine whether the adviser company has adequate policies and procedures to prevent self-dealing and similar improper conflicts.
9. To determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with the contractual responsibilities and authorities.
10. To determine if any litigation is pending against the company and the possible impact of an unfavorable court decision.
11. To evaluate compliance with applicable bank holding company laws, regulations, and interpretations, including compliance with the standards of care and conduct applicable to fiduciaries as required by Regulation Y.

3130.0.2 INSPECTION PROCEDURES

1. Review System approval and activities for conformance with any limitations. Determine if the activity is conducted through a separately incorporated subsidiary of the bank holding company that—
   a. refrains from taking positions for its own account;
   b. observes the standards of care and conduct applicable to fiduciaries with respect to its advisory and transactional services; and
   c. avoids executing customer transactions when acting in an advisory capacity.
2. Prepare financial statements for the last two fiscal years, plus interim if appropriate. Analyze for adverse trends and evaluate for negative effects on affiliates.
3. Evaluate asset quality when warranted, documenting the scope and detailing asset review. Compile classification data, write up classifications if appropriate, and evaluate reserve adequacy.
4. Obtain documentation for all indebtedness. Evaluate funding sources for maturity mismatch, dependence on affiliates' concentrations, and dependability. Review borrowings from affiliate banks for compliance with section 23A of the Federal Reserve Act.
5. Review income and expense accounts and transactions with affiliates for compliance with section 23B of the Federal Reserve Act.
6. Review the company's revenue sources to determine that it has not taken positions and does not, itself, execute transactions when acting in an advisory capacity.
7. Evaluate contracts and service agreements with affiliates. Identify whether the company receives or provides services or products. Determine that the services or products are needed and received or provided, and that the contract or agreement terms represent market rates.
8. Review the company's fee schedule for providing advice and the fees charged by affiliated banks to conduct transactions for the company's customers. Determine whether the bank is being adequately compensated for executing trades, or whether these profits are accruing largely to the benefit of the company.
9. Review checking-account statements for all accounts at affiliate banks for overdrafts since the previous inspection.
10. Evaluate whether the nonbank activities are being performed by affiliate bank personnel or are using bank assets. If so, is the bank adequately compensated?
11. Identify off-balance-sheet activities and contingent liabilities, and assess the risk to the company and any affiliate.
12. Obtain a listing of litigation against the company or any individuals who represent the company from the company's legal counsel, and evaluate potential effects on the financial condition.
13. Obtain and review internal and external audit reports and workpapers.

14. Obtain and review internal and external asset-review reports.
15. Obtain and review copies of the board of directors' and senior management's policies and procedures.
16. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.
17. Review the advisory contracts to determine if there are any conflicts of interests involving the parent company or affiliates, as well as the officers, directors, or principal shareholders and their related interests of the holding company and its affiliates.
18. Evaluate insurance for adequacy.
19. Obtain or verify that workpapers contain the following permanent documentation:
    a. System approval letters
    b. date of incorporation or date acquired
    c. date activity commenced
    d. articles of incorporation and by-laws
    e. commitments
    f. supervisory actions
    g. other pertinent correspondence
20. Obtain and review a listing of shareholders for each class of stock outstanding, and a schedule of officers, directors, and their related interests.

WHAT'S NEW IN THIS REVISED SECTION

This section is revised to amend section 3130.1.6, Laws, Regulations, Interpretations, and Orders. The table references a 2015 Board order that authorizes the merger of two bank holding companies and the acquisition of a bank, which were immediately followed by the acquisition of nonbank subsidiaries authorized to be engaged in financial and investment advisory activities under section 225.28(b)(6) of Regulation Y.

A bank holding company or its nonbank subsidiary that engages in investment or financial adviser activities is subject to section 225.28(b)(6) of Regulation Y. The purpose of an inspection of a company providing investment or financial advice is to determine that it is operating according to applicable laws, regulations, and interpretations, and to determine that the company is subject to an adequate audit program. Regulation Y allows a bank holding company to serve as an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(20)), which defines an "investment adviser" of an investment company as "...any person who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company..."

The Board has issued an interpretive rule regarding the investment adviser activities of bank holding companies under Regulation Y (12 C.F.R. 225.125). The following is a list of some of its provisions:

1. Bank holding companies, including their bank and nonbank subsidiaries, may act as investment advisers to various types of investment companies such as mutual funds and closed-end investment companies. Mutual funds and closed-end investment companies are described in the interpretation.
2. Bank holding company investment adviser activities are limited by the Glass-Steagall Act (Banking Act of 1933 (12 U.S.C. 24, 78, 377, 378)). This act generally prohibits member banks from engaging in the purchase or sale of equity securities other than in an agency capacity.
3. A bank holding company may not sponsor, organize, or control a mutual fund. This does not apply to closed-end investment companies so long as they are not primarily or frequently engaged in the issuance, sale, or distribution of securities.
4. A bank holding company should not act as investment adviser to an investment company which has a name similar to the bank holding company or any of its subsidiary banks, unless the prospectus of the investment company contains certain required disclosures. In no case should a bank holding company act as investment adviser to an investment company that has either the same name as the name of the bank holding company or any of its subsidiary banks, or that has a name that contains the word "bank."
5. Since investment adviser activities may create potential conflicts of interest, the Board determined that a bank holding company and its subsidiaries should not purchase in their sole discretion, in a fiduciary capacity (including as managing agent), securities of any investment company for which the bank holding company acts as investment adviser, unless the purchase is specifically authorized by (1) the terms of the instrument creating the fiduciary relationship, (2) court order, or (3) the law of the jurisdiction under which the trust is administered.
6. A bank holding company may not engage, directly or indirectly, in the underwriting, public sale, or distribution of securities of any investment company for which it or any nonbank subsidiary acts as investment adviser, except in compliance with section 20 of the Glass-Steagall Act. The Board has determined, however, that the conduct of securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory activities, is not deemed to be the underwriting, public sale, or distribution of securities prohibited by the Glass-Steagall Act.
7. A bank holding company or any of its nonbank subsidiaries that have been authorized by the Board under the Bank Holding Company Act to conduct securities brokerage activities (either separately or in combination with investment advisory activities) may act as agent, upon the order and for the account of customers of the holding com-

pany or its nonbank subsidiary, to purchase or sell shares of an investment company for which the bank holding company or its subsidiaries act as an investment adviser.

8. A bank holding company or any of its nonbank subsidiaries that have been authorized by the Board under the Bank Holding Company Act to provide investment advice to third parties generally (either separately or in combination with securities brokerage services) may provide investment advice to customers with respect to the purchase or sale of shares of an investment company for which the holding company or any of its subsidiaries acts as an investment adviser.
9. A bank holding company or its subsidiary bank, at the time a service is provided, must caution customers to read the prospectus of the investment company before investing. Customers must be advised in writing that the investment company's shares are not insured by the Federal Deposit Insurance Corporation and are not deposits, obligations, or endorsed or guaranteed in any way by any bank (unless that is the case). The role of the company or affiliate as adviser to the investment company must be disclosed in writing. Such disclosures may be done orally, but the cusotomer must be given such disclosures in writing immediately thereafter.
10. Because of potential conflicts of interest, a bank holding company which acts both as custodian and investment adviser for an investment company should exercise care to maintain at a minimum level demand deposit accounts of the investment company which are placed with a bank affiliate, and should not invest cash funds of the investment company in time deposit accounts (including certificates of deposit) of any bank affiliate.

3130.1.1 REAL ESTATE DEVELOPMENT ADVISERS FOR STATE AND LOCAL GOVERNMENTS

Advising state and local governments about methods available to finance real estate development projects, and evaluating projected income to determine if debt resulting from proposed development projects can be adequately serviced is permissible if the activities are authorized under section 225.28(b)(6) of Regulation Y.

Before this activity was incorporated into Regulation Y, in 1980, the Board had received certain comments noting that certain aspects of these advisory services may be within the scope of the activity of "management consulting." The Board had found that it was not permissible for bank holding companies to offer management consulting services to nonaffiliated companies. Certain management consulting advice could be provided to unaffiliated depository institutions, however. In view of the relationship that had traditionally existed between banks and state and local governments, and the net public benefits that would result from provision of advice to such governments by bank holding companies, the Board indicated that it would be more flexible in determining what particular services constitute "providing financial advice" rather than "management consulting" when the services are solely for state and local governments rather than other nonbank organizations. With the Board's April 1997 revision of Regulation Y, investment and financial advisory activities were grouped together and a bank holding company could act as an investment or financial adviser without restriction.

The Board also allowed the provision of management consulting services regarding any financial, economic, accounting, or audit matter to any company. These financial activities are directly related to the activities and expertise of bank holding companies. Management consulting services are subject to a revenue limitation, however. They may be provided to any customer on any matter, provided that the total annual revenue derived from the management consulting services does not exceed 30 percent of the company's total annual revenue derived from management consulting activities. Thus, any services provided to state and local governments that are deemed management consulting services are subject to this revenue limitation.

3130.1.2 INSPECTION OBJECTIVES

1. To review the adviser's organizational structure and the qualifications of management to conduct business, and to determine whether they are satisfactory.
2. To determine the status of the adviser's financial condition and the adequacy of internal controls, general accounting policies, and reporting procedures, and to determine if they reflect the guidelines established by management.

3. To determine whether fee income is accurately computed and reported on a consistent basis.
4. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
5. To review and evaluate investment practices considering the adviser's investment responsibilities for the selection and allocation of investments for various types of accounts, and to determine whether they are appropriate.
6. To evaluate funding sources, including indebtedness, and their management based on maturities and interest rates.
7. To determine the adequacy of internal and external audits.
8. To determine whether the adviser company has adequate policies and procedures to prevent self-dealing and similar improper conflicts.
9. To determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with the contractual responsibilities and authorities.
10. To determine if any litigation is pending against the company and the possible impact of an unfavorable court decision.
11. To evaluate compliance with applicable bank holding company laws, regulations, and interpretations, including compliance with the standards of care and conduct applicable to fiduciaries as required by Regulation Y.

3130.1.3 INSPECTION PROCEDURES

1. Obtain the company's policy and procedure manuals, and distribute relevant portions to the examiners for review and compliance evaluation.
2. Review the minutes of meetings of the board of directors, audit committees, and any officer-level committees. Ensure that examiners performing other portions of the inspection review relevant minutes or summaries thereof.
3. Obtain, review, and evaluate the adequacy of internal and external audit procedures, reports, and workpapers.
4. Prepare financial statements for the last two fiscal years, plus the interim period, if appropriate. Analyze and evaluate the information for adverse trends and for negative effects on affiliates.
5. Obtain, review, and evaluate internal and external asset-review reports.
6. Evaluate asset quality where warranted, documenting the scope and detailing asset review. Compile classification data, write up classifications if appropriate, and evaluate the adequacy of contra asset allowances.
7. Obtain documentation for all indebtedness. Evaluate funding sources for maturity mismatch, dependence on affiliates, concentrations, and dependability. Review borrowings from affiliate banks for compliance with section 23A of the Federal Reserve Act.
8. Review checking-account statements for all accounts at affiliate banks, checking for overdrafts since the previous inspection.
9. Complete the inspection checklist (see the sections beginning at 3130.1.3.2) based on the guidance provided in section 3130.1.3.1.
10. Identify off-balance-sheet activities and contingent liabilities, and assess the risk to the company and any affiliate.
11. Obtain a listing of litigation against the company or any individuals who represent the company from the company's legal counsel, and summarize the matters in litigation (or in threatened litigation) and any compromise actions. Evaluate the potential effects on the company's financial condition.
12. Evaluate contracts and service agreements with affiliates. Identify whether the company receives or provides services or products. Determine that the services or products are needed and received or provided, and that the contract or agreement terms represent market rates.
13. Review income and expense accounts and transactions with affiliates for compliance with section 23B of the Federal Reserve Act.
14. Evaluate whether the nonbank activities are being performed by affiliate bank personnel or whether bank assets are being used. If so, is the bank adequately compensated?
15. Review FR System approvals, and check conformance with any specified limitations or commitments.
16. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.
17. Review the advisory contracts to determine if there are any conflicts of interests involving the parent company or affiliates, as well as the officers, directors, or principal share-

holders and their related interests of the holding company and its affiliates.

18. Evaluate insurance, including bond coverage, for adequacy. Determine the extent of current liability insurance relating to the adviser function, and evaluate the adequacy of such coverage—particularly the extent to which possible significant surcharges would be covered by such insurance.
19. Obtain a listing of shareholders for each class of stock outstanding and a schedule of officers, directors, and their related interests.
20. Obtain or update biographical and experience information for key management personnel, together with overall staffing and salary levels as appropriate for full evaluation.
21. Determine whether operating practices provide for adequate legal documents and agreements such that the account activities, in general, are consistent with contractual responsibilities.
22. Ascertain if senior management is aware, or has adopted the procedures necessary to become aware, of its current and potential responsibilities in connection with any regulatory-reporting and/or regulatory-compliance requirements.
23. Obtain or verify that workpapers contain the following permanent documentation:
    a. System approval letters
    b. date of incorporation or date acquired
    c. date activity commenced
    d. articles of incorporation and by-laws
    e. commitments
    f. supervisory actions
    g. other pertinent correspondence

3130.1.3.1 Scope of Inspection

It is expected that inspections of investment adviser subsidiaries will generally be conducted as part of regularly scheduled bank holding company inspections. If, however, the investment adviser subsidiary provides portfolio management services for a significant portion of trust assets held by a state member bank, the Reserve Bank should inspect the investment adviser subsidiary at the same time it examines the trust operations of the bank subsidiary. The scope of the inspection should be based on a review of the nature and complexity of the financial services provided to customers. An adviser which merely provides investment advice and does not provide any additional financial services, such as portfolio management, safekeeping, recordkeeping, or trading services, may not require an inspection. However, an adviser which provides portfolio management, safekeeping, or other services will require an inspection. To determine the scope of the inspection, it is essential to identify what types of services are being offered to customers and to assess the risks associated with those services.

The examiner needs to understand the adviser's operations, including how it represents itself to clients and whether the adviser has any vested interests in the financial services which it offers. Examiners should use their discretion to schedule inspections based on the size and complexity of the adviser's operations. Most section 4(c)(8) BHC subsidiaries will be subject to SEC registration requirements. (See SR-91-4 (SA).) Appropriate checklist questions should be completed for registered investment advisers which provide investment advice to affiliated banks or trust companies and for investment advisers which engage in activities which could have a significant impact on the bank holding company's financial safety and soundness. The checklist should also be completed for all advisers that manage investment portfolios for their customers. The checklist is only a guideline and some of the sections in the checklist may not be applicable. Conversely, the scope of such examinations is not limited to the items included in this checklist.

3130.1.3.2 Inspection Checklist

The questions in this checklist will assist the examiner in evaluating various areas of supervisory concerns.

3130.1.3.2.1 Review of Fundamental Policies and Procedures

The investment adviser's policies and procedures should be reviewed using the following checklist to ensure that fundamental policies and procedures have been established and implemented.

1. Are adequate minutes of the board and board committee meetings prepared?
2. Is the adviser properly chartered and registered?
3. Does the adviser have sufficient blanket bond or other fidelity or liability coverage in place?
4. Is corporate and regulatory reporting performed on a timely basis?

5. Does the above reporting fairly present the accounting and supplemental data reflected by the corporate records?
6. Are internal accounting controls, provided by a segregation of duties or a need for administrative approvals, adequate?
7. Are duties properly segregated in the receiving, disbursing, and recording of cash and cash transactions?
8. Are fee calculations and billing procedures adequate to ensure accuracy and propriety?
9. Are all security transactions authorized or approved by the appropriate management level, and is there documented evidence of the authorization or approval?

3130.1.3.2.2 Supervision and Organization

Supervision refers to the conduct of an adviser's board of directors and senior management in establishing, communicating, and enforcing a system of policies, procedures, and practices suitable to its business objectives and legal requirements. Organization may be characterized as the framework of committees and the assigned responsibilities through which supervision functions. The examiner should (1) review the structure of the organization for adequacy of management information systems and (2) the organization framework as both relate to meeting the entity's stated responsibilities as well as generally accepted standards of conduct. The examiner should review the supervisory function by first identifying the duties and responsibilities of the board of directors. The directors owe the duty of reasonable supervision, including appropriate attention to areas in which the adviser is assuming sensitive and complex fiduciary responsibilities. The next level of review is the committee and officer positions to which certain authority has been delegated. In reviewing this level of supervision, the examiner should keep in mind that certain functions cannot be delegated; for example, approval of significant new services or lines of business, approval of formal policies designed to ensure that the adviser operates in basic compliance with laws and regulations, and the selection and supervision of senior management cannot ordinarily be delegated. Informal delegations and operating practices represent the last level of review. In reviewing both formal and informal delegations, consideration should be given to the institution's size and complexity. A final determination of the adequacy of supervision and organization must be based on findings of the entire inspection of the bank holding company or its nonbank subsidiaries. While topics that have direct or indirect impact on the adequacy of director supervision and management competence are of particular sensitivity, examiners nevertheless have a responsibility to carefully address and comment upon such issues. During the course of the inspection, the examiner should review the supervisory and organizational structure of the bank holding company, with particular reference to investment-related activities. The examiner should determine whether the board of directors has developed adequate objectives and policies.

3130.1.3.2.2.1 Supervision and Organization Checklist

1. If the board of directors does not directly supervise investment adviser activities—
   a. has a responsible board committee(s) been named to exercise this function?
   b. are any delegations consistent with bylaw provisions and other appropriate principles?
   c. do the board's minutes nevertheless reflect periodic but timely review of the conduct and operating results of the function?
2. Do minutes of the board, or its committee(s), reflect that members—
   a. attend meetings with reasonable frequency?
   b. require and approve, where necessary, appropriate written policies, strategic plans, and management reports relating thereto?
   c. review audit and regulatory reports (and management proposals and corrective measures in response thereto), litigation developments, earnings and expense reports, and changes to fee schedules?
3. Through adoption of formal policies and provisions for auditing, does the board adequately seek to ensure the integrity of the organization's records and operational systems?
4. Are policies and procedures adequately communicated to officers and staff?
5. Does the board or a board committee consider, periodically review, and provide for insurance protection?
6. Does the bank holding company maintain access to competent legal counsel and, where appropriate, obtain written opinions on sig-

nificant legal questions such as—
   a. pending or threatened litigation?
   b. account agreements whose terms are unclear or ambiguous or raise complicated points of law?
   c. proposed actions or policies involving matters such as conflicts of interest, restricted securities, ERISA, and other matters involving possible legal exposure?
7. If an account's securities are registered in a nominee name(s)—
   a. is the nominee agreement current?
   b. is the nominee registered with the American Society of Corporate Secretaries (to guard against duplication of the nominee name) and state authorities (where required by local law)?
8. Is staffing adequate, in terms of both numbers and qualifications, to handle the current volume of business?
9. Is there adequate provision for management succession, or for continuing operations in case of the loss of key personnel?
10. Is senior management aware of its responsibilities in connection with, and has it established written policies and procedures to ensure compliance with, any applicable regulatory-reporting requirements?
11. Are significant functions of the investment adviser subject to either internal or external audit? If not, ascertain whether an audit program should either be developed or expanded.
12. When appropriate in light of the size and complexity of the adviser's operations, has management had an audit of financial statements performed by certified public accountants?
13. Have all significant exceptions and recommendations in audits or examinations or inspection reports been corrected, implemented, or otherwise satisfactorily resolved?

3130.1.3.2.3 Portfolio Management

Investment selection is the process whereby the adviser evaluates, selects, and reevaluates those securities or other financial assets it will buy or sell for its clients, or for which it will make recommendations. It includes the process of researching and selecting recommended individual stocks and bonds, and setting objectives or strategies for diversifications by types and classes of securities into general or specialized portfolios, as well as the process of communicating and executing overall strategies for particular accounts.

When an adviser holds itself out as a professional, the adviser will be held to a high standard of prudence and expertise in the investment-selection and -review process. Therefore, advisers must carefully consider policies and procedures in this area in accordance with the size and character of the investment-selection responsibilities undertaken. In furnishing portfolio investment advice, particularly to retail clients, an investment adviser should observe the standards of care and conduct applicable to fiduciaries.[1]

3130.1.3.2.3.1 Investment Standards and Research

1. Are the general investment standards and review and selection responsibilities defined and approved by the board of directors?
2. Does management or senior investment personnel review overall investment policy and potential investment problems at least annually?
3. Is portfolio management policy adequately communicated to appropriate personnel (for example, by including it in committee minutes, directives, or memoranda circulated to such personnel)?
4. Does the institution, where appropriate, diversify investments according to—
   a. types of assets, such as common stocks, fixed-income securities, and real estate?
   b. types of securities by characteristics such as income, growth, and size of company?
   c. types of securities by industry and specific companies within industries?
   d. maturities of debt securities?
   e. geographic location of companies of issue, such as utilities?
   f. tax-exempt income?
5. If the institution has a list of securities approved for purchase, retention, and/or sale—
   a. are recommendations for additions to or deletions from such list(s) approved by a committee or group with appropriate authority and expertise?
   b. are periodic reviews made of the lists of

1. The term "portfolio investment" is intended to refer generally to the investment of funds in a "security" as defined in section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b) or in real property interests, except when the real property is to be used in the trade or business of the person being advised. In furnishing portfolio investment advice, bank holding companies and their subsidiaries shall observe the standards of care and conduct applicable to fiduciaries.

securities approved for purchase, retention, or sale to assess the current appropriateness of the investments listed?

6. If the institution uses any research or analysis in its general investment-review and -selection process—
   a. are appropriate factors taken into account?
   b. is appropriate documentation obtained and filed to reflect consideration of such factors?
7. If the size and character of the entity's discretionary investment responsibilities are such that the type of detailed research considerations and files envisioned in the previous question are not relied on, does it use ratings by acceptable financial-rating agencies, such as Moody's or Standard and Poor's, together with evaluation of basic relevant factors pertaining to the type of security under consideration?
8. Where appropriate, does the organization differentiate its investment-selection process as to the type of account in question, such as those for which the need for growth or income is paramount, or for taxable versus tax-free trusts or retail versus institutional accounts?
9. Do personnel possess sufficient expertise and experience to properly implement the firm's investment-selection systems and responsibilities?

3130.1.3.2.3.2 Account Administration

Special consideration has to be given to accounts subject to the Employee Retirement Income Security Act of 1974 (ERISA), which imposes fiduciary responsibilities upon any person who has any power of control, management, or disposition over the funds or other property of any employee benefit fund. When an adviser exercises investment discretion over such plans, the extensive fiduciary responsibility and prohibited transaction rules of ERISA will apply.

1. Does the adviser have portfolio management procedures which provide for—
   a. consideration of the needs and objectives of particular types of accounts, such as the need for income versus growth or taxable versus tax-free income?
   b. conformity with investment provisions of governing instruments?
   c. consideration of the liquidity needs of the account for anticipated distributions?
   d. appropriate diversification, including avoidance or elimination of concentrations in individual securities and by type and subclass of securities?
2. When assets in discretionary accounts are considered unsuitable, is a program of prudent and timely sale of such assets followed unless retention is required?
3. In order to determine the advisability of retaining or changing assets, does the adviser have procedures for periodic reviews?
4. Do minute books or other records—
   a. identify reviewed accounts?
   b. report written conclusions on the advisability of retaining or disposing of assets in the accounts?
5. As appropriate to the size and character of business, are account synopses and historical data used in the review of account assets?
6. Does the investment-review information include—
   a. amount and description of investment?
   b. categories of investment, such as bonds and stocks?
   c. types of investments within each category, such as industry groups for stocks?
   d. cost?
   e. market or appraised value at review date?
   f. annual income?
   g. yield at market?
   h. rating of recognized financial service?
7. For accounts in which the adviser makes investments at the direction of the client, does the adviser—
   a. review the account to detect illegal, nonconforming, substandard, or otherwise unsuitable investments?
   b. advise the power holder of any improper investments?
   c. inform parties at interest in the account if any improper investment is not disposed of, and seek legal relief, if necessary?
   d. resign from the account if corrective action is not taken concerning improper investments?
8. Have proxy voting policies and procedures as listed below been established for ERISA accounts that are suitable in relation to assumed responsibilities?
   a. voting of routine proxies?
   b. identification and handling of proxy or tender determinations when sensitive social issues, conflicts of interest, significant increases in management power or perquisites, or merger or buy-out proposals are involved?

      NOTE: For requirements relating to

proxy processing and the Shareholder Communications Act of 1985, see Operations and Internal Controls in the *Trust Examination Manual.* For questions relating to the voting of affiliate stock, see Conflicts of Interest in the *Trust Examination Manual.*

When an adviser invests accounts in options and/or futures, the following checklist questions (numbers 9 through 13) should be completed. For additional information as to appropriate uses of options and futures contracts, see SR-83-2(SA) and SR-83-39(SA).

9. When an adviser uses options and/or futures, has the board of directors or a directors'-level committee approved a policy and strategy for their use? Does the policy address—
   a. the investment objectives to be accomplished by the use of these contracts?
   b. the specific types of contracts to be used?
   c. the types of accounts authorized to use these contracts?
   d. restrictions and/or conditions upon use of contracts, such as selection of brokerage houses, position limits, time frames, leveraging, etc.?
10. Was adequate disclosure made and adequate authorization obtained to execute contract transactions for various types of participating accounts?
11. Are adequate systems and controls in effect to ensure—
    a. proper tax treatment?
    b. proper segregation of securities and/or monies?
    c. conformance with account objectives?
    d. adherence to adopted strategy, position limits, and related program parameters?
    e. periodic management evaluation and reporting systems with respect to—
       - results of contract activities upon overall investment performance?
       - market developments, including current liquidity of relevant futures and options contracts in which positions are taken?
       - financial condition, fee competitiveness, and performance of involved broker-dealers?
12. Does the accounting system accurately reflect contract activities with respect to—
    a. transaction details?
    b. current gains or losses on open contract positions?
    c. necessary tax information?
13. Do operating personnel appear sufficiently knowledgeable relative to the level of contract-transactions activity?

3130.1.3.2.4 Conflicts of Interests

The inspection of an investment adviser subsidiary which provides services to an affiliated trust company or bank with a trust department requires expanded inspection procedures. Often the investment adviser subsidiary was organized for the purpose of providing investment advice and services for the trust accounts held at one or more of its affiliates. These subsidiaries often employ the same individuals who worked in the banks or trust company which they advise.

Conflict-of-interest problems may arise when the adviser exercises any "discretion" when there are mutually opposing interests. The most serious conflict of interest is self-dealing, which could include transactions such as an investment in affiliated banks or the purchase of securities from or through an affiliate. To resolve conflicts of interest, such transactions and the fees associated with them must be fully disclosed and authorized by the appropriate parties.

Potential conflict-of-interest situations are not limited to transactions between affiliates, but can be between the adviser and any of its directors, officers, or employees individually. Due to the complexity, sensitivity, and exposure involved in conflicts of interest, it is particularly important that an adviser develop the awareness and policies and procedures to identify and deal with conflicts situations. Therefore, it is considered highly desirable, even when not specifically required by regulation, that written policies be adopted and periodically revised as necessary.

3130.1.3.2.4.1 Self-Dealing

1. Has the adviser—
   a. acquired any assets from itself or its affiliates?
   b. acquired any assets from directors, officers, or employees of the organization or its affiliates, or from any other individuals with whom a connection exists that might affect their best judgment?
2. Has the adviser sold or transferred any account assets, by loan or otherwise, to—
   a. any affiliates?
   b. directors, officers, or employees of any affiliates?

   c. other individuals or corporations with whom such a connection exists or other organizations in which such an interest exists that might affect the exercise of its best judgment?
3. Has the company purchased any securities for a customer account from any member of an undivided syndicate for which the adviser or any of its affiliates are participating, or from a private placement which the adviser assisted?
4. Does the company have satisfactory policies and procedures, in terms of its size and character of business, to address the preceding situations?
5. If the company directs extra fee-producing business to itself or an affiliate (for example, brokerage services or options-trading services), or if it charges separate fees to accounts for securities transactions or other services commonly provided as part of general account administration (for example, fees for cash management or investments in mutual funds when management or administration fees are received by the company or an affiliate)—
   a. has it identified those accounts which may properly participate in such services in accordance with adopted policy, legal opinion, a Department of Labor ruling, and/or other necessary determinations?
   b. has it made appropriate prior disclosures and obtained adequate specific authorizations for those accounts identified as entitled to the services?
6. Have any assets held by the company in one account been sold to another account? NOTE: The transaction may be permissible if appropriate disclosure is made, authorization is received, and the law or the governing instrument do not prohibit it. However, an interaccount transaction for ERISA accounts may be a prohibited transaction. In addition, difficult problems can arise in establishing or documenting a "fair" price for the transaction, particularly if the asset is a thinly traded security or is a unique asset.
7. Does the company have appropriate policies and procedures to ensure—
   a. its discretionary accounts are not left in uninvested cash positions beyond a minimum period of time?
   b. its accounts are invested in affiliate interest-bearing deposits only for appropriate temporary or other purposes? NOTE: To the extent the company has long-term affiliate deposits or significant aggregate holdings, a special review should be made of the company's documentation evidencing the suitability of such investments in view of available alternate vehicles.
8. Are securities of affiliates only purchased upon proper direction or specific authorization in account instruments?
9. When the adviser purchases securities which are underwritten by an affiliate, does the adviser do so only upon proper direction and specific authorization of the customer?
10. Does the company act as investment adviser to an open-end or closed-end investment company that is registered under the Investment Company Act of 1940? If so, do its activities conform with the Board's interpretation at 12 C.F.R. 225.125, which defines the scope of permissible activities?

3130.1.3.2.4.2 Broker Selection

1. When volume of activity warrants, is allocation of brokerage business controlled through an approved list which is periodically reviewed and approved by the company's board or a senior-officer-level committee?
2. Does management attempt to obtain the best service for customers, including periodic evaluations of broker qualifications such as—
   a. financial condition?
   b. past record of good and timely delivery and payment on trades?
   c. quality of execution and ability to handle specialized transactions?
   d. quality of research received, if applicable?
3. Are there procedures to monitor or periodically survey available negotiated commission prices in order to ascertain reasonable costs for the execution requirements of its accounts?
4. If commissions higher than the "lowest" available negotiated commissions are being paid for executions in order to receive goods and/or services—
   a. have such goods and/or services been determined to reasonably qualify as "brokerage and research services" as defined in section 28(e)(3) of the Securities Exchange Act of 1934?
   b. does an appropriate committee periodically (at least annually) review and determine that the value of the goods and services justifies the payment of the higher

brokerage commissions?

5. Does the entity periodically review and maintain records of all goods and/or services received from brokers or third parties in return for brokerage and/or dealer business allocated to particular firms?
6. Do policies and procedures preclude—
   a. selection of broker-dealers on the basis of deposit balances?
   b. agreements or understandings for allocation of specific amounts of business to a broker-dealer such that the adviser company would not be able to cease allocating business to the firm if it were no longer providing acceptable execution?
7. Are auditing and other monitoring controls and reporting procedures in effect to verify the compliance of traders with policies regarding broker selection and payment of commissions? NOTE: Under section 28(e) of the Securities Exchange Act of 1934, the adviser may also legitimately pay more than the lowest-available commission for reasons of execution, financial soundness, and efficiency of delivery and payment.
8. In addition to advisory services, are brokerage services provided for customers pursuant to section 225.28(b)(7)(i) of Regulation Y? If so, the examiner should refer to the securities brokerage inspection procedures and checklist questions for the inspection of brokerage activities.

3130.1.3.2.4.3 Trading Policies and Practices

1. When trading specialists are employed, are there adequate written or unwritten standards of competence, education, and training for such individuals?
2. When specialists are not employed, are the individuals responsible for trading reasonably trained and informed in relation to the volume and character of trading activity they are required to perform?
3. When transactions are permitted to be crossed between accounts, are procedures adequate to ensure fair pricing of the transactions? If it is not clear the transactions are permitted, has the company determined through counsel that crossing is permissible under applicable law?
4. When specialists are employed and volume of activity permits, are block trades considered in order to obtain more favorable trade prices and execution prices for accounts?
5. If applicable, do procedures, including establishment of time frames in advance of such trading, require special authorization and attention for large or block trades which are to be executed in a number of transactions?
6. If procedures permit the combining of purchase or sale orders of the same security—
   a. are resulting benefits in price and/or execution costs applied on a pro rata or average basis to the participating accounts?
   b. are allocable shares similarly pro-rated to participating accounts when a combined trade is not executed at once, but in a number of transactions over a period of time?
7. Does the adviser maintain policies “reasonably designed to prevent the misuse of material non-public information?”

3130.1.3.2.5 Recordkeeping

Registered investment advisers are subject to extensive recordkeeping requirements. SEC Rule 204-2 imposes recordkeeping standards and requires that registered investment advisers keep accurate records. In addition to this recordkeeping, the adviser is subject to the “brochure rule” (Rule 204-3). This rule requires an investment adviser to deliver a specified disclosure statement with respect to its background and business practices to every client or prospective client. In addition to an initial disclosure, the adviser must offer annually to deliver a current disclosure statement upon request. Those advisers which have custody or possession of securities of any client must maintain certain additional records, including separate ledger accounts for each client, copies of confirmations, and a position record showing the interest of each client and the location of the securities.

1. Does the investment adviser make and keep current appropriate books and records including—
   a. journals or summary journals?
   b. a memorandum of each order given by the firm or instructions received, showing terms and conditions of the orders?
   c. all checkbooks, bank statements, canceled checks, and cash reconciliations?
   d. all bills or statements, paid or unpaid?
   e. trial balances, financial statements, and internal audit papers?
   f. written communications received or sent by the firm?
   g. list of discretionary accounts?

   h. powers of attorney and discretionary powers?
   i. written agreements?
   j. copies of each notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication recommending the purchase or sale of a security?
2. Does the adviser maintain a record of every transaction in which the adviser or any ‘‘advisory representative’’ has a direct or indirect beneficial interest?
3. Are partnership articles, articles of incorporation, charter, minute books, and stock certificate books maintained at the adviser’s principal office?
4. If required books and records are photocopied or microfilmed, or if they are produced or reproduced on computer storage media—
   a. are such media indexed and arranged to permit immediate location of any particular record?
   b. were any copies or printouts of such records promptly provided on request?
   c. is at least one copy of the original records that are now on such media stored in a separate location from the original for the time required?
   d. does the adviser maintain procedures for the maintenance and preservation of, and access to, records so as to reasonably safeguard them from loss, alteration, or destruction?
   e. does the adviser have facilities for the immediate, easily readable projection of microfilmed records and for producing easily readable facsimile enlargements?
5. Do the entries in the general ledger and journals properly reflect payments or receipts of monies or other goods or services?
6. Do the financial statements, canceled checks, deposit slips, and check register properly reflect payments or receipts of monies or other goods or services?
7. When the adviser’s financial records indicate that it is capitalized with client funds (through either loans or equity), have adequate disclosures been made to clients about the risks and conflicts of interest involved?

3130.1.3.2.6 Security Storage and Processing

Investment advisers generally do not take possession and control of client funds and securities. However, in those cases in which such responsibilities are assumed, the inspection must evaluate those internal controls which are in place for the safeguarding of client funds and securities. Controls and related processing procedures must be appropriately designed and implemented by the adviser to efficiently and safely facilitate such operations.

1. Does the adviser have custody of client funds or securities?
2. Does the adviser gain effective access to client assets through practices, arrangements, or relationships with clients, such as trustee, executor, or account signator?
3. When the adviser has custody of client funds or securities, does the adviser maintain the following records:
   a. a record reflecting all purchases, sales, receipts, and deliveries of securities, and all debits and credits to such accounts?
   b. a separate ledger account for each client, showing purchases, sales receipts, and deliveries of securities?
   c. copies of confirmations of all transactions for such clients?
   d. a record for each security in which any client has a position, reflecting the name of the client, amount of interest, and location of security?
4. When the adviser renders investment-management services, are the following records maintained:
   a. for each client, a record of securities purchased and sold, containing the date, amount, and price of each transaction?
   b. a record for each security in which any client has a current position, showing the name of each client and current interest or number of shares owned by each client?
5. Are client assets physically segregated from the adviser’s own assets?
6. For the vault and other related security-processing areas, are adequate controls/safeguards in effect which include the following:
   a. Are assets maintained under a system of joint custody or dual control?
   b. Is access to these areas restricted to designated/authorized personnel?
   c. As appropriate, are other controls/safeguards systems in place (for example, rotation of assignments, key/lock combinations, or vault or area entrance log(s))?

d. Is a security-ticket system used as a vault and asset-movement control system?

7. If a security-ticket system is used, are adequate controls/safeguards in effect which include the following:
   a. Are security tickets prenumbered?
   b. Does each copy of the security ticket clearly indicate its destination to ensure prompt and accurate delivery?
   c. Does the security ticket provide the necessary information to ensure proper processing and recording of the transaction?
   d. Does the security ticket contain sufficient copies to ensure that sound internal control is maintained over the physical security-movement process by providing the following with a copy (or copies):
      - portfolio managers who initiated the transactions?
      - appropriate vault/operations personnel?
      - the audit/asset control function?
   e. Are unissued security tickets properly safeguarded and subject to adequate numeric controls?
8. Does the control of security ticket/transaction cancellation and replacement include—
   a. restricting the ability to initiate such action to supervisory personnel?
   b. reporting such activity to the audit/asset control function and other function(s) affected by such action?
   c. procedures to ensure that securities are returned to the vault or that funds charged from an account are redeposited, or that the securities or funds are immediately placed under the control of a new security ticket/transaction?
   d. identifying a replacement security ticket by recording such information on the replacement ticket?
   e. requiring all copies of the replaced security ticket to be forwarded to the audit/asset control function?
9. For assets received, are adequate controls/safeguards in effect which include the following:
   a. Are all assets received promptly placed under joint custody or control?
   b. Is appropriate documentation required and on file for all assets received, and is it compared to actual assets received and posted to control ledgers?
   c. As applicable, are procedures in place for controlling and properly handling assets received by other means, including delivery by mail or messenger?
   d. If assets are not to be physically held or issued (for example, mutual fund shares), is a receipt, statement, or acknowledgment obtained from the issuer or holder and processed by receipt ticket or other means to ensure proper accountability?
   e. If securities received are not properly registered in the company's nominee name, are procedures in place to ensure prompt re-registration, control, and follow-up until re-registration?
10. For the delivery of assets, are adequate control/safeguards in place which include the following:
    a. Are appropriate receipts obtained and on file for securities delivered?
    b. Are procedures in place to ensure that bearer securities are not mailed in amounts in excess of the company's insurance limits?
11. Do vault custodians—
    a. compare securities received/withdrawn to the security ticket?
    b. for withdrawals, verify that the security ticket is signed (initialed) by authorized personnel?
    c. for securities temporarily withdrawn from the vault (for example, for transfer, re-registration, or account/portfolio manager review), is a copy of the security ticket retained by vault personnel pending the return of the security to the vault?
12. For pending security transactions, are adequate controls in effect which include the following:
    a. Are pending items periodically reviewed by operations personnel?
    b. Do procedures provide for prompt follow-up on items which have not been completed within established time periods?
    c. Are exceptions promptly reported and resolved by appropriate personnel (for example, management, supervisors, and/or the audit/asset control function)?
    d. Are current pending security items in compliance with established procedures for reporting exceptions, and are those transactions which have not been completed within established time periods been followed up satisfactorily? NOTE: Examiner judgment should be used in determining the scope of this review. However, at a minimum, the review should include procedures for

handling security transactions pending 30 days or more.

13. Does the security-processing system—
    a. contain a sufficient number of controls/safeguards to properly reflect the current status of and limit an individual's control over a security transaction?
    b. contain sufficient information to identify, locate, and trace the movement of each asset?
    c. provide for adequate segregation of duties and responsibilities?
14. Has individual accountability or responsibility been properly assigned for the physical protection of the securities and related cash flow, if applicable, throughout the security-processing system?
15. Do procedures require that orders for trades originate with account or portfolio managers, with the signature or initials of the authorizing party shown on the order form or purchase/sale ticket?
16. Are transactions made on a first-in, first-out basis (that is, executed in order of receipt), except when combined in blocks for execution pursuant to appropriate written procedures?
17. Do operations personnel perform independently of account or portfolio managers to—
    a. reconcile trade tickets to brokers' confirmations?
    b. monitor and promptly follow up on any outstanding transactions, such as confirmations not received within specified time periods or purchases/sales which have not settled on settlement date?
    c. promptly post payments for purchases/sales to the recordkeeping system and promptly record/remove assets?

3130.1.3.2.7 Other Matters

1. Is the adviser or any of its principals involved in litigation or arbitration which will have an impact on its ability to fulfill its contract with clients?
2. Were any matters of a material nature found in the adviser's correspondence, such as significant client complaints?
3. Did a review of customer-complaint files reveal any possible areas for special inspection focus?
4. Did a review of the adviser's current financial condition raise concerns as to the adviser's solvency or its ability to otherwise continue to provide advisory services?
5. Are there any other aspects of the adviser's operations, or the operations of an affiliate, which raise concerns?

3130.1.4 INSPECTION FINDINGS

A written summary of the subsidiary's activities should be presented to the examiner in charge of the bank holding company inspection and should be included in the inspection report or its supporting workpapers. Material exceptions should be noted with management's responses under an appropriate caption in the open section of the report. Any comments in the report regarding the scope of the investment advisory inspections should note that such inspections are primarily focused on safety-and-soundness considerations and not on compliance with securities laws.

In those cases in which a separate Report of Bank Holding Company Inspection on Investment Advisory Activities is prepared, examiners may use the Uniform Interagency Trust Rating System (see SR-98-37 FRB, revised October 13, 1998, and effective January 1, 1999), which provides a basis for the evaluation of critical areas of supervisory concern. The rating system is generally used by federal supervisory agencies to assess the condition of trust companies. However, the system can be adopted to report on advisory operations as well. When the inspection uncovers significant deficiencies which require corrective action, and the inspection was not done in conjunction with a concurrent bank holding company inspection, a separate report should be prepared and delivered to the inspected nonbank adviser. Send a copy of the summary and any report comments to the Trust Activities Program, Washington, DC 20551.

3130.1.5 ON-SITE INSPECTION BY TRUST EXAMINERS

An investment advisory subsidiary of a bank holding company will normally be registered as an investment adviser under the federal securities laws, and will be subject to examinations of its advisory activities by the Securities and Exchange Commission (SEC). Nevertheless, because investment responsibility is involved in any investment adviser's activities, and since the SEC's routine examinations may be infrequent, periodic on-site inspections should be conducted as an integral part of BHC inspections.

Consideration should be given to using trust examiners to conduct, or at least participate in, on-site inspections of financial and investment advisory nonbank subsidiaries, especially when the subsidiary provides services to an affiliate bank trust department examined by the Board of Governors of the Federal Reserve System. If the bank holding company has to "spin off" the investment research and selection process of its banks' trust departments into an investment advisory subsidiary, there may be a need to review the activities of the trust departments together with those of the advisory subsidiary through an on-site inspection.

The companies being advised on a contractual basis and which were sponsored by the holding company or any affiliate are also defined as affiliates in sections 23A and 23B of the Federal Reserve Act. The examiner should therefore be alert to any intercompany transactions between a bank subsidiary and the advised company. A review of financial statements of such companies is warranted.

3130.1.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Limitations and activity approval	15 U.S.C. 80; section 23A FRA 371c	225.28(b)(6) 225.125	4–177	1997 FRB 275 1971 FRB 512 1972 FRB 149, 571
Activity approval—real estate development advisers for state and local governments		225.28(b)(6)		1997 FRB 275 1980 FRB 962 and 984
Merger of two BHCs under Section 3 of the BHC Act, acquisition of a bank, and followed by the acquisition of non-banking subsidiaries engaged in financial and investment advisory activities	1843(c)(8) and (j)	225.28(b)(6)	225.125	2015 FRB 82 (Board Order No. 2015-26

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

This section renders inspection guidance on financial and investment advisory activities that are provided in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, and financing transactions and similar transactions, and on conducting financial-feasibility studies.[1] This section also provides historical examples of financial and investment advice previously approved by Board order. The examples consist of various kinds of advice with regard to mergers and similar corporate transactions under the current Regulation Y, section 225.28(b)(6)(iii). Some of the examples of advisory nonbank activities were approved for inclusion into Regulation Y long before the revision of Regulation Y that was effective April 21, 1997. The reader of these examples must only take into consideration the current provisions of Regulation Y. There should be no reliance on Board order commitments, old regulatory provisions, supervisory policies, and interpretations made before April 21, 1997, unless they were not revised. Certain former provisions or commitments may no longer be applicable. The historical examples discussed in this section have been revised according to the new regulatory provisions.

If inspection objectives and procedures are stated in a specific section, the examiner should use this specialized guidance. In addition, the examiner should use the generalized inspection objectives and procedures in section 3130.0, which are generally applicable to all advisory activities.

3130.3.1 ADVISER TO A MORTGAGE OR REAL ESTATE INVESTMENT TRUST

An adviser to a mortgage or real estate investment trust (REIT) furnishes expertise in the areas of funds acquisition, lending, investing, and servicing that is similar to the role of adviser to a mutual fund. The contracted service is performed on a fee basis that is generally based on a percentage of the trust's total assets. The intention of the exemption, found in section 225.28(b)(iii) of Regulation Y, is to allow the relationship to be advisory in nature as opposed to controlling. However, in some instances, the relationship between trusts and their advisers has gone beyond the parameters of advice and resulted in legal entanglements, conflicts of interest, and financial exposure for the bank holding company. Because of the potential risk exposures which may result when a bank holding company or its subsidiary engages in this activity, the overall relationship must be subject to particular scrutiny during an inspection.

REITs were established by the U.S. Congress in 1960, effective January 1, 1961. A REIT is a hybrid form of an investment vehicle which is essentially a financial intermediary specializing in real estate lending and investment. A REIT obtains funds by borrowing from financial institutions or other lenders or by issuing shares (equity capital). It invests the funds in real estate, either as a lender or equity owner. REITs are usually owned by passive owners, not operators. REITs are designed to take advantage of benefits within the federal Internal Revenue Code.

There are generally four types of REITs: equity, mortgage, hybrid, and "finite-life." An equity REIT acquires income-producing properties, deriving its earnings mostly from rents. A mortgage REIT provides financing to real estate projects that are owned by others, deriving its earnings from interest charged on the loans. A hybrid REIT combines the equity REIT and the mortgage REIT. The finite-life REIT is structured to self-liquidate within an established time frame.

By meeting certain prescribed requirements during a taxable year, a REIT may function as a conduit with respect to income distributed to its beneficiaries. If at least 95 percent of the trust's income is distributed to the beneficiaries (excluding capital gains), the trust pays no taxes on the distributed income, thus avoiding the double taxation associated with corporations. Therefore, this investment vehicle has the tax advantage of a partnership but offers the limited liability and perpetuity of a corporation.

A REIT must be a corporation (other than an insurance company or bank), an association, or a trust, or it must be managed by at least one trustee, with transferable shares of beneficial interest as form and evidence of ownership. There must be at least 100 beneficial owners, and the trust must elect to be treated as a REIT for tax purposes. A REIT must meet the following threefold gross income test. At least 95 per-

1. Feasibility studies do not include assisting management with the planning or marketing for a given product or providing general operational or management advice.

cent of the trust's income must come from real property rentals, dividends, abatements and refunds of real property taxes, interest on loans, or gains from the sale of securities or real estate, with the further stipulation that no less than 75 percent of the trust's income must be directly related to real property. Also, less than 30 percent of the trust's income can be derived from the sale of any securities held for less than six months and from foreclosure property and real property held for less than four years that is not involuntarily converted.

In addition to the threefold gross income test, there is a twofold investment test which must be met. First, at least 75 percent of the value of the trust's total assets must be real estate assets, government securities, and cash. Second, 25 percent of the trust's total assets may be securities, but the trust cannot hold securities from one issuer which amount to greater than 5 percent of the trust's total assets and more than 10 percent of the outstanding voting securities of the issuer.

3130.3.1.1 Evaluating Advisory Activities for a REIT

A bank holding company may have an insignificant amount of capital invested in the advisory company. However, if the bank holding company or its subsidiaries have extensions of credit or unfunded commitments outstanding, an evaluation of the credit may be needed using normal classification criteria as to their collectibility, particularly if there is substantial risk exposure. Examination/inspection reports of subsidiaries should be reviewed to determine the consolidated exposure. The holding company or its banking subsidiaries may be participating in exchanges or swaps with the advised REIT, whereby trust assets are exchanged for forgiveness of bank debt. Such pending asset swaps should be considered in conjunction with the credit evaluations. The swaps may be for the purpose of reducing the REIT's liabilities, which can involve an exchange of assets with the lender. The lender's balance sheet reflects an exchange of one asset for another together with, possibly, a lump-sum payment of cash to the trust. If a swap is pending, review the criteria that the holding company used to (1) determine the benefit of the swap to the company and (2) select which of the REIT's assets would be considered for the swap. Also, determine the amount of any cash or earning assets that will be given to the trust.

A holding company and a trust have separate and distinct shareholders but common management. The potential exposure in such cases may be pronounced. Such relationships should be reviewed for conflicts of interest. Loans may be booked by the holding company or its subsidiary and subsequently sold to the trust. The credit decision may have been made by the subsidiary, and the REIT's purchase of the loans may have been approved by the affiliated adviser. The benefits to the holding company may include receiving the origination fee and selling the loan to the trust, thereby increasing the REIT's assets, upon which the holding company's advisory fee is based. Following receipt of the sale's proceeds, the process may be repeated. If the holding company has participated in this type of process, there is potential for a conflict of interest. The holding company or its subsidiary may have to repurchase the credit.

Theatened or pending litigation may result from loans that were originated by the holding company or its subsidiaries or that were recommended by the adviser. The number of such loans together with the current payment status of the credit should be determined. If there are numerous loans on a nonaccrual status, the holding company may have accumulated a significant loss. Finally, any suit involving the adviser which pertains to services it performed should be explored as to its validity and potential financial exposure.

3130.3.2 INSPECTION OBJECTIVES

1. To determine the level of risk involved when the bank holding company or its subsidiaries have extensions of credit and unfunded commitments outstanding to the advised trust.
2. To review for conflicts of interests in cases when a holding company and a trust have separate and distinct shareholders but common management.
3. To review all threatened or pending litigation involving loans originated by the holding company or its subsidiaries that were recommended by the adviser.
4. To review all covered transactions between a bank holding company's subsidiary bank and a REIT, if the REIT is sponsored and advised on a contractual basis by the bank or any subsidiary or affiliate of the bank, to ensure that transactions are permitted pursuant to sections 23A and 23B of the Federal Reserve Act.

5. To determine whether the REIT has been advised to sell real estate in the ordinary course of business and, if so, whether the appropriate liability account for corporate federal and state taxes has been established by the advised subsidiary.
6. To determine whether the REIT adviser is providing the appropriate advice to the REIT to generate nonspeculative high yields; adequate liquidity; portfolio diversification; sufficient cash flow to pay dividends; continuous repricing; and adequate public disclosure, including the extent of risk involved.
7. To determine the adequacy and quality of professional management and the level of management's equity stake in the REIT.
8. To determine the effect on net earnings from floating interest rates on asset yields that may have been caused by prepayment risk.

3130.3.3 INSPECTION PROCEDURES

1. Determine if there are any significant extensions of credit or unfunded commitments outstanding. If so—
   a. evaluate the credit using normal classification criteria as to collectibility;
   b. review examination or inspection reports of the holding company's subsidiaries and determine the consolidated exposure; and
   c. review any pending asset swaps in conjunction with the credit evaluations, if the holding company or its banking subsidiaries are participating in exchanges or swaps with the advised REIT whereby trust assets are exchanged for forgiveness of bank debt.
      - Review the lender's balance sheet to make certain that it reflects an exchange of one asset for another, as well as any lump-sum payment of cash to the trust.
      - Review the criteria the holding company used to (1) determine the benefit of the swap to the company and (2) select which of the REIT's assets would be considered for the swap.
      - Determine the amount of any cash or earning assets that will be given to the trust.
2. Determine and evaluate any significant conflicts of interests in cases when a holding company and a trust have separate and distinct shareholders but common management.
   a. Determine if there are any loans booked by the holding company or its subsidiary and subsequently sold to the trust, if the credit decision was made by the subsidiary, and if the REIT's purchase of the loans was approved by the affiliated adviser.
   b. If significant conflicts of interest exist, determine whether the holding company or its subsidiary must repurchase any associated credit.
3. Review all threatened or pending litigation involving loans originated by the holding company or its subsidiaries that were recommended by the adviser.
   a. Determine the number and amount of such loans together with the current payment status of the credit and whether any loans are on a nonaccrual status.
   b. Evaluate any suit involving the adviser that pertains to services it performed as to the suit's validity and potential financial exposure.
4. Evaluate the effect on net earnings and dividends that declining rates (floating-rate assets) have on the prices of floating-rate mortgage assets. Determine the results and the nature of any hedging strategies that are used to offset a decline in net earnings.

See also the inspection procedures in sections 3130.0 and 3130.1.

3130.3.4 FINANCIAL ADVICE ON ISSUING SECURITIES OF FOREIGN GOVERNMENTS IN THE UNITED STATES

3130.3.4.1 Financial Advice to the Canadian Federal, Provincial, and Municipal Governments

An example of providing financial and investment advisory activities is a Board order that was previously approved (now authorized under section 225.28(b)(6)(iii) of Regulation Y). The order specifically authorized the providing of financial advice to the Canadian federal and provincial governments for issuing their securities in the United States. Also, the Board's Regulation K authorizes the provision of such investment, financial, or economic advisory services to foreign governmental entities (see section 211.10(a)(8)). The Board approved the proposed activity on February 12, 1988 (1988 FRB 249).

Another Board order authorized a foreign bank, subject to the BHC Act, to acquire a securities firm to engage in this activity, but to expand the activity to include the providing of such advice to the Canadian municipal governments in addition to the federal and provincial governments. The Board concluded that the slight modification would not alter the activity to render it less closely related to banking. The Board approved the order on March 28, 1988 (1988 FRB 334). Other approved Board orders for this activity are 1988 FRB 500 and 1988 FRB 571.

3130.3.4.2 Providing Financial Advice to the Japanese National and Municipal Governments and Their Agencies

Another example of providing advice to foreign governments is a bank holding company that applied for the Board's approval to engage, through its wholly owned securities subsidiary, in certain securities-related, foreign-exchange, and investment and financial advisory activities. The activity, which consisted of providing financial advice to the Japanese national and municipal governments, had not previously been authorized for bank holding companies. When making its decision, the Board referred to similar orders as well as to the facts provided. It approved these advisory services by order on June 4, 1990. (See 1990 FRB 654.)

The Board, effective September 10, 1992, added the providing of financial advice to foreign governments, such as advice with respect to the issuance of their securities, to the activities permissible by Regulation Y, currently authorized by section 225.28(b)(iii).

3130.3.5 PROVIDING FINANCIAL-FEASIBILITY STUDIES AND VALUATION SERVICES

The following provides an example of a bank holding company that was authorized to provide financial-feasibility studies and valuation services, including expert-witness testimony in connection with the valuation services. A bank holding company (the applicant) had requested the Board's approval to acquire 100 percent of the voting shares of a company (the company) that engaged in investment advisory, investment management, and financial advisory services. The company engaged in providing (1) financial-feasibility studies for specific projects of private corporations, (2) valuations of companies and of large blocks of utility stock for a variety of purposes, and (3) expert-witness testimony on behalf of utility companies in rate cases.

In providing financial-feasibility studies, all financial aspects of the particular project were evaluated, including economic conditions, sales and earnings statements, balance sheets, and cash-flow data. Each engagement involved analyzing and projecting the income to be generated by a particular project. The Board believed that this activity was functionally similar to the financial advice traditionally offered by banks to their commercial lending customers. The applicant provided evidence revealing that certain major banks perform similar financial-feasibility analysis services for their customers. The Board thus approved the provision of such financial-feasibility studies for corporations. Certain commitments were made to guard against any possible conflicts of interests and related adverse effects between the applicant's credit-extending subsidiaries and the company, acting as an adviser regarding the financial-feasibility studies. Included was the condition that the company's financial advisory activities would not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis.

Upon consideration of the above, the Board also determined the activity of providing valuations of companies, as well as the expert-witness testimony incidental to such valuations, to be permissible. The commercial lending and trust departments of banks commonly make valuations of a broad range of tangible and intangible property, including the securities of closely held companies. The applicant provided evidence that numerous banks compete directly with the company in offering corporate valuations for a fee.

The Board, effective September 10, 1992, added the providing of financial-feasibility studies to the list of nonbanking activities permitted by Regulation Y (see section 225.28(b)(6)(iii)). With the Regulation Y revisions, effective April 1997, the Board specifically determined that feasibility studies do not include assisting management with the planning or marketing for a given project or providing general operational or management advice. The 1992 amendment to this regulation permitted bank holding companies to conduct feasibility studies for high net worth individuals, as well as corporations, and financial and nonfinancial institutions. With the April 1997 amendment, such services could be provided to any person.

3130.3.5.1 Valuation Services

The valuation services included the following activities:

1. the valuation of a company for purposes of acquisitions, mergers, and divestitures
2. tender-offer evaluations
3. advice for management or for a bankruptcy court on the viability and capital adequacy of financially troubled companies and on the fairness of bankruptcy reorganizations
4. valuation opinions on transactions in publicly held securities
5. valuations on the fair market value of employee stock ownership trusts
6. periodic valuation of stock of privately owned companies held in pension or profit-sharing plans, charitable trusts, or venture-capital funds
7. the valuation of a privately owned company or of a large block of publicly owned securities for estate-tax purposes
8. for estate-tax purposes, valuations of a company's common stock and other securities for recapitalization of a privately held company

3130.3.5.2 Utility-Rate Testimony in Support of Utility-Company Valuations

The company frequently provided expert witness testimony on behalf of utility firms in rate cases. The company's personnel were retained to give expert testimony on financial matters such as the cost of capital, economic conditions, and the rate of return expected by investors in utility securities. The Board believed that to a large degree the activity may be considered incidental to the company's general provision of economic information and advice which is permissible under section 225.28(b)(6)(ii) of Regulation Y. Also, banks routinely calculate the cost of capital for customers to advise them regarding financial alternatives.

3130.3.6 EDUCATION-FINANCING ADVISORY SERVICES

Four bank holding companies (collectively, the notificants) gave notice pursuant to section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of their intention to each acquire more than 5 percent of a company (the company) that would provide education-financing advisory services.[2] The company would enable state governments to assist parents in financing the higher education of their children.

The company will (1) develop and manage an educational savings and lending program on behalf of the state, (2) design and provide necessary computer software for the program, (3) provide marketing and program materials, and (4) train state personnel to implement the program. The notificants would eventually provide the services to various state governments nationwide.

As part of developing the education savings and lending program, the company would assist in formulating and defining its overall scope; provide the research necessary to begin operations; design the program's operations; and organize the program in cooperation with all interested parties, including coordinating participation among the state authorities. The company would also coordinate key functions of a college-funding program, such as marketing, public relations, training, investment, lending, legal documentation, financial recordkeeping, and ongoing program evaluation. In addition, the company would design, install, and maintain the computer software necessary to implement the program's services. The company's compensation would be based on application fees received by a state educational assistance authority and the amount of investment and loan balances held by the program.

All of the intended services are integrally related to advising and administering student-loan and college-savings programs. Banks offering their own student-loan and college-savings programs engage in many of the planned activities and are uniquely suited to advise and assist other potential providers, including state governments, in structuring and implementing student-loan and college-savings programs.[3] The Board previously concluded that bank holding companies may provide similar advisory and support services to state authorities that are engaged in making student loans.[4] Accordingly,

2. The notificants would have varying ownership interests in excess of 5 percent. Other individual ownership interests of less than 5 percent would be held by various banks and savings institutions located in one state. Each notificant committed that the company would be treated as a subsidiary within the meaning of the BHC Act (12 U.S.C. 1841(d)).

3. See 12 C.F.R. 225.28(b)(1) and (6).

4. See 1985 FRB 725.

based on all the facts of record, the Board concluded that the proposed activities are closely related to banking under section 4(c)(8) of the BHC Act. The Board approved the notice on September 25, 1995 (1995 FRB 1042). Approval of this proposal is specifically conditioned on the notificants' compliance with the commitments made in connection with this notice.

3130.3.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing financial-feasibility studies, valuation services, utility-rate testimony, but not "public" credit ratings		225.28(b)(6)(iii)		1985 FRB 118, 120
Financial-feasibility studies for issues of tax-exempt revenue bonds and private corporations				1987 FRB 59
Advice in connection with merger, acquisition/ divestiture, and financing transactions and advice regarding loan syndications, interest-rate swaps, and interest-rate-cap transactions		225.28(b)(6)(iii)		1987 FRB 59
Providing financial advice to the Canadian federal, municipal, and provincial governments, such as with respect to the issuance of their securities in the United States		225.28(b)(6)(iii)		1988 FRB 249 1988 FRB 334
Financial advice to the Japanese national and municipal governments		225.28(b)(6)(iii)		1990 FRB 654
Financial advice to state and local governments		225.28(b)(6)(iii)		1973 FRB 701
Financial advice vs. management consulting				1972 FRB 674, 676
Investment advice pertaining to income-producing real property				1983 FRB 564
Investment advisory activities and joint ventures with securities firms		225.28(b)(6)(iii)		1994 FRB 638
Education-Financing Advisory Services				1995 FRB 1042
Regulation Y revision		62 *Federal Register* 9290 to 9307 (February 28, 1997)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3130.4.1 INFORMATIONAL, STATISTICAL FORECASTING, AND ADVICE ON SUCH TRANSACTIONS AS FOREIGN EXCHANGE, SWAPS, COMMODITIES, AND DERIVATIVES

Providing financial and investment advisory activities may consist of a bank holding company's providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, caps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.[1] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible. The Board has also found that providing advice in connection with currency swaps is permissible,[2] as well as providing advice regarding loan syndications.[3] This section provides an example of a February 16, 1983, Board order permitting a bank holding company to establish a de novo subsidiary to offer certain informational, advisory, and transactional services including the provision of the following:

1. General economic information and statistical forecasting with respect to foreign exchange and money markets through time-sharing networks. The services included the analysis of foreign-exchange and money market trends in the context of economic and political developments and the provision of information with respect to foreign exchange.
2. Advisory services designed to assist customers in monitoring, evaluating, and managing their foreign-exchange exposure, including making recommendations regarding policies and procedures to enhance a customer's ability to identify, measure, and manage financial risks in a multicurrency environment. The newly formed subsidiary would also provide advice on the timing of purchases and sales of foreign exchange in both spot and forward markets.
3. Transactional services with respect to foreign-exchange exposures. The subsidiary would arrange foreign-exchange transactions by an affiliated bank holding company and other commercial banks.

As a condition for approval, the applicants were required to seek the Board's authorization if they engaged in any additional activities within the United States. (See 1983 FRB 221.)

Effective February 6, 1984, the Board amended Regulation Y to allow bank holding companies to offer foreign-exchange advisory and transactional services that include providing general information and statistical forecasting with respect to foreign-exchange markets. The activity included arranging for "swaps" among customers with complementary foreign-exchange exposures and the execution of foreign-exchange transactions, provided the activity would be conducted through a separately incorporated subsidiary of the bank holding company that will observe the standards of care and conduct applicable to fiduciaries with respect to its foreign-exchange advisory and transactional services.

3130.4.1.1 Inspection Objectives

1. To determine the financial effect of the activity on the parent BHC and its bank subsidiary (or subsidiaries).
2. To determine that the specific activities provided by the company are permissible.
3. To determine that the company is not exposing itself to conflicts of interest between its own role of recommending foreign-exchange positions to its customers and any role its affiliates may have in executing foreign-exchange transactions.

3130.4.1.2 Inspection Procedures

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent holding company or the bank subsidiary (or subsidiaries).
2. Review the company's policies and procedures to determine that the following are present:
   a. adequate minutes of the board and board committee meetings
   b. adequate blanket bond coverage
3. Review a sample of recommendations to determine that a reasonable basis exists for the company's recommendations.

1. See 62 Federal Register 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
2. See 1989 FRB 308.
3. See 1987 FRB 220.

4. Review the company's fee schedule for providing advice and the fees charged by affiliated banks to conduct foreign-exchange transactions for the company's customers. Determine whether bank subsidiaries are being adequately compensated for executing trades, or whether these profits are accruing largely to the benefit of the bank holding company or its nonbank subsidiaries.
5. Review the company's revenue sources to determine that it has not taken foreign-exchange positions and does not execute foreign-exchange transactions.

3130.4.2 FINANCIAL ADVICE AS TO THE STRUCTURING OF AND ARRANGING FOR LOAN SYNDICATIONS, INTEREST-RATE SWAPS, CAPS, AND SIMILAR TRANSACTIONS

A bank holding company may provide information, statistical forecasting, and advice with respect to any transaction in swaps, caps, and similar transactions; commodities; and any forward contract, option, future, option on a future, and similar instruments.[4] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible.[5] The Board has also found the provision of advice regarding loan syndications to be permissible.[6]

An example of a Board order regarding providing financial advice is one in which a bank holding company (BHC) applied for the Board's approval to establish its company de novo as a financial advisory firm. The Board had not previously approved the structuring of and arranging for loan syndications (see section 225.25(b)(6)(ii) of Regulation Y) or arranging for interest-rate "swaps" and interest-rate caps, and similar transactions (see section 225.28 (b)(6)(iv) of Regulation Y). Interest-rate caps are contractual agreements wherein the seller of a cap agrees to make payment to the purchaser of a cap if a particular interest-rate index (prime) exceeds a predetermined level, with payments calculated on an assumed principal amount for a deferred time period. The caps and swaps are typically used to manage or hedge outstanding positions in the financial markets.

The Board's authorization included the following conditions:

1. The advice rendered by the company on an explicit fee basis will be rendered without regard to correspondent balances maintained by the customers of the company at any depository institution subsidiary of the BHC.
2. Company's financial advisory activities shall not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis. The Board, on November 28, 1986, approved the activity by order (1987 FRB 59). (See 1990 FRB 756.) The Board subsequently, effective September 10, 1992, added this nonbanking activity to the list of activities permitted by Regulation Y. (See section 225.28(b)(6)(iii) for loan syndications and 225.28(b)(6)(iv) for interest-rate swaps and caps.)

Reference can also be made to another Board order (1991 FRB 184) relating to providing advice on joint ventures, leveraged buyouts, restructurings, recapitalizations, and other corporate transactions (see 225.28 (b)(6)(iii) of Regulation Y), as well as to providing advice regarding the structuring and arranging of swaps, caps, and similar transactions relating to interest rates, currency and exchange rates and prices, and economic and financial indexes (see 225.28(b)(6)(iv) of Regulation Y).

3130.4.3 ADVICE RELATING TO THE STRUCTURING OF AND ARRANGING FOR CURRENCY SWAPS

A foreign bank subject to the BHC Act applied for the Board's approval to acquire a company engaged in certain securities, foreign-exchange, and financial advisory activities. The Board previously determined the activities proposed by the BHC, except for providing advice relating to the structuring of and arranging for currency swaps, to be closely related to banking. As for advice on currency swaps, it was noted that most banks that provide advice relating to interest-rate swaps also provide advice relating to currency swaps. Providing advice as to currency swaps was deemed to be functionally and operationally similar to providing advice relating to the structuring of and arranging for interest-

4. See 62 Federal Register 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.
5. See 1989 FRB 308.
6. See 1987 FRB 220.

rate swaps. Both transactions have the common objectives of securing low-cost funds and converting one type of risk to another, and both transactions require similar documentation. The Board approved the activity by order on February 13, 1989 (1989 FRB 308). The Board, effective September 10, 1992, added providing advice as to currency swaps to the nonbanking activities permitted by regulation. See section 225.28(b)(iv) of Regulation Y.

3130.4.4 ADVICE WITH RESPECT TO FUTURES CONTRACTS

3130.4.4.1 Limited Advisory Services with Respect to Futures Contracts on Stock Indexes and Options on Such Futures Contracts

The following is an example of a bank holding company that applied to the Board to engage de novo, through a wholly owned subsidiary, in the provision of advisory services with respect to futures contracts on stock indexes and options thereon. The advisory services to be provided consisted of general research and advice on market conditions and hedging strategies, client-account information and reconciliation of trades, and communication linkage between clients and exchange floors in connection with the subsidiary's futures commission merchant activities. The services offered to customers were provided either as part of an integrated package of services or for a separate fee.

The futures advisory services were essentially identical to the advisory services previously approved by the Board by regulation and order with respect to other financially related futures contracts. The Board concluded the applicant's provision of advisory services for futures contracts on stock indexes and for options thereon to be permissible (1987 FRB 220 and section 225.28(b)(6)(iv) of Regulation Y).

Previously, the Board had approved the execution and clearance of futures contracts on stock indexes and options thereon (1985 FRB 251). At that time, however, the Board had not approved a proposal to provide investment advisory services in connection with the execution and clearance of such instruments.

3130.4.4.2 Advice on Certain Futures and Options on Futures

This section is a historical example of a bank holding company that requested the Board's approval to provide de novo investment advice concerning futures and options on futures contracts on foreign exchange, government securities, and bullion and money market instruments. In addition, the company would provide portfolio investment advice, for which applicant had previously received authorization pursuant to Regulation Y (the authorization is currently included in section 225.28(b)(6)(iv)).

Previously, the Board had approved the provision of investment advice as a futures commission merchant (FCM) (section 225.28(b)(7)(iv)(A)) or as a commodity trading adviser (CTA) registered with the Commodity Futures Trading Commission (CFTC). The provision by an FCM or CTA of such advice could include providing counsel, publications, written analyses, and reports relating to the purchase and sale of futures contracts and options on futures contracts that bank holding company futures commission merchant subsidiaries are permitted to execute and clear. Such advisory services could also consist of providing written or oral presentations on the historical relationship between the cash and futures markets or the functions of futures as hedging devices, demonstrating examples of financial futures uses for hedging, and assisting in structuring a hedging strategy for a cash position. FCMs and CTAs are subject to registration with and regulation by the Commodity Futures Trading Commission pursuant to the Commodity Exchange Act, as amended. (7 U.S.C. 1).

Before incorporation of the advisory activity into Regulation Y (see 1986 FRB 369), the Board had determined by order that the provision of futures and options advice by FCMs is permissible and closely related to banking (see 1985 FRB 168 and 111, 1984 FRB 780, and 1984 FRB 369). A CTA could provide such advice even though it is not acting as an FCM.

The issue presented by this latter proposal was whether the conduct of this activity by company would be a proper incident to banking if company, serving as an adviser, did not meet the *former* Regulation Y requirement of registering with the CFTC as a CTA or FCM. The applicant expected to qualify for a statutory exemption (7 U.S.C.6m) from the registration under section 4m of the Commodity Exchange Act. This exemption provides that any person who, during the previous 12 months, has not furnished commodity advisory services to more than 15 persons and has not represented himself or herself to the public as a CTA is exempt from the registration requirements for CTAs under the act. The applicant's proposal permitted company to provide commodity trading advice without those safeguards. The Board held that it expects the adviser to disclose to its customers substantially the same information required for registered CTAs, including the CTA's performance record, conflicts of interest, possible trading risks, and civil and criminal actions against the CTA.

The Board concluded that the possible adverse effects would be further minimized by the following conditions:

1. Company will remain subject to the antifraud provisions of the Commodity Exchange Act as well as other restrictions in the act.
2. The adviser will not trade for its own account (except to hedge), will limit its advice to instruments that banks deal in extensively (foreign exchange, bullion, government securities, and money market instruments), and will only serve customers that are financially sophisticated and have significant dealings or holdings in the underlying commodities or instruments. The Board approved the application by order on October 18, 1988 (1988 FRB 820).

3130.4.5 PROVIDING DISCRETIONARY PORTFOLIO MANAGEMENT SERVICES ON FUTURES AND OPTIONS ON FUTURES ON NONFINANCIAL COMMODITIES

With respect to the Regulation Y provisions effective April 21, 1997, discretionary portfolio management advice is not separately listed in section 225.28(b)(6)(iv). Discretionary investment advice is discussed, however, within the preamble to the final rule. The preamble emphasizes that such advice may be provided to any person (such advice is no longer limited to institutional investors) regarding contracts relating to financial and nonfinancial assets.

Foreign banking organizations (applicants) subject to the BHC Act provided notice to engage through their subsidiary (company) in providing investment advisory services with respect to futures and options on futures on financial and nonfinancial commodities, including discretionary portfolio management services.[7] The Board previously determined that the proposed activities, with the exception of providing discretionary portfolio management services with respect to futures and options on futures on nonfinancial commodities, are closely related to banking.

The Board had permitted bank holding companies to provide investment advice with respect to futures and options on futures on both financial and nonfinancial commodities. (See section 225.28(b)(6)(iv) of Regulation Y.) The Board also previously approved providing discretionary portfolio management services with respect to futures and options on futures on financial commodities. (See 1995 FRB 386.) In addition, the Office of the Comptroller of the Currency permits national banks to engage in discretionary funds management with respect to futures and options on futures on nonfinancial commodities. (See OCC Interpretive Letter No. 494 (December 20, 1989).)

In this regard, applicants committed that company would provide the proposed discretionary portfolio management services only at the request of the customer. Applicants also committed that company would comply with applicable law, including fiduciary principles. In addition, applicants proposed that company exercise its discretionary portfolio management authority only in purchasing and selling exchange-traded futures and options on futures contracts previously approved by the Board. The Board gave its approval on June 30, 1995 (1995 FRB 803).

3130.4.6 COMBINATION OF PROVIDING ADVICE WITH OTHER NONBANKING ACTIVITIES

3130.4.6.1 Providing Nonfinancial Futures Advice and the Combining of Foreign-Exchange, Government Securities Advisory, and Execution Services

A BHC applicant requested the Board's permission to engage in trading options on foreign exchange and offering investment advice on financial and nonfinancial options and futures contracts, securities, and interest-rate and currency swaps. The applicant applied to provide these advisory services through a partnership, of which it would own 80 percent of its equity.

7. Company does not trade futures or options on futures for its own account or provide futures commission merchant execution or clearance services.

This partnership would provide these advisory services only to the applicant, its affiliates, and the applicant's partner, a commodity trading organization. The partnership would provide execution services only to the applicant and its affiliates, not to the applicant's partner.

The Board had not previously approved the provision of nonfinancial futures advice for bank holding companies. The Board noted that the Office of the Comptroller of the Currency (OCC), by OCC Interpretive Letter 494 (December 20, 1989), determined that a national bank could provide execution, clearing, and advisory services for customer transactions in standardized, exchange-traded "nonfinancial" futures contracts and options, such as futures on oil and agricultural products. The OCC determined that the contracts are financial products and that the provision of investment advice was essentially the same as the advice given with respect to financial futures contracts. The OCC contends that investment advice is incidental to the bank's authority to purchase and sell the instruments on behalf of its customers.

The Board has permitted bank holding companies to provide advice with respect to futures and options on futures relating to bank-eligible securities, bullion, and foreign exchange (12 C.F.R. 225.28(b)(6)(iv)). The Board also has permitted bank holding companies to provide investment advice with respect to options and futures contracts based on broad-based indexes of stock and bonds (1990 FRB 770). The Board thus determined that the provision of investment advice with respect to investing in options and futures, based on nonfinancial instruments, to be the functional equivalent of providing advice on options and futures based on financial instruments. In each case, the bank holding company subsidiary is furnishing advice with respect to trading of a financial instrument. The partnership would not provide advice to third parties without Federal Reserve approval. The Board thus approved the providing of investment advice on nonfinancial futures, options, and options on futures.

The applicant also proposed that the partnership provide execution services to the applicant's wholly owned subsidiary and to the applicant's U.S. branches with respect to—

1. over-the-counter options on foreign exchange, U.S. government securities, and other money market instruments, and indexes on such securities and instruments;
2. exchange-traded transactions in futures, options, and options on futures on foreign exchange, U.S. government securities, and other money market instruments, and indexes on such securities and instruments; and
3. spot and forward transactions in foreign exchange.

The Board previously approved the combination of advice and execution for—

1. foreign-exchange transactions (1990 FRB 649),
2. transactions on derivative instruments based on U.S. government securities and other money market instruments (1990 FRB 664), and
3. securities brokerage (1989 FRB 396).

The Board approved by order the providing of the combination of foreign-exchange and government securities advisory and execution services on December 21, 1990 (1991 FRB 126).

For these reasons, the Board approved the providing of discretionary portfolio management services with respect to futures and options on futures on nonfinancial commodities on June 30, 1995. (See 1995 FRB 803).

3130.4.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Provide information and advice on foreign operations and arrange foreign-exchange transactions				1983 FRB 221
Foreign-exchange and advisory and transactional services added to Regulation Y		225.28(b)(6)(iv)		
Financial advice as to the structuring of, and arranging for loan syndications, interest-rate swap, caps, and similar transactions		225.28(b)(6)(iii) and (iv)		1987 FRB 59 1990 FRB 756
Advisory services with respect to futures contracts on stock indexes and options on such futures contracts		225.28(b)(6)(iv)		1987 FRB 220
Providing discretionary portfolio management services on futures and options on futures on nonfinancial commodities		225.28(b)(6)(iv)		1995 FRB 803
Providing nonfinancial futures advice and the combining of foreign-exchange, government securities advisory, and execution services		225.28(b)(6)(iv)		1995 FRB 803
Advice in connection with currency swaps		225.28(b)(6)(iv)		1989 FRB 309

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The financial and investment advisory nonbanking activity of consumer financial counseling may consist of providing advice, educational courses, and instructional materials to individuals on consumer-oriented financial-management matters, including debt consolidation, applying for a mortgage, bankruptcy, budget management, real estate tax shelters, tax planning, retirement and estate planning, insurance, and general investment management. The authority for this advisory activity is currently derived from section 225.28(b)(6)(v) of Regulation Y.

This nonbanking activity was added to the Regulation Y "laundry list" in 1986. Previously, the Board authorized the provision of consumer financial counseling services by order. (See 1979 FRB 65, 1979 FRB 265, 1985 FRB 253, and 1985 FRB 662. These references are only historical examples.) A bank holding company may provide information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, caps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.[1] The Board has found financial advice regarding interest-rate swap and cap transactions to be permissible. The Board has also found that providing advice in connection with currency swaps is permissible,[2] as well as providing advice regarding loan syndications.[3] The revised Regulation Y, effective April 1997, deleted restrictions on consumer-counseling services that prohibited bank holding companies from promoting specific products and services, and from obtaining or disclosing confidential customer information without the customer's consent. These restrictions do not apply to banks that engage in the above activities.

Prudent management should take into consideration certain actions to prevent potential conflicts from arising. When considering these orders, the Board was concerned that the provision of consumer financial counseling activities could potentially result in unfair competition, conflicts of interest, and other adverse effects. (See 1979 FRB 267.) Examiners should be alert to problems that may arise from such conflicts as they review this nonbanking activity. Further, the examiner should determine whether counselors, as a general practice, are advising each customer that they are not required to purchase any services from affiliates, and determine whether customers have the option to exclude themselves from service and product offerings provided by affiliates.

1. See 62 *Federal Register* 9,290 (February 28, 1997) (12 C.F.R. 225.28 (b)(6)) or 1997 FRB 275.

2. See 1989 FRB 308.

3. See 1987 FRB 220.

3130.5.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing financial-management courses, counseling, and related instructional materials				1979 FRB 265
Engaging, through an acquired bank, in consumer financial counseling				1985 FRB 253
Providing consumer financial counseling services as a permissible nonbanking activity		225.28(b)(6)(v)		1986 FRB 833 1985 FRB 662

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Financial and investment advisory services include tax-planning and tax-preparation services. Tax planning involves providing advice and strategies designed to minimize tax liabilities. For individuals, this includes analysis of the tax implications of retirement plans, estate planning, and family trusts; for corporations, it includes analysis of the tax implications of mergers and acquisitions, the portfolio mix, specific investments, previous tax payments, and year-end tax planning. Tax preparation involves the preparation of tax forms and advice concerning liability based on records and receipts supplied by the client. This nonbanking activity was included in the Regulation Y ''laundry list'' in 1986. (See section 225.28(b)(6)(vi).) Such services may be provided to any person. Effective April 21, 1997, certain restrictions were removed. These Regulation Y revisions deleted restrictions in the area of tax-planning and tax-preparation services that prohibited bank holding companies from promoting specific products or services and from obtaining or disclosing confidential customer information without the customer's consent. These restrictions do not apply to banks. This fact needs to be considered when referring to the historical examples that follow.

The Board had previously approved, by order (1985 FRB 168), the activity of tax-preparation services for individuals. Since tax-preparation services for corporations is functionally or operationally similar to the tax-preparation services that banks already provide to individuals as well as to their affiliates and other financial institutions, the Board approved the providing of corporate tax-preparation services. When the nonbanking activity was incorporated into Regulation Y in 1986, tax-planning and tax-preparation services were authorized, not only for individuals and corporations, but for noncorporate businesses, such as partnerships and sole proprietorships and tax-exempt nonprofit organizations. Tax-planning and tax-preparation services must be conducted in accordance with applicable jurisdictional law.

3130.6.1 INSPECTION OBJECTIVES

1. To ascertain whether the customer has the option to be excluded from promotions of other specific products and services.
2. To determine what financial effect the activity has on the parent company and its subsidiaries.
3. To determine whether the company has formal written policies and procedures to ensure accurate, timely, and confidential preparation and maintenance of customers' tax returns.
4. To determine whether the tax-return preparers are appropriately qualified to provide such tax services, and to determine the extent of management's involvement in the activity.
6. To identify the potential and extent of off-balance-sheet risk associated with the activity.

3130.6.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent company or the bank subsidiaries.
2. Determine whether bonding and other insurance coverage is adequate in relation to the risks associated with the activity.
3. Review pertinent contracts, client lists, public advertising and information, correspondence, and other documentation representing the services provided, and determine if charges for the tax-preparation service are on an explicit fee basis that is not dependent on the amount of tax savings achieved.
4. Determine if the client has a written legal opinion on file certifying that the activity is not considered the practice of law.
5. Review pertinent correspondence and the minutes of board of directors and board committee meetings, and determine if any significant law suits, Internal Revenue Service adverse actions, or other potential or contingency losses are pending and probable because of inaccurate tax-return preparation. Analyze their probable effect in relation to the financial condition of the company.
6. Review the company's formal written policies and procedures for assurance of professional competence in providing sound tax-planning advice and the accurate, timely, and confidential preparation and maintenance of customer's tax returns. The policies and procedures should require that tax-planning advice be clearly communicated by persons who are adequately supervised and who possess the necessary professional technical training and experience needed to provide tax-planning advice.

3130.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Preparation of tax returns in a non-fiduciary capacity is closely related to banking				1985 FRB 168
Permissible nonbanking activity		225.28(b)(6)(vi)		1986 FRB 833

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised (subsection 3140.0.2.2) to include a brief summary of a June 10, 2016, Board order (FRB Order no. 2016-07) that approved a notice by a foreign bank holding company and its foreign wholly owned subsidiary bank to engage in permissible nonbanking activities under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y. The nonbanking activities include railcar leasing and the provision of certain railcar fleet management services pursuant to section 225.28(b)(3) of Regulation Y (leasing personal property and acting as an agent, broker, or advisor in leasing personal property) and section 225.21(a)(2) (engaging in incidental activities that are necessary to carrying on permissible nonbanking activities). The table of Laws, Regulations, Interpretations, and Orders has been amended to include the order in subsection 3140.0.7.

3140.0.1 LEASING AUTHORIZATIONS WITHIN REGULATION Y

Leasing is a form of financing that provides a lessee (the customer) the right to use land or depreciable assets without tying up working capital. As a result of the tax benefits that can arise from the ownership of equipment, real property, or tangible personal property, leasing provides the lessor (the owner of the property) with a generally higher rate of return than what could be achieved through lending. In 1971, "leasing personal property or acting as agent, broker, or adviser in leasing such property" was added to the Regulation Y list of permissible nonbanking activities for bank holding companies. In 1974, the authority to engage in this activity was expanded to include the leasing of real property.

In 1997, restrictions on leasing activities were removed to permit greater flexibility to acquire leaseable property in quantity and to sell or re-lease property upon the lease's expiration. The removed restrictions consisted of the maximum lease term, maximum holding period for leased property, limit on acquisitions of property to specific leasing transactions, restriction on leases to those that served as the functional equivalent of extensions of credit, and 100 percent limit on the amount of reliance that could be placed on the value of leased property. The added clarifications consisted of more details on the requirements for a nonoperating lease, particularly those for automobile rentals.

3140.0.2 PERMISSIBLE LEASING ACTIVITIES

Two types of leasing activities are permissible for bank holding companies: full-payout leasing and high-residual-value leasing. A *full-payout lease* is the functional equivalent of an extension of credit that relies primarily on rental payments and tax benefits to recover the cost of the leased property and related financing costs. *High-residual-value leasing* may involve significant reliance on the expected residual value of the leased property—on average, under 50 percent. However, this value can extend up to the full original cost of the property (that is, to recover the full acquisition cost of the leased property plus related financing costs).

When leasing personal or real property, or acting as agent, broker, or adviser, only those leasing transactions meeting the following criteria are considered permissible:

1. The lease must be on a nonoperating basis.
2. The initial lease term must be at least 90 days.
3. For leasing involving real property—
   a. at the inception of the initial lease, the effect of the transaction must yield a return that will compensate the bank holding company, as lessor, for its full investment in the property plus the estimated total cost of financing the property over the term of the lease (this includes rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease); and
   b. the estimated residual value (yield) of the property at the expiration of the initial term of the lease may not exceed 25 percent of the acquisition cost of the property to the bank holding company (lessor).

With respect to leasing personal or real property on a nonoperating basis, the bank holding company or its subsidiary may not engage in operating, servicing, maintaining, or repairing leased property during the lease term. A bank holding company, however, can arrange for a third party to provide the services or products. (See Regulation Y, section 225.28(b)(3).)

As for automobiles, a bank holding company may not (1) provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories either in bulk or for an individual vehicle after its delivery to the lessee; (3) provide the loan of an automobile during the vehicle's servicing; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license (registration) without authorization from the lessor.

3140.0.2.1 Automobile Fleet Leasing and Fleet-Management Services

A foreign banking organization (FBO) that is treated as a bank holding company requested an opinion from the Board's staff regarding leasing activities that the Board has determined to be permissible under section 225.28(b)(3) of Regulation Y. (See 12 C.F.R. 225.28(b)(3).) In connection with its automobile-leasing activities, the FBO provides, through a wholly owned automobile fleet leasing subsidiary (AFLS), fleet-management services to its automobile fleet leasing customers. In connection with making automobile and equipment leases that conform with the requirements of Regulation Y, AFLS engages in the business of commercial lending and financial leasing of motor vehicle fleets and equipment located throughout the United States, and providing fleet-management services to companies that lease corporate automobile fleets. AFLS and other participants in the business market and deliver the three services as a bundled service to clients.[1]

To better provide fleet-management services to its automobile-leasing customers (in connection with leases that conform with Regulation Y), AFLS acquired another fleet-management-services subsidiary company (FMSS) that (1) arranges for third parties to provide vehicle maintenance, accident-management services, and safety-management services and (2) directly provides client-support services in connection with the services arranged by AFLS. FMSS, in addition to permissible leasing activities, conducts some fleet-management services for automobiles that are owned by the client and that are not, therefore, subject to a lease.

As represented, approximately 90 percent of the vehicles serviced by FMSS are leased and 10 percent are client-owned. Revenues earned from fleet-management services that are provided for client-owned vehicles are less than 2 percent of the AFLS's total revenues. The FBO asked whether it would be permissible for it to provide fleet-management services with regard to automobile fleets if the customer owns rather than leases the vehicles.

In an opinion issued on December 19, 2003, Board staff noted that Regulation Y, as a general matter, permits a bank holding company to engage in any incidental activities that are necessary to carry on an activity permitted by the regulation.[2] Board staff stated also that, in light of the nature of the practices in the fleet-management industry and the difficulty in continually monitoring the migration between leased and owned vehicles in the same fleet, some ability to perform fleet servicing for owned vehicles is necessary to retain customers in connection with AFLS's fleet-leasing activities. Board staff determined, in view of all the facts of record, including this necessity, the minimal amount of revenue earned from servicing owned vehicles,[3] and the fact that the activity is primarily an agency activity, that the FBO could provide fleet-management services to owned vehicles as an activity incidental to the FBO's authorized leasing activities. In a December 19, 2003, opinion, Board staff stated that the provision of fleet-management services on owned vehicles is subject to the same restrictions set forth in Regulation Y for leased vehicles.[4]

3140.0.2.2 Railcar Leasing and Railcar Fleet Management Services

On June 10, 2016, the Board approved a notice (FRB Order no. 2016-07) by a foreign bank holding company and its foreign wholly owned subsidiary bank to engage in nonbanking activities under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y. Fifty percent of the voting shares of a rail trans-

1. The Board previously found providing fleet-management services to be permissible if the fleet involves vehicles that are under a lease that conforms to Regulation Y. (See 12 C.F.R. 225.28(b)(3).) Permissible leases are considered to be the financial equivalent of a loan.

2. See 12 C.F.R. 225.21(a)(2). Staff also noted that the courts have recognized the authority of bank holding companies to engage in incidental activities that are reasonably necessary to the conduct of closely related activities.

3. AFLS has stated that it will limit its fleet-management services involving vehicles not subject to a Regulation Y permissible lease to no more than 15 percent of the fleet-management revenues and to 5 percent of the total leasing revenues of AFLS.

4. See 12 C.F.R. 225.28(b)(3).

port company (Delaware Corporation) would be acquired, thereby acquiring its wholly owned Illinois corporate subsidiary that engages in railcar leasing and related activities in North America. As a result of the acquisition, the wholly owned subsidiary bank would engage in certain nonbanking activities. The nonbanking activities include railcar leasing and the provision of certain railcar fleet management services pursuant to section 225.28(b)(3) of Regulation Y (leasing personal property and acting as an agent, broker, or advisor in leasing personal property) and section 225.21(a)(2) (engaging in incidental activities that are necessary to carrying on permissible nonbanking activities).

3140.0.3 ACCOUNTING FOR LEASES

Leasing has become a prominent financing vehicle. Lessors have employed a number of different methods in structuring and accounting for leases. Standards for lease accounting are set forth in Accounting Standards Codification (ASC) Topic 840, "Leases" (formerly FASB Statement No. 13, "Accounting for Leases," as amended and interpreted).

Accounting for leases must be viewed from the perspective of the parties involved in the leasing transaction, the lessee and the lessor. Negotiations and closing costs incurred with respect to the lease should be written off over the life of the lease. In applying ASC Topic 840, certain terminology is used. Basic terms that should be considered are described below.

Inception of a lease. The inception of a lease refers to the date the lease contract was signed or to the date that the construction was completed, or, if earlier, to the date of the written commitment stating the significant terms.

Term of the lease. The lease term consists of the noncancelable term and the period comprising the bargain renewal option.

Fair value of lease property. The fair value of a lease consists of the price that the property could be sold in an arm's-length transaction.

Economic life of the leased property. The economic life of the leased property represents the period over which the property is expected to be economically beneficial to one or more users for its intended purpose.

Estimated residual value of the leased property (ERV). The residual value is the estimated fair value of the leased property at the expiration of the lease term.

Interest rate implicit in the lease. The implicit interest rate is the discount rate that causes the sum of the minimum lease payments and the unguaranteed residual value at the end of the lease term to be equal to the fair value of the property at the beginning of the lease term.

Lessee's incremental borrowing rate. The incremental borrowing rate is the interest rate at which the lessee could borrow the funds to purchase the leased property.

3140.0.3.1 Accounting for Leases by a Lessee

The two methods for accounting for leasing transactions by a lessee are the operating method and the capitalized-lease method.

3140.0.3.1.1 Operating Method of Accounting for Leases

The operating accounting method merely records the cost of the rental payments as an expense when it is required to be paid in accordance with the terms of the lease agreement.

Example: Assume that equipment is leased for $100,000 per year for three years. Under this method, the annual cost would be recorded as a rental expense on the income statement:

Dr. Rent	$100,000	
Cr. Cash		$100,000

To record an annual payment of rent based on an operating-lease agreement.

3140.0.3.1.2 Capitalized-Lease Method of Accounting for Leases

3140.0.3.1.2.1 When a Lessee Is to Use the Capitalized-Lease Method

If *any one* of the following conditions exist, the lessee must capitalize the lease:

1. The asset is owned by the lessee at the end of the lease term.
*2. The lease term is equal to or more than 75 percent of the estimated economic life of the asset.
3. The lessee can purchase the asset below its fair market value before or at the end of the lease term (bargain purchase option).
*4. The present value of the minimum lease payments at the beginning of the least term is equal to or more than 90 percent of the fair market value of the property.

*If the lease begins in the remaining 25 percent of the asset's estimated economic life, these items do not apply; such leases are considered operating leases.

Using this method, the lease is recorded as an asset at the lesser of the present value of the rental and other minimum lease payments or the fair value of the leased property as though the lease obligation was being purchased on credit. The payment made is treated as a payment made on an installment debt. At the same time, the asset is being amortized over the lease term. The lease obligation is treated as a long-term debt. The discount rate that is used to capitalize the lease is the lessee's incremental borrowing rate or the interest rate implicit in the lease agreement.

Example #1: This example illustrates the capitalized-lease method using the same example as above with the added fact that the lease agreement contains an interest rate of 10 percent. Assume that the interest rate of the lease agreement is the same as the lessee's marginal borrowing rate.

Dr. Capitalized Lease	$248,685	
Cr. Lease Obligation		$248,685

To record an equipment lease obligation under a capitalized-lease agreement.

(Present value of $100,000 per year for three years at a 10 percent interest rate)

1st Year

Interest Expense	$ 24,869	
Lease Obligation	75,131	
Cash		$100,000

To record the first year's payment on an equipment lease obligation.

($248,685 × .10 = $24,869)

Dr. Equipment Lease Amortization	$ 82,895	
Cr. Capitalized Lease		$ 82,895

To record the annual amortization of a capitalized equipment lease.

($248,685/3 years)

2nd Year

Dr. Interest Expense	$ 17,355	
Dr. Lease Obligation	82,645	
Cr. Cash		$100,000

To record the second annual lease payment under a three-year capitalized-lease agreement.

(Interest = $248,685 + 24,869 − $100,000 = $173,554 × .10 = $17,355)

Dr. Lease Amortization	$ 82,895	
Cr. Capitalized Lease		$ 82,895

To record the second year's lease amortization under a three-year capitalized lease.

3rd Year

Dr. Interest Expense	$ 9,091	
Dr. Lease Obligation	90,909	
Cr. Cash		$100,000

To record the third year's lease payment under a three-year capitalized-lease obligation.

(Interest = $173,554 + $17,355 = $190,909 − $100,000 = $90,909 × .10 = $9,091)

The financial statements are to include footnotes that disclose the present value of noncancelable lease commitments where the lessor either recovers more than 75 percent of the economic life of the asset leased or recovers the investment plus a reasonable return.

3140.0.3.2 Accounting for Leases by a Lessor

3140.0.3.2.1 Operating Lease (Lessor)

A lessor would have the following accounting entries for an operating lease:

Dr. Cash	$xxx,xxx	
Cr. Rent Income on Leased Assets[5]		$xxx,xxx
Dr. Depreciation Expense	$xxx,xxx	
Cr. Accumulated Depreciation—Leased Assets		$xxx,xxx

In order for the *lessor* to be able to capitalize a direct-financing lease, any one of the same four criteria for a lessee must apply along with two additional criteria:

5. Any rent received in advance would be initially credited to "unearned rent revenue."

1. Collectibility of the minimum lease payments must be reasonably predictable.
2. No important uncertainties exist as the amount of unreimbursable costs incurred.

In accounting for the lessor's capitalized lease transactions, there are some common accounts that are used. These are described below.

Unearned income from lease financing receivables. Unearned income represents the unearned interest liability account that is netted against the total of lease payments receivable which includes the estimated residual value for balance-sheet presentation. It represents the "interest" income equal to the excess of rentals receivable over the fair value of the property at the inception of the lease.

Lease financing receivables. This asset account is established in the amount of total lease payments to be received from the lessee. The amount by which the rentals receivable exceeds the cost of the property is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed asset account, then transferred to lease payments receivable.

Throughout the lease term, the rentals receivable account is periodically reduced by the full amount of each rental payment received.

3140.0.3.2.2 Direct Financing Capitalized Lease

In this situation, a finance company purchases equipment from a manufacturer (recorded as equipment [asset] when purchased). The finance company (lease financing nonbanking subsidiary) then leases that equipment and records it as a normal financing lease. There is *no* dealer profit from the sale of the asset. Unearned interest income is recognized over the life of the lease using the effective interest method. Since the lessor has "sold" the asset, no depreciation is recorded.

Example #1: Lease with No Guaranteed Residual Value by the Lessee

Assume that the finance company purchases equipment costing $100,000. It then leases the equipment to a lessee under a five-year lease agreement that requires annual payments of $25,000 per year. At the end of the lease term, the lessee will own the equipment. The implied interest rate is 7.931 percent (comparison of the present value of the equipment of $100,000 against the $25,000 annual payment for five years).

Dr. Equipment	$100,000	
Cr. Cash		$100,000

To record the purchase of equipment to be leased

Dr. Lease Financing Receivables	$125,000	
Cr. Equipment		$100,000
Cr. Unearned Income from Lease Financing Receivables		25,000

To record the initial lease

Year 1

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 7,931	
Cr. Income from Lease Financing Receivables		7,931

To record the receipt of the first equipment lease payment.

Lease Payments Receivable	$125,000
Unearned Interest Revenue	−25,000
	$100,000 × .07931 = $7,931

Year 2

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 6,577	
Cr. Income from Lease Financing Receivables		$ 6,577

To record the receipt of the second equipment lease payment.

Lease Payments Receivable	$100,000	
Unearned Interest	−17,069	($25,000 − 7,931)
(Present Value of Remaining Receivable	$ 82,931)	× .07931 = $6,577

Year 3

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 5,116	
Cr. Income from Lease Financing Receivables		$ 5,116

To record the receipt of the third equipment lease payment.

Lease Payments Receivable	$ 75,000	
Unearned Interest	−10,492	($17,069 − $6,577)
(Present Value of Remaining Receivable	$ 64,508)	× .07931 = $5,116

Year 4

Dr. Cash	$ 25,000	
Cr. Lease Financing Receivables		$25,000
Dr. Unearned Income from Lease Financing Receivables	$ 3,539	
Cr. Income from Lease Financing Receivables		$ 3,539

To record the receipt of the fourth equipment lease payment.

Lease Payments Receivable	$ 50,000	
Unearned Interest	−5,376	($10,492 − $5,116)
(Present Value of Remaining Receivable	$ 44,624)	× .07931 = $3,539

Year 5

Dr. Cash	$ 25,000	
Cr. Leases Financing Receivables		$ 25,000
Dr. Unearned Income from Lease Financing Receivables	$ 1,837	
Cr. Income from Lease Financing Receivables		$ 1,837

To record the receipt of the fifth equipment lease payment.

Lease Payments Receivable	$ 25,000	
Unearned Interest	−1,837	($5,376 − $3,539)
(Present Value of Remaining Receivable	$ 23,163)	× .07931 = $1,837

Example #2: Lease with a Residual Value (Guaranteed by the Lessee)

A lessor acquires property to be leased for $14,000 (its fair value at the inception of the lease). The estimated economic life of the property is five years. The lease has a noncancelable lease term of four years with a rental payment due of $3,649 at the end of each year. The lessee guarantees the residual value at the end of the four-year lease term in the amount of $4,000. The lessor's implied rate of interest in the lease is 10.8695 percent. The present value of the minimum lease payments at this interest rate and monthly payments exceeds 90 percent of the fair value of the property at the inception of the lease (.90 × $14,000 = $12,600).

Year 1

January 1, 19x1

Dr. Equipment	$ 14,000	
Cash		$ 14,000

To record purchase of equipment for the purpose of a financing lease.

Dr. Lease Financing Receivables	$ 18,596	
Cr. Equipment		$ 14,000
Cr. Unearned Income from Lease Financing Receivables		4,596

To record investment in direct-financing lease

December 31, 19x1

Dr. Unearned Income from Lease Financing Receivables	$ 1,521	
Cr. Income from Lease Financing Receivables		$ 1,521

To recognize the portion of unearned income that is earned at the end of the first year of investment.

(Fair value of property at inception of the lease of $14,000 × 10.8695% = $1,521)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record receipt of the first year's rental

Year 2

Dr. Unearned Income from Lease Financing Receivables	$ 1,290	
Cr. Interest Income from Lease Financing Receivables		$ 1,290

To recognize the portion of unearned income that is earned at the end of the second year of investment

($14,000 + 1,521 − 3,649 = $11,872 × 10.8695% = $1,290)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record the receipt of the second year's rental

Year 3

Dr. Unearned Income from Lease Financing Receivables	$ 1,034	
Cr. Income from Lease Financing Receivables		$ 1,034

($11,872 + 1,290 − 3,649 = $9,513 × 10.8695% = $1,034)

To recognize the portion of unearned income that is earned at the end of the third year of investment

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivables		$ 3,649

To record the receipt of the third year's rental.

Year 4

Dr. Unearned Income from Lease Financing Receivables	$ 751	
Cr. Income Lease Financing Receivables		$ 751

To recognize the portion of unearned income that is earned at the end of the fourth year of investment.

($9,513 + 1,034 − $3,649 = $6,898 × 10.8695% = $751)

Dr. Cash	$ 3,649	
Cr. Lease Financing Receivable		$ 3,649

To record the receipt of the fourth year's rental.

Dr. Cash	$4,000	
Cr. Lease Financing Receivables		$ 4,000

To record the receipt of the lessor's guaranteed residual value (guaranteed by the lessee) at the end of the lease term.

($6,898 + 751 − $3,649 = $4,000)

3140.0.3.2.3 Balance-Sheet Presentation

The lease payments receivable would be reported on the balance sheet as a single amount "net investment" (Lease Financing Receivables less the balance of the Unearned Income from Lease Financing Receivables). If the lessor has established an allowance for possible lease losses, this amount is shown separately as a deduction from the net investment. The net investment in the direct financing lease is $18,000 for example #2 above. It consists of the gross investment of $18,596 ($3,649 × 4 annual rental payments) plus the $4,000 residual value less the unearned income of $4,596.

3140.0.3.2.4 Classification

If it is deemed appropriate to classify a lease, the amount to be classified (in example #2 above) would be the net investment. For illustration, assume that two of the four payments had been received on the lease, that income has been recognized monthly according to the effective interest rate method, and that the lease is now considered a loss. Further assume that the third payment should have been received eight months ago. It is determined during the inspection that the lease should be classified as doubtful of collection. The balance to be classified is the net investment of $7,728. This consists of the balance of Lease Financings Receivable of $9,513 (includes the $4,000 estimated guaranteed residual value) less the balance of Unearned Income from Lease Financings Receivable of $1,785 ($1,034 + $751 = amount due on regular payment intervals) or a net investment of $7,728.

3140.0.3.2.5 Delinquency

It is considered appropriate to state in the inspection report the percentage of delinquency in the lease portfolio. The percentage is calculated by deviding the aggregate rentals receivable on delinquent leases (less unearned income on the delinquent leases) by the total of rentals receivable on all leases (less their unearned income). Estimated realizable values would not be included in the delinquent amounts unless they were guaranteed by the lessee.

3140.0.4 LEVERAGED LEASES

The lessor can ''leverage'' a lease transaction by borrowing a substantial portion of the acquisition cost from a long-term lender, with the rentals and the property pledged as collateral for the loan. The lessor borrows in order to finance a leasing transaction with a small, or perhaps, a negative equity in the property to be leased.

The initial step in accounting for this type of lease involves calculating the cash flows over the term of the lease. The cash flows include the income tax effects of tax deductions to the lessor, the lessor's initial investment in the property, the rental receipts net of debt service, and the proceeds expected to be received from the sale of any residual. The next step in accounting for a leverage lease involves determining the applied interest rate that, when applied to the net investment in the years that the net investment will be positive, would precisely allocate the net income to the positive years. See appendix E of SFAS 13 for an example as to how to account for a leveraged lease.

3140.0.5 INSPECTION OBJECTIVES

1. To determine the effect of the investment in the leasing subsidiary upon consolidated operations, and indirectly upon the bank subsidiaries' safety and soundness.
2. To determine if the company is operating in compliance with applicable laws and regulations, and to ensure that corrective action is initiated if warranted.
3. To determine if policies, procedures, and controls are adequate to protect the company from mismanagement, unnecessary risk, and loss.
4. To assess the management's ability to operate the company in a safe and sound manner.
5. To determine that accounting practices do not overstate income.

3140.0.6 INSPECTION PROCEDURES

The decision whether the operations of a leasing subsidiary will be inspected ''on-site'' is based on the availability and adequacy of leasing company data at the offices of the parent company. Item 1 below provides a listing of information necessary to the inspection process. If this and any other information necessary to assess the overall condition of the subsidiary is available at the parent's office or can be obtained through a written request to the subsidiary, an on-site inspection may not be necessary. The inspection frequency requirements, found in section 5000.0.4, should be reviewed in making such a determination.

1. The following information should be available at the start of the inspection:
   a. trial balance of all leases and outstanding credits,
   b. listing of accounts on which payments are delinquent 30 days or more, or on which payments are otherwise not being made according to schedule,
   c. comparative interim and fiscal financial statements of the leasing company,
   d. listing of unbooked assets and contingent liabilities,
   e. cash-flow projections for the current fiscal year and the next fiscal year,
   f. listing of available lines of credit,
   g. copies of the most recent internal and external audit reports, and
   h. minutes of board and executive committee meetings since the date of the previous inspection.
2. Establish a ''credit line'' above which all leases will be reviewed. The line can be set at an amount that will cause a certain percentage of the dollar volume of the lease portfolio to be reviewed (e.g., between 70 percent and 80 percent), or at an amount that will cause the review of each lease exceeding a certain percentage of gross capital. Leases on which payments are delinquent are to be reviewed regardless of amount.
3. Analyze the creditworthiness of the lessees. Consideration is given to the figures derived from the lessee's financial statements, as well as cash flow, trends and projections of growth in sales and income, and the qualifications of management.

   Delinquency on a lease obligation is potentially more serious than delinquency on a conventional loan. If the property under lease is necessary for the lessee's continued production of income, as is frequently the case, the lessee's financial condition will be seriously deteriorated before the lessee is willing to risk losing the property by default.

4. For those leases which might result in loss to the lessor, or for which financial information was not adequate to make such a determination, transcribe the following information to line sheets:
   a. name and line of business of lessee
   b. name of guarantor(s)
   c. original date of the lease contract
   d. original amount of the rentals receivable
   e. ERV of the property
   g. book value of the investment in the lease as of the inspection date
   h. cost of the property
   i. description and location of the property
   j. amount and frequency of rental payments
   k. original amount, term, rate, and schedule of amortization of any nonrecourse debt associated with the lease
   l. lessor's percentage of equity participation in the lease obligation, if applicable
   m. summary financial data indicating the creditworthiness of the lessee, and guarantors, if applicable
5. Before the conclusion of the inspection, discuss with management all classified leases. Inadequate or negative cash flow and unfavorable trends reflected in financial statements of the lessee are usually indicative of a substandard lease. Leases classified doubtful typically include those on which payments are delinquent for an extended period and those on which the lessor's recovery of investment is dependent upon an event of unknown probability, such as a pending lawsuit or insurance claim.

   A loss classification results from the lessee's inability or refusal to continue making payments.
6. Prepare a write-up to support the classifications. The write-up should include the lessee's type of business, present financial status, circumstances which led to the classification, the probability that the terms of the lease can be met, and the amount of protection afforded by sale or re-lease of the underlying property.
7. Review a sample of the lessor's computations of lease yields to determine whether the lessor will recover not less than the full investment in the property plus the estimated total cost of financing the property over the term of the lease. This includes rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease.

   With respect to the full-payout lease, governmental entities may be prohibited from entering into leases for periods exceeding one year. In that case, the bank holding company or its subsidiary (as lessor) should demonstrate that the lease is expected to be continually renewed until the cost is fully recovered.
8. Ascertain whether title to the property rests with the lessor, and that the lessor has taken steps to protect its ownership rights. Evidence of filing under the Uniform Commercial Code, where appropriate, should be found in the documentation file. Aircraft should be registered with the FAA, interstate vehicles with the ICC, and ships with the Coast Guard.
9. Check for cancellation or other provisions in the contract which could jeopardize the full-payout status of the lease. There is no need to take exception to a cancellation provision which provides for payment by the lessee of an amount which allows the lessor to recover fully its investment in the property.
10. Check that insurance coverage is effective on leased property and is provided by the lessee in compliance with all insurance provisions of the contract in an amount sufficient to protect against loss from property damage. Public liability insurance should also be provided to protect against loss from lawsuits which could arise from situations such as the crash of leased aircraft.
11. Review the lessee's duties under the contract with respect to repairs and taxes. Determine whether the lessor has instituted procedures to check that the lessee's required duties are being performed.
12. Review the status of all property acquired for lease purposes but which is not now under lease. Determine the reason for the "off-lease" status of the property, ascertain the realizable value of the property, and investigate whether the off-lease property will be sold or re-leased within the required two-year period.
13. Investigate the lessor's procedures for periodic review of the reasonableness of the estimated residual value. The estimate should be reviewed at least annually and reduced in amount on the books if the value has declined on a presumably permanent basis.
14. Review past operations of the lease company to determine if projections of income and ERV have been realistic in light of actual experience.
15. Review the minutes of the meetings of the

board and executive committees to determine whether purchases of property and delinquent leases are reported to the board.

16. Determine if the company has entered into leases with companies owned or controlled by any director, officer, or 10 percent shareholder of the leasing company or holding company. Compare the rates and terms on such leases to the rates and terms offered on leases to companies of similar credit standing.
17. Check for lease concentrations to any one lessee or industry and prepare a comment for the inspection report if any concentration is considered unwarranted.
18. Determine whether the company has established limits for the maximum amount of "credit" to be extended to a single lessee. If such limits have been established, investigate whether the company adheres to them. If they have not been established, inquire as to the company's policy on this matter.
19. Provide the examiner-in-charge with information to be included in the inspection report, including:
    a. scope of the inspection (on- or off-premises)
    b. comments concerning any policies or conditions having an adverse effect on the leasing company or parent company
    c. brief history of the company and a description of its activities
    d. summary analysis of financial factors of the company, including trends in the volume and classification of receivables, adequacy of capital and reserves, return on assets, and contribution to consolidated income and consolidated assets
    e. statutory authority under which the company operates
    f. details of all borrowings of the company from within the holding company system and from external sources
    g. details of any litigation in which the company is a defendant
    h. scope and frequency of audit of the company by both internal and external auditors
20. Compare current earnings performance and balance-sheet ratios of the company with past performance and industry composites.
21. Determine whether cash flows of the company are adequate to service all debts.
22. Assess the adequacy of internal controls over the company's operations.
23. Check for action taken on matters criticized in the most recent audit reports and the previous inspection report. Determine if leases classified "loss" were removed from the books.
24. Investigate whether any affiliated banks maintain compensating balances for lines of credit of the leasing company, and if so, whether the leasing company compensates the bank for maintenance of the balances. If "loss" leases have not been removed from the books, discuss with management the reasons why the charge-offs were not made. Determine whether the financial statements and reports submitted to the Board of Governors were misstated as a result of the "no charge-off" decision.
25. For higher residual value leasing, determine that—
    a. the residual values have been estimated accurately;
    b. residual values are reviewed and adjusted annually;
    c. the initial terms of the lease are at least 90 days;
    d. the lessor relies on a residual value of the leased property that will recoup the acquisition cost of the property and any related financing or other associated costs;
    e. the aggregate book value of all tangible personal property held for such a lease, having an estimated residual value in excess of 25 percent of the acquisition cost of the property, does not exceed 10 percent of the BHC's consolidated domestic and foreign assets;
    f. the BHC maintains separately identifiable records of the leasing transactions and activities; and
    g. each company maintains capitalization fully adequate to meet its obligations and support its activities, and that its capital levels are commensurate with industry standards for companies engaged in comparable leasing activities.

3140.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Automobile Leasing				1976 FRB 930
Consumer leasing	15 U.S.C. 1667			
Higher residual value leasing				1991 FRB 490, 187 1990 FRB 462, 960
Personal or real property leasing activities of bank holding companies		225.28(b)(3)		
Special-purpose leasing corporation			3-712	
Railcar leasing, railcar fleet management services (leasing personal property and acting as agent, broker, or adviser in leasing personal property)		225.28(b)(3)		2016 FRB Q2 Board Order 2016-07
Engaging in incidental activities reasonably necessary to carrying on permissible nonbanking activities		225.21(a)(2)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

The Board considers the making of equity and debt investments in corporations or projects designed "primarily to promote" community welfare as an activity closely related to banking. The Board includes such investments in the list of permissible nonbanking activities in Regulation Y; however, bank holding companies must obtain prior approval to engage in these activities. The Board, effective April 21, 1997, included the provision of advisory and related services for programs designed primarily to promote community welfare into Regulation Y. Such advisory activities had previously been permitted only by Board order. For examples of advisory services approved for community development projects, see 1990 FRB 671, 1989 FRB 576, and 1988 FRB 140.

3150.0.1 INVESTMENTS IN CORPORATIONS OR PROJECTS TO PROMOTE COMMUNITY WELFARE—BOARD INTERPRETATION

The Board also provides guidance with regard to investments in community welfare projects through its interpretation (see section 225.127 of Regulation Y (12 C.F.R. 225.127)). This interpretation describes projects that the Board has considered as promoting community welfare as their primary intent. These include but are not limited to—

1. projects to construct or rehabilitate housing for low- or moderate-income persons,
2. projects for construction or rehabilitation of ancillary local commercial facilities necessary to provide goods or services principally to persons residing in low- or moderate-income housing, and
3. projects designed explicitly to create improved job opportunities for low- or moderate-income groups.

Because the Board believes that bank holding companies should take an active role in the quest for solutions to the nation's social problems, it has not defined other types of investments designed primarily to promote the community welfare in order to give bank holding companies greater flexibility in developing new and creative approaches to resolving community problems. Accordingly, the Board has maintained the flexibility to determine whether an activity is primarily designed to promote the community welfare. Factors that the Board might consider include whether the activity benefits low- and moderate-income individuals in areas such as housing and employment and the need for specialized community development activities in different localities. The Board will consider a range of different activities, but will probably not approve a proposal that does not in some way either benefit low- or moderate-income individuals or benefit the specialized needs of local communities.

Once a bank holding company has obtained Board approval to engage in community development activities pursuant to Regulation Y, the holding company may, without further System approval, engage either directly or through a subsidiary in certain community development activities, so long as such activities do not exceed 5 percent of the bank holding company's total consolidated capital stock and surplus.

A bank holding company may invest and provide financing—

1. to a corporation or project or class of corporations or projects that the Board previously has determined is a public welfare project pursuant to paragraph 23 of section 9 of the Federal Reserve Act (12 U.S.C. 338a);
2. to a corporation or project that the Office of the Comptroller of the Currency previously has determined, by order or regulation, is a public welfare investment pursuant to section 5136 of the Revised Statutes (12 U.S.C. 24 (Eleventh));
3. to a community development financial institution (other than a bank or bank holding company) pursuant to section 103(5) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4702(5));
4. for the development, rehabilitation, management, sale, and rental of residential property if a majority of the units will be occupied by low- and moderate-income persons or if the property is a "qualified low-income building" as defined in section 42(c)(2) of the Internal Revenue Code (26 U.S.C. 42(c)(2));
5. for the development, rehabilitation, management, sale, and rental of nonresidential real property or other assets located in a low- or moderate-income area provided the property

is used primarily for low- and moderate-income persons;
6. to one or more small businesses located in a low- or moderate-income area to stimulate economic development;
7. for the development of, and to otherwise assist with, job training or placement facilities or to foster programs designed primarily for low- and moderate-income persons;
8. to an entity located in a low- or moderate-income area if that entity creates long-term employment opportunities, a majority of which (based on full-time equivalent positions) will be held by low- and moderate-income persons; and
9. for providing technical assistance, credit counseling, research, and program development assistance to low- and moderate-income persons, small businesses, or nonprofit corporations to help achieve community development.

3150.0.2 EXAMPLES OF BOARD-APPROVED ACTIVITIES DESIGNED TO PROMOTE COMMUNITY WELFARE

With its primary thrust to promote community welfare rather than creating a focus on a collateral effect, economic rehabilitation and development should focus on providing housing, services, or jobs for low- or moderate-income residents or groups. Examples of projects previously approved by the Board include an investment in—

1. an agricultural test farm (testing crops, equipment, alternative farming methods and chemicals, and providing student agricultural research opportunities and financial planning workshops for farmers (see 1990 FRB 671);
2. an entity that provides education to young persons (see 1991 FRB 70) through a nonprofit, tax-exempt bank holding company (educational programs consisted of the American economic system, how to start a business, college financial planning, and career opportunities in banking);
3. the acquisition and redevelopment of a sole medical clinic in a small rural town without public transportation that was located 30 miles from another facility and was needed to attract new physicians to replace those retiring (see 1991 FRB 63); and
4. a limited partnership to develop a nearly vacant office building into a hotel complex within a major city, located adjacent to a public housing project. Commitments included providing training to welfare recipients residing in public housing projects and employing low- and moderate-income individuals at the hotel complex, and donating a portion of the profits to a nonprofit corporation designated to provide low-cost housing, employment, and business opportunities for disadvantaged residents. (See 1996 FRB 679.)

3150.0.3 EXAMPLES OF INVESTMENTS VIEWED AS NOT PROMOTING COMMUNITY WELFARE

The Board has indicated that some investments are not designed primarily to promote community welfare unless there is substantial evidence to the contrary, even though the investment may benefit the community to some extent. Examples include investments to build or rehabilitate high-income housing or commercial, office, or industrial facilities which are not designed explicitly to create job opportunities for low-income persons, even though the investment may benefit the community to some extent. This latter point was made in an order (see 1996 FRB 679) whereby the Board denied an application by a bank holding company to acquire an investment in an industrial development corporation involved in the construction of a shopping and office complex in an urban renewal area. The Board identified the critical issue as whether the project was devised primarily to promote the community welfare or primarily designed as a profit-making venture in which the benefits to the community were merely a collateral effect.

In another case, the Board denied a proposal intended to acquire a company that indirectly acted as a managing general partner of a private development venture. The venture was a large-scale, urban redevelopment initiative, jointly sponsored by government and private entities, that was intended to revitalize a geographic area that was largely abandoned within a working middle-class community. (See 1990 FRB 672.)

3150.0.4 INSPECTION OBJECTIVES

1. To determine that new investments and financing in community development and other corporations and projects are designed primarily to promote community welfare.
2. To determine that previous investments and financings continue to meet the standards

imposed by section 225.28(b)(12) of Regulation Y.

3. To determine that the activity remains within the scope of regulatory approval when such approval involves specific rather than general investments.
4. To determine that advisory and related services for programs designed primarily to promote community welfare are being conducted within the scope of their regulatory approval.

3150.0.5 INSPECTION PROCEDURES

As is standard practice in the examination of other subsidiaries engaged in nonbanking activities, a thorough review of pertinent books, records, contracts, and financial statements should be undertaken by the examiner. To fulfill the inspection objectives concerning this activity, the examiner may have to go beyond routine investigative practices. Since this activity encompasses a wide variety of programs, procedures will have to be developed on an ad hoc basis. When federal or state approval of the program is required, the examiner may wish to review applications and other materials submitted to such authorities. The terms or conditions imposed by such bodies as well as the subsidiary's continued eligibility may also be of importance. Contact with responsible federal or state officials may be deemed appropriate in certain cases. Such contacts, however, should be initiated only in accordance with respective Reserve Bank procedures. When a community welfare project or financing does not include the involvement of another governmental body, the examiner will need to verify directly whether goals essential to the nature of the activity, such as providing housing for the elderly or jobs for low- or moderate-income people, are being met. In this regard, the burden should be on the holding company to provide such data. In some instances, an on-site visit to the project may be appropriate.

3150.0.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible investments described	1701	225.28(b)(12) 225.127	4–178	1972 FRB 495 1978 FRB 45 1984 FRB 452
Provision of community development advice on a fee-for-service basis				1988 FRB 140 1989 FRB 576
Purchase of land for agricultural testing activities				1990 FRB 672
Nonprofit, tax-exempt BHC—educational programs in economics, starting businesses, financial planning, career opportunities in banking				1991 FRB 70
Projects to create improved job opportunities for low- or moderate-income groups				1992 FRB 619
Approval of community development converting an office building into a hotel complex, located next to a public housing project designated as "difficult to develop"				1996 FRB 679
Denial of a bank holding company formation by a community development corporation				1976 FRB 639
Denial of a venture that would revitalize an abandoned area in a middle-class community				1994 FRB 733

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3160.0.1 PROVISION OF DATA PROCESSING AND TRANSMISSION SERVICES

Under section 4(c)(8) of the BHC Act, the permissibility of bank holding company data processing activities is generally predicated upon the type of data processed or transmitted. Subsidiaries formed under this section may engage in business directly with outside customers, unlike section 4(c)(1) subsidiaries, which can act only as servicers for affiliates[1] and cannot deal directly with outside customers.

The intent of section 4(c)(8) is to permit bank holding companies and their nonbank subsidiaries to directly provide to customers financially or economically oriented services (or services that are similar to these services) that banks have traditionally used in their own internal operations and provided to their customers. Such services (with prior approval) are unrestricted as to location and may be provided from out-of-state locations.

3160.0.2 INCIDENTAL ACTIVITIES

The Board regards the following as incidental activities necessary to carrying on permissible data processing activities:

1. Making excess computer time available to anyone as long as the only involvement by the bank holding company system is furnishing the facility and the necessary operating personnel. This stipulation applies when—
   a. the equipment is not purchased solely for the purpose of creating excess capacity to sell;
   b. hardware is not offered in conjunction with excess capacity; and
   c. the facilities for the use of the excess capacity do not include providing any software other than systems software (including language), network communications support, and the operating personnel and documentation necessary for maintaining and using these facilities.
2. Selling byproducts of permissible data processing and data transmission activities when they are not designed, or appreciably enhanced, for the purpose of marketability.
3. Furnishing any data processing service upon request of a customer if the service is not otherwise reasonably available in the relevant market area.

3160.0.3 SECTION 4(c)(8) vs. SECTION 4(c)(1)

Section 4(c)(1) data processing subsidiaries, which do not require prior approval, are limited as follows:

1. They can furnish computer services *only* for the internal operations of the bank holding company and its bank affiliates.[1]
2. Direct computer services to nonaffiliated customers are not permitted. Any contract to furnish services to nonaffiliated customers must be between the affiliate bank and its customer, with the data processing subsidiary acting as a servicer for its affiliate bank. In addition, the kinds of services furnished are limited to those that a bank can normally provide.

Section 4(c)(8) data processing subsidiaries may deal directly with the customer. In accordance with section 4(c)(8) of the BHC Act and section 225.28(b)(14) of Regulation Y, the kinds of services nonbank subsidiaries of bank holding companies may provide to others are—

1. data processing and transmission services, facilities (including hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or databases by any technological means, if—
   a. the data to be processed or furnished are financial, banking, or economic data and
   b. the hardware provided in connection with the data processing and transmission services is offered only in conjunction with software designed and marketed for the processing and transmission of financial, banking, or economic data, and the general-purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.
2. data processing, data storage, and data transmission services for a third party that are not financial, banking, or economic related if the subsidiary's total annual revenue derived from

1. In this context, "affiliates" is limited to other organizations that have subsidiaries of the same parent bank holding company as the servicer.

those activities does not exceed 30 percent of its total annual revenues derived from data processing, data storage, and data transmission activities. On November 26, 2003, the Board approved an increase of this limit to *49 percent*, effective January 8, 2004. See 1993 FRB 1158, 2004 FRB 55, and section 3160.2. The Board currently recognizes that, in certain situations, a bank holding company may have bona fide operational reasons for conducting its financial and related nonfinancial data processing activities through separately incorporated subsidiaries. In these cases, bank holding companies may request permission to administer the 49 percent revenue test on a business-line or multiple-entity basis. See section 225.28(b)(14) of Regulation Y (12 C.F.R. 225.28(b)(14)).

3160.0.4 MINICOMPUTER ACTIVITIES

Some data processing subsidiaries are actively engaged in placing minicomputers with some of their customers. However, if the subsidiary acts as sales agent for the manufacturer and receives a commission, it is in violation of section 225.28(b)(14) of Regulation Y and should be advised to cease the practice.

3160.0.5 HARDWARE AND SOFTWARE AS AN INTEGRATED PACKAGE

Customers of data processing services require that suppliers provide them with hardware and software as an integrated package. Providing general-purpose hardware is permissible only if the cost of the hardware does not exceed 30 percent of the cost of the packaged offering, and only in conjuction with permissible software. When hardware is provided in a specialized form (such as ATMs), its provision meets the *National Courier* test and is closely related to banking and therefore not subject to the 30 percent limitation.

3160.0.6 PACKAGED FINANCIAL SYSTEMS

The Board found that providing packaged financial systems, including data processing hardware and software, to be installed on the premises of the customer is closely related to banking if conducted within the limits of Regulation Y.

3160.0.7 EXCESS CAPACITY

The sale of excess computer time is currently treated in a Board interpretation as a permissible incidental activity. The interpretation (12 C.F.R. 225.123(e)(1)) currently permits a bank holding company to make excess computer time available to anyone so long as the only involvement of the holding company is furnishing the facility and the necessary operating personnel. Data processors that process time-sensitive data must maintain sufficient capacity to meet peak demand and provide backup in case of equipment failure. Excess capacity necessarily results from such needs; thus the sale of excess capacity is necessary to reduce costs and to remain competitive. Bank holding companies are limited in the sale of excess capacity as follows:

1. A bank holding company may not purchase data processing equipment solely for the purpose of creating excess capacity.
2. A bank holding company may not sell hardware in conjunction with excess capacity.
3. A bank holding company may provide only limited types of software in connection with its sale of excess capacity. This includes systems software (that is, software designed only to control and operate the hardware and not to perform substantive operations), network communications support, and the operating personnel and documentation necessary for maintaining and using these facilities.

3160.0.8 BYPRODUCTS

The sale of byproducts for the development of a program for a permissible data processing activity is treated in a Board interpretation (12 C.F.R. 225.123(e)) as a permissible incidental activity. Byproducts may be data, software, or data processing techniques or information developed by the bank holding company. Byproducts *may not* be designed or appreciably enhanced for the purpose of marketability.

3160.0.9 REQUIREMENT OF SEPARATE RECORDKEEPING

The Board's data processing interpretation is designed to minimize any possibility of unfair competition. A bank holding company subsidiary or related entity that provides permissible data processing and data transmission activities (services, facilities, byproducts, or excess capacity) must keep separate books and records and provide the documents to any new or renewal customer upon request.

3160.0.10 SUMMARY

Holding company EDP proposals are evaluated from the standpoint of whether the proposed data processing activities involve banking, financial, or related economic data within the meaning of the Board's Regulation Y. Processing, storing, and transmitting data for third parties, when the data are not financial, banking, or economic, is permissible if the revenues derived from those activities do not exceed 49 percent of the subsidiary's total annual revenues derived from data processing, data storage, and data transmission activities. For examples of previous Board authorizations for data processing and transmission services in accordance with Regulation Y, see sections 3160.1 through 3160.5.

The data processing that is permissible under Regulation Y encompasses various data processing services, including sales analysis, inventory analysis, freight payment, municipal tax billing, credit union accounting, and savings and mortgage company bookkeeping and payroll processing.

3160.0.11 INSPECTION OBJECTIVES

1. To determine that the full range of EDP services performed are permissible financially oriented activities in compliance with applicable laws and regulations.
2. To review the relationship between the data processing subsidiary and its affiliates and the effect of those relationships on the affairs and soundness of the bank affiliate.
3. To determine if operating policies are adequate and if management is operating in conformance with the established policies.
4. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.

NOTE: All bank-related EDP servicers receive EDP examinations conducted by the primary bank regulator; these examinations cover detailed operations, audit, proper backup, and overall computer operations. The bank holding company–related inspection should focus on the types and permissibility of services performed, the revenue limitations of section 225.28(b)(14) of Regulation Y, the types of customers serviced, and transactions between affiliates. The inspection should also provide an overall financial evaluation.

3160.0.12 INSPECTION PROCEDURES

3160.0.12.1 Pre-Inspection

1. Where available, review the EDP examination report in conjunction with the lead bank examination for details of the subsidiary's operations and management.
2. Review correspondence files and the application memo for the history of the subsidiary.

3160.0.12.2 On-Site

3. Have a brief meeting with the chief executive officer of the subsidiary to establish contact and present a brief indication of the scope of the inspection.
4. Ask the controller of the company for the schedules and other information requested in the entry letter.
5. Request the following information and schedules in addition to what was requested in the entry letter:
   a. complete list of the computer applications the subsidiary performs
   b. list of customers
   c. policy and procedures manual, if any
   d. copy of the latest internal and external financial and operational audits and internal control reviews
   e. copy of the types of management reports the subsidiary submits to the parent company and directors
   f. internal management organization chart
   g. copy of the agreement executed with the affiliates concerning the services provided and the fees collected
6. Review minutes of meetings of the board of directors and of the executive committee to determine the broad types of the company's operations.
7. Determine the scope of the inspection, based on evaluations of—
   a. corporate minutes,
   b. schedules,

c. accounting records,
d. internal controls, and
e. the scope of the work performed by the internal auditor.

8. Review the trial balances and compare them with the respective general ledger control accounts.
9. Where necessary, interview pertinent division heads.
10. Determine if management information systems are adequate and if regular periodic reports are made available. Determine if the reports provide sufficient segregated details on the annual revenues earned from (1) financial-, banking-, or economic-related data processing and data transmission services and (2) third-party nonfinancial data processing and data transmission services. Ascertain whether the information will allow verification of compliance with the revenue limitations found in section 225.28(b)(14) of the Board's Regulation Y.
11. Verify that the subsidiary of the bank holding company is complying with the revenue limitations found in section 225.28(b)(14) of Regulation Y.
12. Review the data processing, data storage, and data transmission services provided to customers for violations of the Board's regulations and interpretations. Obtain sufficient documentation for the workpapers.
13. Prepare a statement of condition with a minimum two-year comparison. More than two years may be prepared if the information is available and meaningful.
14. Prepare a statement of income using the same procedures outlined above.
15. Review all significant internal policies. Determine if the policies were developed internally or by the parent company.
16. Review the subsidiary's management reports to the parent company. Is the reporting complete and frequent (at least quarterly)? Is the parent company fully aware of the subsidiary's operations or problems?
17. Review the adequacy of internal and external financial and operational audits and internal control reviews. Interview the EDP auditor and review the audit reports and CPA management letters (for the period of the inspection). Also conduct interviews with the auditors, including the EDP auditor (if one was engaged).
18. Review the condition of the company's records, that is, their availability, completeness, and accuracy. Deficiencies should be discussed in detail with recommendations for improvement.
19. Review all intercompany transactions. Be consistently alert for any transactions with affiliate bank(s) that would be a violation of Federal Reserve Act sections 23A and 23B and Regulation W.
20. Review significant litigation and other contingent liabilities.

3160.0.13 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
EDP auditing		225.28(b)(14)		
Types of activities—incidental activities		225.123 and 225.123(a)	4–176	1975 FRB 215
Data processing as an activity closely related to banking		225.123(e)		1974 FRB 58
Section 4(c)(1) type of EDP services		225.118	4–195	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Retention of data subsidiary				1972 FRB 318
Order authorizing a bank holding company to engage in expanded data processing and data transmission activities				1982 FRB 505
Amendment of Regulation Y for expanded activities		225.28(b)(14)		1982 FRB 552 1997 FRB 275
Order authorizing a BHC to offer financial-office service and the service of designing and assembling data processing hardware. Receipt of hotel information and the ability to make airline and hotel reservations is not related to the provision of banking, financial, and economic data.		225.28(b)(14)		1986 FRB 497
Order authorizing engaging in electronic benefit services, stored-value-card services, and electronic data interchange services				1993 FRB 1158
Order authorizing the provision of a network for the processing and transmission of medical payment data				1994 FRB 139
Order authorizing the provision of traveler's checks and postage stamps via an ATM card and terminal				1994 FRB 1107
Order allowing a BHC to process certain nonfinancial data—personnel information for financial institutions for use in their internal operations				1995 FRB 295
Order authorizing optical scanning and database preparation				1995 FRB 1049
Order authorizing engaging in the development, production, and provision of customer home banking—personal financial management using personal computers				1996 FRB 363

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Order allowing a BHC to engage in— (1) providing data processing and data transmission services to non-affiliated financial institutions and (2) assisting the institutions in offering their customers banking and financial services over the Internet				1996 FRB 674 1996 FRB 680
Order approving limited nonfinancial data processing and transmission services, including customer identification, account, and information or verification files for detecting fraudulent use.				1996 FRB 348
Order approving the development and provision of a data processing and data transmission system (''gateway'') to depository institutions and their affiliates. The system would make home banking and other financial services available to the institutions' and affiliates' customers. The gateway would provide customers with an electronic link to an Internet provider.				1997 FRB 135
Order approving the development and sale of computer software to broker-dealers and financial institutions that would allow customers to purchase and sell securities over the Internet using personal computers.				1997 FRB 335
Amendment of Regulation Y to expand the ability of BHCs, including FHCs, to process, store, and transmit nonfinancial data in connection with data processing, storage, and transmission activities.				2004 FRB 55

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

A bank holding company applied for the Board's approval to acquire all the shares of a nonbank data processing company to engage in the processing and transmission of certain medical-payment data. The nonbank subsidiary plans to engage in activities that specialize in a range of medical-payment electronic funds transfer services, including the development of software products related to the processing of medical-claims payments.

Basic network services. The Board determined by order that a nonbank subsidiary of a bank holding company may provide a network for the processing and transmission of medical-payment data between health-care providers (such as physicians, hospitals, and pharmacies) and entities responsible for paying medical benefits (such as health insurers, health maintenance organizations, and preferred provider organizations). These nonbanking activities are permissible under the Bank Holding Company Act and the Board's Regulation Y (12 C.F.R. 225.28(b)(14)). The information on the patient's medical-benefits card (made available by paying organizations) would be used to access the system (similar to a debit or credit card). In general, health-care providers would enter claims information into the network with a request for payment, and the payers would authorize electronic fund transfers for full or partial payment of the claims.

The bank holding company's nonbank subsidiary would also process and transmit medical-treatment data necessary for the processing of claims, and would furnish providers with access to a coverage-information database. The database would transmit information about the terms of a particular payer's medical coverage contract, such as the extent to which specific medical treatments are covered by the patient's insurance policy. While such medical and coverage data are not financial data, the processing and transmission of these data are essential to the transmission and processing of the medical payments and financial information in the network. Also, these data processing services allow the electronic transfer of funds. The Board found that the processing and transmission of the medical and coverage data, in connection with the nonbank subsidiary's operation of a payments network, are permissible as incidental activities. The Board further determined that the nonbank subsidiary's operation of a medical-payments network would constitute permissible data processing and data transmission activities under the BHC Act.

Adjudication software. The Board also authorized the bank holding company's nonbank subsidiary to furnish claims-adjudication software to payers. The software is designed for the processing of routine claims and would include the basic rules of a payer's coverage contract. Claims-adjudication processing would involve the interaction of financial and banking data and medical and coverage data as a necessary prelude to electronic funds transfer. The Board found that the processing of medical and coverage data involved in claims adjudication is an integral and necessary part of the processing of related financial and banking information, and the nonbank subsidiary's processing of underlying payment transactions. The Board concluded that the nonbank subsidiary's provision of claims-adjudication software is permissible as an activity incidental to its provision of software for the processing of banking and financial data and to its operation of a medical-payments network.

Electronic data interchange. The bank holding company's nonbank subsidiary also plans to provide medical–payments system participants with statistical and other data derived from the information in its database. Each participant would have on-line access to all of the data it places into the system, and third parties designated by a payer or provider could also receive access to the data owned by that customer. The Board has previously stated that bank holding companies may provide byproducts of permissible data processing and data transmission activities as long as the byproducts are not designed, or appreciably enhanced, for the purpose of marketability (12 C.F.R. 225.123(e)(2)). The Board has also indicated that byproducts include data, software, or data processing techniques that may be applicable to the data processing requirements of other industries.

The nonbank subsidiary may perform limited selection, combination, and similar functions on raw data so that the data can be transmitted to the customer in a reorganized and more usable form. It may also design software that would enable customers to perform similar reorganization functions on raw data. The Board concluded that the proposed electronic data interchange services would constitute permissible byproducts of the nonbank subsidiary's primary data processing activities, and are therefore permissible as an incidental activity.

The Board's approval of the application on December 22, 1993, is based on the facts of record and is subject to the commitments and representations that were made by the applicant and the conditions referred to in the order. (See 1994 FRB 139.)

Four bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act to engage de novo, through their joint venture corporation (the company), in nonbanking activities consisting of engaging in electronic benefit transfer services, stored-value-card services, and electronic data interchange services. The applicants proposed to engage in the activities throughout the United States. The applicants provide data processing and transmission services through the company to retail merchants using point-of-sale (POS) terminals and to banks who are members of the company's automated teller machine (ATM) network.

3160.2.1 ELECTRONIC BENEFIT TRANSFER SERVICES

The electronic benefit transfer services would involve data processing and transmission services required to permit the delivery of governmental program benefits (such as welfare payments and food stamps) through the ATM and POS terminals of participating merchants and banks. Under a benefits-services system, a benefit recipient would be issued a magnetically encoded card similar to an ATM card, which could be used to obtain access to a government benefit account maintained on behalf of the recipient. The Board concluded that such activities are financial activities that are operationally and functionally similar to the electronic payment and data processing services provided by banks and bank holding companies in the operation of ATM and POS networks. In particular, the proposed benefit services involve the processing of access and authorization requests submitted to, and the processing of electronic payments originating from, financial accounts on the same basis as transactions initiated with traditional credit and debit cards. The Board thus concluded that such electronic benefit transfer activities are closely related to banking and permissible for bank holding companies under the BHC Act.

3160.2.2 STORED-VALUE-CARD SERVICES

Stored-value-card services would involve data processing and transmission services and electronic payment services related to stored-value cards. These cards are similar to credit or debit cards in which authorized funds can be transferred and credited using magnetic stripe or computer chip technology. The services would be provided in connection with both "closed" and "open" stored-value-card systems. Closed systems include both single-vendor stored-value-card systems and systems designed for single-use sites. An open system, by contrast, refers to multiple-vendor, multiple-site stored-value-card systems.

3160.2.2.1 Stored-Value-Card Closed Systems

In most current closed systems, cash must be deposited in a particular vendor's card-dispensing terminal, and the card received from the terminal may be used only for purchases from that specific vendor. The card itself is disposable, and the only account reconciliation that may be required would involve the vendor's own cash receipts, the amount of funds debited from the cards at turnstiles or other points of sale, and the amount of the vendor's liabilities stored on outstanding cards. The company intended to play a role in the operation of this basic type of closed system, as well as to help develop and operate more complex closed systems. These systems would use a plastic card containing electronic technology, such as a computer chip or magnetic stripe, to which funds could be credited and from which funds could be debited, for an indefinite period of time. The company proposed performing accounting functions in customer accounts and accounting for the level of the vendor's stored liabilities. In such a capacity, the company would be responsible for the settlement and reconciliation of these customer and vendor accounts. The company would also perform other functions, such as embossing and issuing cards and arranging for funds collection.

3160.2.2.2 Stored-Value-Card Open Systems

The applicants anticipate that stored-value cards eventually will operate in an open system similar to a POS network, which allows value stored on a card to be used with a wide range of participating vendors. The applicants expect that the company's principal stored-value-card activities would involve the development and operation of such open systems.

In an open system, customers' debit cards would hold an integrated computer chip or some type of comparable technology capable of storing value for use in stored-value-card transactions. Value could be placed on the card at an ATM adapted to read and place value on the chip, at a limited-purpose ATM-type machine whose only functions would be to add value to the chip and to transfer stored value back to the customer's account, or at a cash-to-card machine or other value-transfer device (collectively, value terminals). These value terminals would be operated, in at least some cases, by the company. Once value is placed on a card, equivalent funds could be transferred to the company, which would hold the funds for payment of stored-value-card transactions. Stored value would leave the chip when the customer purchases goods or services either at a POS terminal (which may be operated by the company) or at a vending machine, telephone booth, mass transit turnstile, or other unmanned delivery location (collectively, reader terminals), or when the customer transfers funds back to an account at a value terminal. Reader terminals generally would be offline devices not connected to the company's ATM or POS networks. Instead of a direct electronic connection, a reader terminal would retain, for a period of time, value representing the amount of customer purchases at the terminal. Then, at the vendor's convenience, the company, the vendor, or a third party would collect value from the reader terminals using specially designed collection cards issued by the company. The collection cards would then be submitted to the company so that funds can be properly credited. Once these transactions occur, the company would be responsible for making settlement by transferring funds to the accounts of participating merchants and other appropriate parties.

The Board concluded that the company's activities in providing stored-value-card services, in both closed and open systems, are closely related to banking. The activities involve processing debits and credits to the stored-value cards and performing related accounting and settlement functions, and are thus a data processing activity. Financial balances are maintained and adjusted at POS and other terminals as the customer purchases various items or adds value to the card, and the activity constitutes the processing of banking, financial, or economic data within the meaning of Regulation Y. In addition, aspects of the company's stored-value-card services are functionally similar to the issuance and sale of consumer payment instruments such as traveler's checks, which are activities that banks conduct and that the Board has previously determined to be closely related to banking within the meaning of the BHC Act. The Board concluded that the company's proposed services in connection with stored-value cards, in either an open system or a closed system, are closely related to banking.

3160.2.3 ELECTRONIC DATA INTERCHANGE SERVICES

The company also proposes to furnish retail merchants with data collected from sales transactions consummated at the merchant's place of business (data services). The data collected and furnished would relate to specific items and quantities of products purchased by the customer, as well as to customer-purchasing patterns over a period of time. The data would be formatted so that it could be used by the merchant for inventory control, targeted marketing, and other purposes. The company's data services generally would be furnished to merchants as an adjunct to its POS-transaction-processing services and would be rendered through a retail merchant's POS terminals. The company does not intend to offer data services independently. In addition, the data that are collected by the company would be furnished only to the merchant that is a party to the underlying sales transaction; that is, the company does not intend to provide such information to third parties.

The company's data services would be limited to capturing, formatting, and furnishing data collected from sales transactions consummated at a particular merchant's place of business. In addition, the data collected would be furnished only to that merchant and only in accordance with the merchant's specific instructions. The company does not intend to provide software, render advice, or provide other services associated with the marketing or other uses of the data. The applicants do anticipate, however, that the company could provide additional related functions, such as issuing store coupons or credits related to a merchant's marketing programs at POS terminals. Based on the facts presented, the Board determined that the sales data that would be processed under the proposed data services are financial and economic data within the meaning of Regulation Y.

3160.2.4 BOARD APPROVAL

Based on all the facts of record, the Board approved the applications. The Board's approval is specifically conditioned on compliance with the commitments made in connection with the applications and with the conditions referred to in the order. (See 1993 FRB 1158.)

Regulation Y provides that a bank holding company may render advice to anyone on processing and transmitting banking, financial, and economic data. On November 26, 2003, the Board approved an amendment to section 225.28(b)(14) of Regulation Y to expand the ability of all bank holding companies, including financial holding companies, to process, store, and transmit nonfinancial data in connection with their financial data processing, storage, and transmission activities. The Board raised the total annual revenue limit from 30 percent to the 49 percent limit that applies to nonfinancial data processing activities. Specifically, a company (a nonbank subsidiary of a bank holding company) conducting data processing, data storage, and data transmission activities may conduct nonfinancial data processing, data storage, and data transmission activities (those that are not financial, banking, or economic in nature) if the total annual revenue derived from those activities does not exceed 49 percent of the company's total annual revenues derived from data processing, data storage, and data transmission activities. (See 12 C.F.R. 225.28(b)(14).)

Data Processing Activities: Obtaining Travelers' Checks and Postage Stamps Using an ATM Card and ATM Terminal Section 3160.3

Eleven bank holding companies (the applicants) applied for the Board's approval to engage through a joint venture corporation (the company) in certain nonbanking activities related to the operation of a retail electronic funds transfer network, including data processing and data transmission activities related to automated teller machine (ATM) and point-of-sale (POS) transactions, as well as electronic benefit transfer, stored-value card, and electronic data capture and interchange services. (A complete list of the proposed activities is found at 1994 FRB 1110–1111.)

The applicants also proposed to offer through the company certain data processing and data transmission services not previously considered by the Board. Those services consisted of allowing customers to use their ATM cards at an ATM terminal to withdraw funds from a bank account in the form of travelers' checks or postage stamps. Payment for the transactions would be accomplished by a debit to a cardholder's deposit account.

The transactions would occur at terminals that would not be owned and operated by the company. Cardholders buying postage stamps or travelers' checks at an ATM terminal would purchase those products from the bank owning the ATM. The decision on which travelers' checks to issue would remain with the bank that owns the ATM terminal, and the company would not be the issuer of the travelers' checks.

The company's primary activities would be processing and transmitting access requests and payment authorizations. The company would also provide terminal-driving services, load ATM terminals with postage stamps and travelers' checks, and market the products through the network.

The Board determined that the proposed activities involved the processing of access and authorization requests submitted to deposit accounts on the same basis as other transactions initiated with a traditional debit card. The activity is operationally and functionally similar to the data processing services provided by banks and bank holding companies in their operation of ATM and POS networks. Traditionally, banks have been permissibly engaged in the sale of travelers' checks and postage stamps. The Board thus found the company's proposed data processing and transmission activities, with respect to these transactions, to be closely related to banking. (See 1994 FRB 1107.)

Five bank holding companies (the applicants) applied for the Board's approval to engage, through a joint venture subsidiary (the company), in certain data processing activities pursuant to Regulation Y. The applicants, through the company, would provide data processing and related services to banks and other automated teller machine (ATM) owners in connection with the distribution through ATMs of tickets, gift certificates, prepaid telephone cards, and other documents evidencing a prepayment for goods or services.[1]

The company would provide the software and telecommunications channels necessary to transmit cardholder requests, card-issuer authorizations, and related switching and account reconciliation services. Specifically, the company would provide terminal driving services that include—

- establishing and maintaining an electronic link between an ATM and a telecommunications switch to transmit cardholder requests and card-issuer authorizations; and
- operating the feature and functions displays on an ATM screen using computer software to permit an ATM to dispense various products in addition to currency.

The company would also provide switching services and transaction processing to transmit account debiting, transaction authorization, and settlement data between the ATM owner, or its bank, and the cardholder's bank.

A typical transaction would consist of an ATM cardholder selecting a particular product, such as a concert ticket, from a menu displayed on the ATM screen. The electronic commands transmitted by the company would verify that the deposit account or line of credit designated by the cardholder had sufficient funds to effect the purchase. Following authorization, the ATM would dispense the product and issue a receipt. The card-issuing bank would then debit an amount equal to the cost of the purchase from the cardholder's designated account and transfer the funds to the account of the merchant or ATM owner, using settlement procedures established by the company's ATM network.

The Board previously determined that a bank holding company could provide data processing and related services necessary to permit customers to use an ATM card to debit a deposit account or line of credit at an ATM terminal for cash and credit transactions, and for the purchase of travelers' checks, money orders, and postage stamps. The Board has further determined that a bank holding company may provide data processing services that support the use of credit cards by consumers in the direct purchase of goods and services from a merchant. (See 1995 FRB 492, 1990 FRB 549, and 1985 FRB 113.)

The data processing proposed in this case involves the same type of data processing support as the Board has previously approved for credit card transactions and other more traditional types of ATM transactions. The Board thus concluded that the activities proposed by the applicants are permissible, consisting of data processing and transmission services encompassed within the Board's Regulation Y, and are thus closely related to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. (See 1996 FRB 848.)

1. The tickets would include public transportation tickets and tickets to entertainment events. Gift certificates and prepaid telephone cards would be issued in fixed denominations for a specific merchant or group of merchants, and they would evidence prepayment of the purchase price of merchandise or services to be selected by the bearer at some time in the future. The ATM owners would also sell products that could be offered for sale directly by a financial institution, such as mutual fund shares or insurance policies, where permitted by applicable law.

3160.5.1 ENGAGE IN TRANSMITTING MONEY IN THE UNITED STATES

A bank holding company gave notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through two companies (the companies) in the activity of transmitting money for customers within the United States and its territories (''domestic money transmission services'') to third parties located in foreign countries.[1] The activity was to be conducted at first through a network of approximately 1,200 ''outside representative offices'' located in California, Florida, Illinois, and Texas that are under contract with the companies to provide money transmission services.[2] The bank holding company proposes to engage in the planned activity nationwide. The companies are corporations that currently engage in the business of money transmission to Mexico through representatives in California, Florida, Illinois, and Texas.

Domestic money transmission services would be provided in the following manner: A customer would contact the companies directly by means of a dedicated telephone located in the outside representative office to request that the companies transmit funds to a third party for a fee. The outside representative would collect cash and a fee from the customer, issue a receipt, and deposit funds in an account maintained by the outside representative solely for the purpose of receiving funds in trust to be transmitted to a third party. The outside representative may maintain this account at any bank, including a subsidiary bank, but would have no agreement with any bank to accept deposits on its behalf. Neither the outside representatives nor the companies would be FDIC-insured institutions.

The companies would collect funds deposited in an outside representative's account daily through an automated clearinghouse (ACH) or similar transaction and deposit an amount equal to the amount to be transmitted into an account they maintain at a bank, which may include one of its subsidiary banks, located near the third party receiving the funds. The third party would be notified that money is available at a local disbursement site, which could include a bank subsidiary of the bank holding company or consumer finance office or an unaffiliated check-cashing, finance, or other type of office. Funds would be made available to the third party by a check drawn on the companies' account almost immediately after the transmission order is placed by the customer.[3]

A customer would not transmit funds to any bank account maintained by the customer or any third party. Thus, the bank holding company would not use this service to collect deposits for customers of its subsidiary banks or any other bank.

There was no agreement between a customer and a bank to accept money in an account for use by the bank in connection with the proposed domestic money transmission services. The companies and their outside representative would accept money from a customer for the sole purpose of transmitting funds to a third party. A customer would not give funds to the companies with the expectation that the companies would permit the customer to reclaim the funds on demand or after a period of time. Moreover, the companies would not maintain balances or pay interest on the money they receive, and they would only hold funds long enough to transmit them to the designated third party.[4]

The Board previously determined that money transmission abroad is closely related to banking.[5] The Office of the Comptroller of the Currency (OCC) also has concluded that it is permissible for a national bank to accept money from nonbank affiliates for the purpose of transmitting the funds to a foreign country and that a

1. The Board previously approved the bank holding company's acquisition of a company to engage in the activity of transmitting funds to third parties in Mexico by using an unaffiliated foreign bank to make the cash payments. See 1995 FRB 974.

2. Outside representative offices would be expanded to include consumer finance offices in addition to existing grocery stores, travel agencies, pharmacies, and insurance agencies.

3. The domestic money transmission services do not involve lending money because only funds provided by the customer would be transmitted to a third party. The plan does not involve the paying of checks. Although the third party receives money by means of a check drawn on an account maintained by the companies, the receipt of funds in check form is not the payment of a check (see *Independent Bankers Ass'n of America v. Smith*, 534 F.2d 921, 943–45 (D.C. Cir. 1976)).

4. Many states permit companies that are not chartered as banks to transmit money without deeming this activity to involve the taking of deposits. The bank holding company is required to conduct the proposed activities in compliance with licensing and other requirements of relevant state law.

5. See 1990 FRB 270.

nonbank affiliate that participates with the national bank in transmitting money abroad would not become a branch of the bank.[6] Based on all the facts of record and for the reasons discussed in this and the Board's previous orders, the Board concludes that domestic money transmission services are closely related to banking. The Board has relied on the fact that the companies are subject to licensing and examination by state authorities.[7] The companies have committed to comply with all applicable reporting requirements, including reporting all transactions over $10,000 to the Internal Revenue Service. The bank holding company committed to apply the internal controls currently in place at the financial services company to ensure compliance with the Bank Secrecy Act.[8]

Based on the foregoing and all the facts of record, the Board approved the notice on October 17, 1995 (see 1995 FRB 1130). The Board's decision was specifically conditioned on the bank holding company's complying with all the commitments made in connection with the notice and obtaining all necessary approvals from state regulators.

6. The OCC has reasoned that nonbank offices that transmit funds through a national bank to a third party do not constitute "branches" under federal law.

7. This order was specifically conditioned on requiring the bank holding company to obtain all necessary state licenses.

8. These procedures include a weekly review of all transactions over $10,000. In addition, the companies will require customer identification, including the customer's current address and occupation, for all transmissions above $3,000. The companies also will run a computer match of all remitters and recipients by name and Social Security number so that reporting requirements cannot be evaded by means of a series of transactions.

The Board has included within Regulation Y (section 225.28(b)(10)(ii)(B)) the authority for bank holding companies to engage in the printing and selling of magnetic ink character recognition (MICR)-encoded items as part of support services. This activity includes this primary activity and also the printing and selling of corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require MICR encoding. The activity was initially authorized as a permissible activity by Board order, whereby such documents were to be printed for and sold exclusively to depository institutions. The applicant associated with that Board order proposed to acquire a controlling interest in a printing company that prints and sells checks and related documents. It planned to engage in a joint venture with another company that engages in check printing and other printing activities. The Board concluded for that application that checks and other MICR-encoded documents used in the payments process are provided in specialized form and that they are an integral part of a fundamental banking service, and thus the activity is deemed closely related to banking. See 1986 FRB 794. The Board included the nonbanking activity in the Regulation Y "laundry list," effective April 1997.

3170.0.1 INSURANCE ACTIVITIES PERMISSIBLE FOR BANK HOLDING COMPANIES

Before the enactment of the 1970 amendments to the Bank Holding Company Act, the Board by order authorized certain bank holding companies to engage in insurance activities. The specific type of permissible insurance activity for each bank holding company was described in its Board order. These few bank holding-companies that commenced insurance agency activities before January 1, 1971, have grandfather rights under the current statutes and regulations (section 4(c)(8)), exemption G and 12 (CFR 225.28(b)(11)(vii)). These bank holding companies may, with the prior approval of the Board, engage in general insurance agency activities without restriction as to location or to type of insurance sold. (See section 3170.0.3.7)

The 1970 amendments to the Bank Holding Company Act authorized the Board to determine permissible nonbanking activities under section 4(c)(8). Subsequently, on September 1, 1971, the Board amended Regulation Y to permit bank holding companies to engage in certain insurance agency activities.

The Board further amended the section of Regulation Y concerning permissible insurance agency activities on September 1, 1981. The 1981 amendments limited permissible insurance activities previously authorized by Regulation Y. The first amendment deleted from the Board's regulations the authority for bank holding companies to act under section 4(c)(8) of the Bank Holding Company as agent for the sale of insurance for themselves and their subsidiaries. This amendment reflected a court decision of the United States Court of Appeals for the Fifth Circuit that acting as agent for the sale of insurance for the bank holding company and its nonbanking subsidiaries was impermissible (permissible for banks, however). Such insurance is permissible, however, if conducted pursuant to section 4(c)(1)(C) of the BHC Act.[1] The second 1981 amendment deleted from the Board's regulations the authority to act as agent for insurance sold as a matter of convenience to the public. The opinion also found that the part of the Board's regulation relating to the sale of "convenience insurance"[2] exceeded the scope of the provisions of section 4(c)(8) of the Bank Holding Company Act. The sale of this other insurance was considered impermissible.

On October 15, 1982, Congress enacted the Garn–St Germain Depository Institutions Act (Public Law 97-320). Title VI of that act amended section 4(c)(8) of the Bank Holding Company Act. This amendment stated that insurance agency, brokerage, and underwriting activities are *not* "closely related" to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. However, the amendment provided for seven exceptions to the general prohibition of bank holding companies engaging in insurance activities. One of the seven exceptions contains grandfather exemptions for insurance agency activities conducted on May 1, 1982, or for those insurance activities approved by the Board on or before May 1, 1982. As a result, bank holding companies receiving Board approval on or before May 1, 1982, may continue to engage in their insurance agency activities. (See section 3170.0.3.4)

The seven types of insurance activities allowed as permissible for bank holding companies are as follows:

1. Acting as agent, broker, or principal (i.e., underwriter) for credit-related life, accident and health, or unemployment insurance.
2. For bank holding company finance subsidiaries, acting as agent or broker for credit-related property insurance in connection with loans not exceeding $10,000 ($25,000 in the case of a mobile home loan) made by finance company subsidiaries of bank holding companies. (The Board interpreted this provision as permitting only the sale of insurance that does not exceed the outstanding balance of the loan—vendor's single interest insurance rather than general property insurance that covers the borrower's equity interest.)

1. The Board's Regulation Y was amended as of December 1983 to include the sale of insurance for a holding company based on the services provision of section 4(c)(1)(C) of the BHC Act, which did not require any prior Board approval. Included in the regulation were the services of selling, purchasing, or underwriting such insurance as blanket bond insurance, group insurance for employees, and property and casualty insurance for the bank holding company or its subsidiaries.

2. "Convenience insurance" consisted of insurance that was sold as a matter of convenience to the purchaser. The premium income from the sale of this insurance was expected to constitute less than 5 percent of the aggregate insurance premium income of the holding company. The sale of this insurance was not designed to permit entry into the general insurance-agency business.

3. Acting as agent for the sale of any type of insurance in a place with a population not exceeding 5,000, or with insurance agency facilities that the bank holding company demonstrates to be inadequate.
4. Any insurance agency activity engaged in by a bank holding company or its subsidiaries on May 1, 1982 (or approved as of May 1, 1982), including (i) insurance sales at new locations of the same bank holding company or subsidiaries in the state of the bank holding company's principal place of business or adjacent states or any state or states in which insurance activities were conducted by the bank holding company or any of its subsidiaries on May 1, 1982, or, (ii) insurance coverage functionally equivalent to those engaged in or approved by the Board as of May 1, 1982.
5. Acting, on behalf of insurance underwriters, as supervisor of retail agents who sell fidelity insurance and property and casualty insurance on holding company assets or group insurance for the employees of a bank holding company or its subsidiaries.
6. Any insurance agency activities engaged in by a bank holding company having total consolidated assets of $50,000,000 or less. Life insurance and annuities sold under this provision, however, must be authorized by (1), (2), or (3) above.
7. Any insurance agency activity that is performed by a registered bank holding company, which was engaged in some insurance activity before January 1, 1971, pursuant to the approval of the Board.

These seven types of insurance allowed by the amendment to section 4(c)(8) of the Garn–St Germain Act are generally consistent with the types of insurance activities previously authorized by the Board. The one general exception related to the prohibition of the sale of property and casualty insurance.

3170.0.2 INSURANCE AGENCY ACTIVITIES

Insurance agency activities are among the most widely practiced nonbank activities engaged in by bank holding companies. Many bank holding companies are involved in the sale of insurance at some level in the organization; however, the inspection focuses on these activities only when performed by the parent company or by a nonbank subsidiary (excluding bank-owned subsidiaries). Many of the smaller bank holding companies engage directly in these activities rather than through insurance agency subsidiaries. In either arrangement, however, sales are usually conducted on the premises of the subsidiary bank by personnel who most often serve as officers or employees of the bank or parent company.

Performance of insurance agency activities has been profitable for most bank holding companies with many of the smaller companies relying heavily on the commissions generated to service acquisition or other related indebtedness. In most cases, little or no expenditures for fixed assets are required since the premises of the subsidiary banks or parent company are utilized. Likewise, little or no liabilities are incurred since there are minimal assets to be financed.

3170.0.3 PERMISSIBLE TYPES OF COVERAGE INCLUDING GRANDFATHER PRIVILEGES

As noted above, the Board, effective November 7, 1986, approved a revision of specific insurance agency and underwriting activities permissible for bank holding companies under section 4(c)(8) of the BHC Act (section 225.28(b)(11) of Regulation Y). In clarifying the scope of insurance activities that are closely related to banking and permissible for bank holding companies under the Garn–St Germain Act, the Board included in its revised Regulation Y the seven specific exemptions contained in that statute.

3170.0.3.1 Insurance Activities Permissible for Bank Holding Companies per Section 225.28(b)(11)(i) of the Board's Regulation Y

Permissible insurance agency activities include the sale of life, accident and health, and involuntary unemployment insurance that is directly related to an extension of credit by a bank holding company with respect to its own extensions of credit and those of its subsidiaries. For the purpose of determining what activities are permissible, the Board interpreted the term "extension of credit" to include direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases meet all the criteria contained in section 225.28(b)(3) of Regulation Y, which defines leases as the functional equivalent of an extension of credit. (See the discussion of leasing in section 3140.0.)

The regulation requires that insurance coverage be limited to the ''outstanding balance due'' on an extension of credit. The ''outstanding balance due'' is calculated as follows:

1. Include:
   a. principal and interest
   b. reasonable administrative fees outstanding on the loan
   c. the balance of payments due in a lease transaction
2. Exclude:
   a. the residual value of the leased item (since the lessor owns the leased item and the lessee is not obligated to purchase the item by paying the residual value)

The insurance may provide for total repayment of the extension of credit in the event of the death of the borrower or for periodic payments on the extension of credit when the borrower is temporarily disabled or unemployed. Such single or periodic payments may not exceed the balance on the loan and thus provide for additional general life or accident coverage.

While ordinarily such credit-related insurance coverage would be declining term as payments reduce the balance due on an extension of credit (loans in connection with first mortgages), a bank holding company may write or sell a level term policy on nonamortizing loans. Policies written or sold pursuant to this paragraph, moreover, may be individual rather than group policies, and the premiums on such policies may be age-related. The Board continues to require that insurance policies sold or written to cover the ''outstanding balance due'' insure only named borrowers or lessees of a particular bank holding company. Accordingly, such policies could cover both spouses jointly only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company.

The Board permits, with regard to an extension of credit, the sale and underwriting of credit-related life, accident and health, and involuntary unemployment insurance (1) with respect to lease transactions, as previously discussed, when such lease transactions are the equivalent of loans; (2) in connection with loans secured by residential first mortgages; and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

The regulation explicitly permits the sale of life, disability, and involuntary unemployment insurance with respect to a lease transaction, provided the lease is the type of nonoperating, full payout lease described as permissible for bank holding companies in section 225.28(b)(3) of Regulation Y. The Board has determined that such leases are the ''functional equivalent of an extension of credit.'' It believes that this type of lease is encompassed in the term ''extension of credit'' as it is used in exemption A of the Garn–St Germain Act.

As discussed previously, the first exemption of the Garn–St Germain Act permits the sale of any type of life, disability, and involuntary unemployment insurance relating to an extension of credit, including home mortgage redemption insurance. Home mortgage insurance insures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. The Board has determined that home mortgage redemption insurance is closely related to banking because it supports the lending function (1986 FRB 339 and 671) by providing for repayment of residential mortgage loans at a time when the death or disability of the borrower may delay or disrupt the scheduled repayment of such loans. Home mortgage redemption insurance in connection with residential mortgage loans is considered as fulfilling the same function as credit life and credit accident and health insurance with respect to other types of loans. The Board recognized that such insurance functions as credit insurance in supporting a bank's lending function (see the Board's approval for the *sale* of such insurance by bank holding companies within 1975 FRB 45).

In approving the activity of home mortgage redemption insurance by order, the Board previously relied on commitments by applicants to inform, in writing, borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and before closing. The Board continues to require that such notices be provided to borrowers. In addition, the Board continues to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrowers' ability to rescind the insurance and to limit premium financing as an incentive to sell such insurance.

The Board considers an "extension of credit" as covering loans that are made or purchased by the bank holding company or its subsidiaries. Credit-related insurance may be continued on the loans that were sold, and are now only being serviced, provided that they were made or purchased by the bank holding company or its subsidiaries. The Board permits bank holding companies to sell credit-related life, accident and health, and involuntary unemployment insurance where the bank holding company previously placed funds at risk. In this situation, the bank holding company must continue to limit its insurance coverage to the outstanding balance due on the extension of credit by the borrower.

A bank holding company may not sell or underwrite insurance when merely servicing a loan and *it has never placed its funds at risk* either by originating or purchasing the loan; the bank holding company is permitted to collect and transmit insurance premiums, act as intermediary in renewing existing policies or adjusting coverages, and engage in other activities which are incidental to the servicing of loans. The bank holding company may collect a fee for such services, providing that the fee is based on the provision of the service and is not a premium for insurance sold. In that case, the bank holding company would be engaging in loan servicing rather than insurance activities.

3170.0.3.2 Section 225.28(b)(11)(ii) of Regulation Y—Sale of Credit-Related Property Insurance by Finance Company Subsidiaries of a BHC

The Garn–St Germain Act restricts the authority of bank holding companies to engage in property and casualty insurance activities. Before 1982, the Board approved the sale of property and casualty insurance that was directly related to an extension of credit by a bank or bank-related firm in the bank holding company system. The sale of property insurance is now limited to an extension of credit made by a finance company that is a subsidiary of a bank holding company, acting as agent or broker. A finance company subsidiary may only engage in the sale of such property insurance if—

1. the insurance is limited to assuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit;
2. the extension of credit is not more than \$10,000, or \$25,000 if it is to finance the purchase of a residential manufactured home[3] and the credit is secured by the home; and
3. the applicant commits to notify borrowers in writing that—
   a. they are not required to purchase such insurance from the applicant;
   b. such insurance does not insure any interest of the borrower in the collateral; and
   c. the applicant will accept more comprehensive property insurance in place of such single interest insurance.

3170.0.3.2.1 Definition of a Finance Company

A "finance company" for purposes of the sale of property insurance includes all non-deposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual states as finance companies that engage in a significant degree of consumer lending. Finance companies, under this provision, include those entities that may be authorized to accept limited types of time or savings deposits under state law but which a state has defined to be a finance company. Since exemption B of the Garn–St Germain Act is directed to consumer loans, the regulation requires that a qualifying company be engaged in that type of lending to a significant degree as measured by either number of loans, percentage of loans, percentage of loan amounts outstanding, or some similar measure. The Board will evaluate the amount of the consumer lending on a case-by-case basis.

3170.0.3.2.2 Property Insurance a Finance Company May Sell

Section 225.28(b)(11)(ii) of Regulation Y permits finance company subsidiaries of bank holding companies to engage in the sale of single-interest property insurance that insures against damage or loss only to the extent of the lender's interest in the property that serves as collateral-for a loan. The Garn–St Germain Act limits the permissible insurance coverage to "the out-

3. These limitations increase at the end of each year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

standing balance due on an extension of credit.'' It does not contemplate general property insurance that covers the entire value of the property, including the balance due the lender and the equity interest of the borrower/owner. Generally such insurance is declining balance and the only interest in the collateral property that may be insured is that of the lender.

The sale of single-interest insurance is permitted provided that the BHC finance company subsidiary does not require such insurance of borrowers who have adequate property insurance on the loan collateral. In addition, the finance company subsidiary is required to disclose in writing that such insurance, if required, need not be purchased from the lender and that such insurance does not cover the borrower's interest in the property. The requirement is also imposed by the Board's Regulation Z, section 226.4(d)(2), if the premium is excluded from the finance charge.

3170.0.3.3 Section 225.28(b)(11)(iii) of Regulation Y—Insurance in Small Towns

Engaging in any insurance activity is permitted in a place where the bank holding company or a subsidiary of the bank holding company has a lending office in a community that—

1. has a population not exceeding 5,000 (as shown by the last preceding decennial census) or
2. has inadequate insurance-agency facilities, as determined by the Board, after notice and opportunity for hearing.

In order to provide insurance agency activities in a town with a population not exceeding 5,000, or in a community that has inadequate insurance agency facilities, the bank holding company must have a lending office that serves the public in the small town. The regulation specifically requires that the office be a lending office in order to provide the bank holding company with a link to the town, to avoid remote operation from a central location of a network of small-town insurance agencies, and generally to maintain insurance as a fee-generating activity to help sustain a small-town lending office as an independent, viable profit center.

The *current* requirement does not limit the sale of insurance to a ''principal place of banking business'' located in a community not exceeding a population of 5,000. Also, a bank holding company insurance agency is not precluded from selling insurance to those residing outside the community who initiate the transaction at the agency's place of business in the town of less than 5,000. Advertising in the community newspaper or a telephone book that may serve an area larger than the community of 5,000 is also not prohibited. The current regulation requires that the bank holding company or a subsidiary thereof establish or have a lending office in the community that has a population not exceeding 5,000.

3170.0.3.4 Section 225.28(b)(11)(iv) of Regulation Y—Insurance Agency Activities Conducted on May 1, 1982

This provision of the regulation includes engaging in any specific insurance agency activity[4] if the bank holding company, or subsidiary conducting the specific insurance agency activity, conducted the insurance agency activity on May 1, 1982, or received Board approval to conduct the insurance agency activity on or before May 1, 1982. Activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of an acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

A bank holding company or subsidiary engaging in a specific insurance-agency activity under section 225.28(b)(11)(iv) of Regulation Y may—

1. engage in such specific insurance-agency activity only at locations—
   a. in the state in which the bank holding company has its principal place of business (as defined in 12 U.S.C. 1842(d));
   b. in any state or states immediately adjacent to such state; and
   c. in any state in which the specific insurance-agency activity was conducted (or was

4. Nothing in paragraph (iv) precludes a BHC subsidiary that is authorized to engage in a specific insurance-agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger was for legitimate business purposes and prior notice has been provided to the Board.

approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and
2. provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982, by such bank holding company or subsidiary.

This provision of the regulation parallels exemption D of the Garn–St Germain Act and grandfathers those insurance agency activities in which individual bank holding companies were engaged on May 1, 1982. Under this provision, a bank holding company or subsidiary thereof may continue to engage in particular types of insurance agency activities that were permissible before the passage of the Garn–St Germain Act but which are now prohibited by that act. A qualifying bank holding company may engage, for example, in the sale of property and casualty insurance on property serving as collateral for loans made by a lending subsidiary of the holding company.

A qualifying bank holding company may also engage in grandfathered insurance related to the provision of "other financial services" previously authorized under section 225.28(b)(11)(i)(B) of Regulation Y. This type of insurance is not considered to be related to an extension of credit under the Garn–St Germain Act. As a result, the Board *no longer permits* the sale of insurance related to the provision of the general financial services offered by a bank or bank-related firm. Such insurance included, for example, insurance on the contents of safe deposit boxes, or savings completion insurance on certificates of deposit, Christmas club accounts, individual retirement accounts, tuition completion plans, or credit-related insurance for serviced loans. Prior to the Garn–St Germain Act, insurance related to the provision of general financial services was permitted to be sold to borrowers whose loans were neither purchased nor originated, but may have been serviced by the bank holding company. Insurance with respect to loan servicing was the primary type of insurance previously permitted by the Board as related to such financial services. Now, the Garn–St Germain Act limits the sale of insurance by bank holding companies in general to insurance related to an extension of credit.

3170.0.3.4.1 Limitations on Expansion of Grandfather Rights

Exemption D provides for limited expansion of grandfathered insurance agency activities in order to permit qualifying bank holding companies to remain effective insurance agent competitors. The exemption presented three issues that the Board resolved in paragraph (iv) of the regulation: (1) defining which subsidiaries of a bank holding company may engage in otherwise impermissible insurance agency activities under exemption D; (2) the scope of permissible geographic expansion; and (3) the scope of product-line expansion.

Specific Subsidiaries That May Engage in Grandfathered Activities

Grandfather rights do not inure to the benefit of the entire holding company system by virtue of the fact that a particular subsidiary was engaged in insurance agency activities before May 1, 1982. Only the subsidiary of the bank holding company that was engaged in insurance activities on May 1, 1982, or received Board approval to engage in insurance activities before May 1, 1982, has grandfather status.

The Board believes that the emphasis in the legislative history on the transfer of grandfather rights shows the intent of Congress to prohibit not only the transfer of such rights from "grandfathered" subsidiaries to those affiliates wholly without grandfather rights, but also to prohibit the transfer of grandfather rights with respect to particular kinds of insurance from one "grandfathered" subsidiary to another. Thus, a subsidiary that sold only credit life insurance before the grandfather date should not acquire grandfather rights to sell property and casualty insurance solely because an affiliate sold property and casualty insurance before the grandfather date. The grandfather rights of a particular subsidiary are limited to the precise activities (or their functional equivalent) engaged in before May 1, 1982. This requirement does not preclude the transfer of grandfather rights in the case of a bona fide merger (1983 FRB 554, 555).

Section 225.28(b)(11) of the Board's Regulation Y is only intended to clarify the exemptions in title VI of the Garn–St Germain Act. It does not authorize any bank holding company to commence any insurance activity, or to acquire a company with insurance activities, without compliance with the notice and application requirements of section 4(c)(8) of the BHC Act.

Geographic Expansion by a Grandfathered Subsidiary of a Bank Holding Company.

The language of exemption D of the Garn–St Germain Act, while limiting the grandfathered activities to those agency activities conducted by the specific grandfathered subsidiary, *does allow* expansion into states where such specific types of agency activities "were conducted by the bank holding company or any of its subsidiaries on May 1, 1982 . . ." If a bank holding company subsidiary is selling a particular type of insurance in a given state, the Board does not believe there is any regulatory or business purpose served by restricting another grandfathered subsidiary from engaging in the same activity in the same location.

Product-Line Expansion

The Board's regulation provides for product-line expansion. A grandfathered subsidiary of a bank holding company may seek approval from the Board to engage in the sale of new types of insurance that protect against the same types of risks as, or are otherwise functionally equivalent to, insurance sold on the grandfather date.

3170.0.3.4.2 Transfer of Grandfather Rights among Subsidiaries

A grandfathered subsidiary of a bank holding company (or its successor) may retain its grandfather rights after merger with an affiliate, if such merger is based on legitimate business concerns, for example, centralized management or increased efficiency, rather than as a means of extending insurance powers. The regulation further provides that bank holding companies must advise the Board before any such merger for legitimate business purposes in order to confirm the transfer of grandfather rights.

3170.0.3.5 Section 225.28(b)(11)(v) of Regulation Y—Bank Holding Company's Insurance Coverage for Internal Operations

The Garn–St Germain Act approved, and the revised Regulation Y included, insurance agency activities where the activities are solely limited to supervising on behalf of insurance underwriters the activities of retail insurance agents who sell—

1. fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries and
2. group insurance that protects the employees of the bank holding company or any of its subsidiaries.

This provision of Regulation Y is reflective of an intent on the part of Congress to avoid preempting certain practices permissible under Texas law. This insurance relates to a particular situation that may have little applicability elsewhere.

3170.0.3.6 Section 225.28(b)(11)(vi) of Regulation Y—Small Bank Holding Companies

The Board has determined in section 225.28(b)(11)(vi) of its Regulation Y that engaging in any insurance agency activity is permissible if the bank holding company has total consolidated assets of $50 million or less. A bank holding company performing insurance agency activities under this paragraph *may not* engage in the sale of life insurance or annuities except as provided in section 225.28(b)(11)(i) and (iii) of Regulation Y, and it may not continue to engage in insurance agency activities pursuant to that provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed $50 million.

A bank holding company is required to cease general insurance-agency activities pursuant to this provision within 90 days after the end of the quarterly reporting period in which the bank holding company's total assets exceed $50 million. Thereafter, the bank holding company may continue to engage in the sale of insurance pursuant to other exemptions.

3170.0.3.7 Section 225.28(b)(11)(vii) of Regulation Y—Insurance Agency Activities Conducted before 1971

The Board has determined in section 225.28(b)(11)(vii) of its Regulation Y that any insurance agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance agency activities before January 1, 1971, as a consequence of approval by the Board before January 1, 1971, is permissible.

3170.0.3.7.1 Agency Activities

The Board adopted a position in section 225.28(b)(11)(vii) permitting any qualifying bank holding company to engage in general insurance-agency activities without restriction as to location or to type of insurance sold (1985 FRB 171 and 1984 FRB 235, 470). A company qualifies under this provision if it was engaged in insurance agency activities as a consequence of Board approval before January 1, 1971. A very limited number of active bank holding companies received such Board approval in the period from passage of the BHC Act in 1956 until January 1, 1971.

The regulation does not limit the insurance agency activities of a qualifying company by requiring that the company engage only in the sale of such types of insurance as it sold before 1971 from such locations as it conducted insurance agency activities before 1971. The Board's regulation permits the limited number of qualifying companies to engage in general insurance-agency activities pursuant to exemption G regardless of their precise insurance agency activities before 1971 (1985 FRB 171 and 1984 FRB 470).

3170.0.4 INCOME FROM THE SALE OF CREDIT LIFE INSURANCE

3170.0.4.1 Policy Statement on Income from Sale of Credit Life Insurance

Effective May 1, 1981, the Board adopted a policy statement (1981 FRB 431) generally prohibiting employees, officers, directors, or others associated with a state member bank from profiting personally from the sale of life insurance in connection with loans made by the bank. The bank may, however, allow their employees and officers to participate in the income under a bonus or incentive plan not to exceed 5 percent of the recipient's annual salary. Income from the sale of credit-related life insurance should most appropriately be credited to the bank, or alternately to a bank holding company or other affiliate of the bank so long as the bank receives reasonable compensation for its role in selling the insurance. As a general rule, ''reasonable compensation'' means an amount equivalent to at least 20 percent of the affiliate's net income attributable to the bank's credit life insurance sales. (Insurance agency activities engaged in directly by a bank subsidiary are regulated by the chartering authority. However, intercompany transactions should be reviewed by BHC inspection personnel.)

3170.0.4.2 Disposition of Credit Life Insurance Income

The Comptroller of the Currency has issued a regulation dealing with sales of credit life, health, and accident insurance by national banks which prohibits transfer of insurance commissions to an affiliate of the bank unless commission income in proportion to the shares held by the bank's minority shareholders is placed in trust and paid to them periodically. Where the subsidiary bank is wholly owned by a bank holding company, however, the regulation allows the commissions to be credited to the holding company or to its wholly owned subsidiaries (12 C.F.R. 2).

3170.0.5 INSPECTION OBJECTIVES

1. To determine the extent of insurance operations and the overall condition of subsidiaries engaged in insurance agency and underwriting activities.
2. To determine whether the types of insurance sold are in accordance with the provisions of section 225.28(b)(11) of Regulation Y.
3. To determine the impact of the performance of the activities on the parent bank holding company and its subsidiaries.
4. To suggest corrective action when necessary in the areas of policies, procedures, or laws and regulations.

3170.0.6 INSPECTION PROCEDURES

Where the insurance activities are performed through an insurance agency or underwriting subsidiary, perform the following activities:

1. Compare the company's general ledgers with statements prepared for the latest FR Y-6 and the annual report to the state insurance department.

2. Review minutes of the board of directors meetings.
3. Review the activity's compliance with the Board's policy statement on income from the sale of credit life insurance (See section 3170.0.4.1) and the Comptroller of the Currency's regulation dealing with the sales of credit life, health, and accident insurance by national banks (12 C.F.R. 2).
4. Review any agreements, guarantees, or pledges between the subsidiary and its parent holding company or affiliates.

Where the insurance activities are performed through an insurance agency or underwriting subsidiary or directly by the parent company, perform the following procedures:
1. Obtain copies of insurance policies issued to determine that the types and terms of insurance coverage sold are within the scope of those permitted by the Board under section 225.28(b)(11) of Regulation Y.
2. Check for compliance with section 106(b) of the 1970 Amendments to the BHC Act (prohibition against tie-in arrangements).

3170.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
General description of permissible insurance agency and underwriting activities		225.28(b)(11)	4–050.1	1986 FRB 829
Garn–St Germain Depository Institutions Act, title VI amending section 4(c)(8) of the BHC Act	1843(c)(8)			
Insurance agency activities permitted for national banks	Section 13, paragraph 11 of the Federal Reserve Act			
Permissibility of some types of mortgage insurance				40 *Federal Register* 2766 40 *Federal Register* 13042 1975 FRB 45 1975 FRB 678
Impermissibility of mortgage guarantee insurance				40 *Federal Register* 44624
Court review of activity				533 F. 2d 224 (5th Circuit, 1976) 558 F. 2d 729 (5th Circuit, 1977)

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Level term credit life insurance				39 *Federal Register* 26318 39 *Federal Register* 32796 40 *Federal Register* 11647
Permissible insurance coverage limited to actual debtors				39 *Federal Register* 7493
Sale of home mortgage redemption insurance				1986 FRB 339, 671 1975 FRB 45
Joint credit life insurance				39 *Federal Register* 38942 1974 FRB 138
Tie-in arrangements	Section 106(b) of the Bank Holding Company Act Amendments of 1970	225.7		38 *Federal Register* 6441 1975 FRB 693, 678, 686
Permissibility of selling insurance in small communities				44 *Federal Register* 65051
Policy statement on income from sale of credit life insurance			3–1556	1981 FRB 431
Transfer of insurance agency grandfather rights in the case of a bona fide merger				1983 FRB 554, 555
Permissibility of credit-related property and casualty insurance activities				1984 FRB 452
Insurance agency activities conducted before 1971—BHCs permitted to engage in insurance agency activities without restriction as to location or to type of insurance sold				1985 FRB 171 1984 FRB 235, 470
General insurance-agency subsidiary qualifies for grandfather privileges under exemption D of the Garn–St Germain Act; grandfather privileges do not terminate upon its acquisition by a nongrandfathered BHC				1987 FRB 276, 672

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3180.0.1 INSURANCE UNDERWRITING ACTIVITIES

On December 11, 1972, after consideration of a public hearing held on March 24, 1972, the Board amended Regulation Y to add the activity of underwriting credit life insurance and credit accident and health insurance to the list of activities in which a bank holding company may engage, provided that such insurance is directly related to an extension of credit by the holding company system. Such insurance ensures a bank or bank-related firm of repayment of a credit extension in the event of death or disability while at the same time providing the borrower with financial security in either event. In approving this activity, the Board set forth, in a footnote to Regulation Y, requirements to ensure that performance of the activity would result in demonstrable benefits to the public. The Board stated that applications to engage in underwriting activities would be approved only in cases in which the applicant demonstrates that such approval would benefit the consumer or result in other public benefits and that normally such a showing would be made by a projected reduction in rates charged the public for the insurance or an increase in other public benefits resulting from bank holding company performance of this service.

On October 3, 1986, the Board adopted a revision of the provisions of Regulation Y that deals with permissible insurance agency and underwriting activities for bank holding companies. The general revision of the insurance provisions of Regulation Y combined both the insurance agency and insurance underwriting activities reflects amendments to the Bank Holding Company Act by the Garn–St Germain Depository Institutions Act of 1982. The revision of the provisions relating to insurance underwriting eliminated the rate-reduction requirement that previously applied to those companies engaged in the underwriting of credit life, credit accident and health, and involuntary unemployment insurance. Accordingly, bank holding companies engaging in this activity may charge premiums as permitted by the states.

In order for insurance underwriting (including home mortgage redemption insurance) to be permissible in accordance with section 225.28(b)(11) of the Board's revised Regulation Y, the insurance must—

1. be directly related to an extension of credit[1] by the bank holding company or any of its subsidiaries and
2. be limited to ensuring the repayment of the outstanding principal balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor.

3180.0.1.1 Insurance Underwriting Activities Permissible for Bank Holding Companies per Section 225.28(b)(11)(i) of the Board's Regulation Y—Credit Insurance

The Board permits the insurance underwriting activities described above as well as the insurance agency activities described in section 3170.0.

In section 225.28(b)(11)(i) of Regulation Y, the Board issued three significant interpretations of the term ''extension of credit'' as contained in the Garn–St Germain Act. It permits the underwriting of credit-related life, accident and health, and involuntary unemployment insurance (1) with respect to lease transactions where such lease transactions are the equivalent of loans (leasing is addressed in section 3140.0), (2) in connection with loans secured by residential first mortgages, and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

Permissible insurance underwriting requires that the credit insurance must be directly related to an extension of credit by the bank holding company or any of its subsidiaries. An ''extension of credit'' includes direct loans to borrowers, and the lease of real or personal property, and loans purchased from other lenders. The first significant interpretation, noted above, allows the inclusion of leasing personal or real property, provided the lease is a nonoperating and full-payout lease, the insurance ensuring the payment of the remaining lease payments that are due in the event of the death, disability, or involuntary unemployment of the lessee.

1. ''Extension of credit'' includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full-payout leases.

The interpretation thus defines leases as the functional equivalent of an extension of credit.

The second interpretation in paragraph (i) of the regulation involving the definition of "extension of credit" is the permissibility of underwriting home mortgage insurance, which ensures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. Exemption A of the Garn–St Germain Act permits the underwriting of any type of life, disability, and involuntary unemployment insurance related to an extension of credit by a bank holding company as long as the face value of the insurance policy does not exceed the "outstanding balance due" on the extension of credit. The Board continues to require that insurance policies written insure only named borrowers or lessees of a particular bank holding company. Such policies could cover both spouses jointly, but only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company (see 1974 FRB 138).

The Board had previously held that the underwriting of home mortgage insurance is not closely related to banking in part because it is more like general life insurance than credit life insurance and in part because banks have not generally underwritten such insurance (see 1980 FRB 660 and 1982 FRB 318). Recently, however, the Board permitted bank holding companies to underwrite such insurance (see 1986 FRB 339 and 1986 FRB 671). In permitting this activity by order, the Board provided detailed findings that the underwriting of home mortgage redemption insurance is permitted by exemption A of the Garn–St Germain Act, is closely related to banking, and does not present the possibility of such significant adverse effects that it should not be added to the list of activities permissible for bank holding companies. The Board also found that home mortgage insurance supports the lending function. The Board thus believes, for the reasons cited in the above-cited orders, that the underwriting of home mortgage redemption insurance is permissible for bank holding companies.

In approving the underwriting of home mortgage insurance by order, the Board relied on commitments by applicants to inform, in writing, borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and before closing. In processing applications to engage in the underwriting of home mortgage redemption insurance pursuant to the current regulation, the Board, and the Reserve Banks acting pursuant to delegated authority, will continue to require that such notices be provided to borrowers. In addition, the Board will continue to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrower's ability to rescind the insurance and to limit premium financing as an incentive to sell and underwrite such insurance.

A third significant interpretation of the term "extension of credit" found in exemption A of the Garn–St Germain Act involves the underwriting of insurance in connection with the serviced loans (see section 3170.0.3.1) The Garn–St Germain Act limits bank holding companies in general to insurance related to an extension of credit. The term "extension of credit" is used in exemption A to describe transactions in which the funds of the bank holding company or its subsidiaries have been placed at risk, including direct loans or leases or loans that have been purchased. Loans that are merely being serviced by the bank holding company generally would not be covered by this definition.

The underwriting of insurance on loans being serviced is necessary only when the term of the insurance was originally shorter than that of the loan. The bank holding company that is selling and underwriting insurance on the loan that it originated and is servicing is, in effect, only extending the term of its original insurance policy to be coterminous with the duration of the loan. It is providing insurance that it could have provided previously. A bank holding company may not underwrite insurance in the case where it is merely servicing a loan and it has never placed its funds at risk either by originating or purchasing the loan.

3180.0.2 LIMITED PROPERTY INSURANCE RELATED TO AN EXTENSION OF CREDIT (FINANCE COMPANY SUBSIDIARY OF A BANK HOLDING COMPANY)

The Board's revised regulation does not permit the underwriting of this type of insurance. See section 225.28(b)(11)(ii) of Regulation Y and section 3170.0.3.1 for information on authorized insurance agency activities.

3180.0.3 INSURANCE ACTIVITIES BEFORE 1971

The Board's revised regulation (section 225.28(b)(11)(vii)), as it relates to exemption G of the Garn–St Germain Act, does not authorize underwriting activities for bank holding companies. See section 3170.0.3.7 for information on the respective authorized insurance-agency activities under exemption G.

3180.0.4 UNDERWRITING AS REINSURER

The majority of bank holding company subsidiaries engaged in insurance underwriting are reinsurers rather than direct underwriters. As reinsurer, these companies engage a direct insurer to issue the policies, collect the premiums, pay claims, maintain accounting books and records, prepare federal and state tax returns, and perform other services necessary to conduct the insurance activities. Usually, such reinsurance companies will have executed a reinsurance agreement and a service agreement with the direct underwriter which spell out all services to be performed and set the fees to be paid for such services. The above arrangement involves a minimum of activity by the reinsurer and is probably most often chosen by bank holding companies since it does not place additional burdens on management and precludes hiring actuaries and other professional personnel to manage the insurance company.

There are many ratios or measures used to evaluate the condition of insurance underwriters. The National Association of Insurance Commissioners has developed a system consisting of nine ratios that measure various aspects of life and health insurance companies' financial condition and stability *(The Early Warning System for Life and Health Insurance Companies)*. These tests establish benchmarks which are likely to distinguish between troubled and sound companies. The examiner may wish to compare the subject company's ratios to these benchmarks. When making comparisons, however, the examiner should recognize that one insurer may require a somewhat better ratio than another due to greater underwriting and investment risks. Smaller companies will generally maintain a proportionately larger surplus account since loss experience on a small volume of business tends to fluctuate more widely.

Another possible source of information available to help determine a company's condition is *Best's Insurance Reports*. The report is published annually and provides pertinent financial and historical data for legal reserve life insurance companies operating in the United States and Canada. It assigns a rating for each company in the report. Information presented in the report is taken from annual statements filed with the state insurance departments. It should be noted that reports filed with the insurance departments are prepared using the statutory method of financial accounting and presentation rather than generally accepted accounting principles. Beginning in 1973, insurance companies were required to adhere to generally accepted accounting principles for certification of financial statements (see *Audits of Stock Life Insurance Companies*, American Institute of Certified Public Accountants), however, they continue to report under the statutory method to the state insurance departments. The statutory method is basically a cash-basis accounting presentation which generally depicts a more conservative position. Certain assets are "not admitted" by regulatory authorities in the financial presentation because they are not readily convertible into cash for the payment of claims and expenses.

Policy reserves represent the primary liability portion of underwriters' balance sheets. There are several acceptable methods permitted by state authorities for calculating these reserves. Most of these methods are rather complicated and a description of their calculation is beyond the scope of this manual. However, insurance companies are generally closely regulated by state authorities, which place primary importance on determining the adequacy of the policy reserves. A review of the latest available insurance examination report should give an evaluation of the adequacy of the reserves.

Reinsurance arrangements may distribute the insurance and losses in many different ways between the direct insurer and the reinsurer. An understanding of such arrangements is essential in determining the extent of risk incurred by the company being inspected.

3180.0.5 INSPECTION OBJECTIVES

1. To determine the extent of underwriting activities and the overall condition of subsidiaries engaged in underwriting.
2. To determine whether the activities performed are within the scope of those permitted under section 225.28(b)(11) of Regulation Y.

3. To determine the impact of the underwriting operations on the parent bank holding company and its subsidiaries.
4. To suggest corrective action where necessary in the areas of policies, procedures, or laws and regulations.

3180.0.6 INSPECTION PROCEDURES

Where the insurance underwriting activities are performed through an underwriting subsidiary, perform the following procedures:

1. Compare the company's general ledgers with statements prepared for the latest FR Y-6. (Generally, records are maintained on the statutory accounting basis and are more easily tied to the financial statements in the annual report to the state insurance department).
2. Review minutes of the board of directors meetings.
3. Review the quality and liquidity of the subsidiary company's investments in CDs, stocks, bonds, or other marketable securities.
4. Review intercompany transactions, including balances maintained with or assets purchased from affiliated banks.
5. Review any agreements, guarantees, or pledges between the company and its parent holding company or affiliates.

Where the insurance activities are performed either directly or through an underwriting subsidiary, perform the following procedures:

1. Review copies of any reinsurance and/or service agreements executed with other insurance companies.
2. Review the latest annual report submitted to the state insurance department.
3. Review the latest report of examination prepared by the state insurance department.
4. Check calculation of premium charges by a random sample of policies for adherence to the state rate structure.
5. Obtain copies of insurance policies issued to customers to determine that the types of insurance coverage and terms offered are within the scope of those permitted under section 225.28(b)(11) of Regulation Y.

3180.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Permissible underwriting activities	12 U.S.C. 1843(c)(A)–(G)	225.28(b)(11)	4–050.1	
Underwriting of permissible credit-related home mortgage insurance				1986 FRB 671, 339
Nonpermissibility of mortgage guarantee insurance				1974 FRB 727
Underwriting of joint credit life insurance			4–337	39 Federal Register 7493 1974 FRB 138

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Courier activities are permissible for bank holding companies if the items being transported by the courier are themselves related to bank operations. Examples of such items are drafts, money orders, travelers' checks, commercial papers, written instruments, and data processing material. Currency and bearer-type negotiable instruments which require more than normal security measures may not be transported by the company.

If the courier company operates under the exemptive provision of section 4(c)(8) of the Bank Holding Company Act, the following restrictions are placed on its operations to ensure competition:

1. The company must be a separate, independent corporate entity.
2. The company must be profit-oriented and not subsidized by the holding company system.
3. Services of the company must be performed on a specific-fee basis with direct payment from the customer. Payment may not be made indirectly such as through maintenance by the customer of deposit balances at an affiliated bank.
4. Upon request, the company must furnish comparable services at comparable rates to firms which compete with banking or data processing subsidiaries of its parent company, unless compliance with the request would be beyond the practical capacity of the company.

The last restriction was intended to prevent use of bank-affiliated courier services for the purpose of gaining an advantage over competitors to whom courier services were not otherwise available.

3190.0.1 INSPECTION OBJECTIVES

1. To determine if the company is operating in compliance with applicable laws and regulations, and ensure that corrective action will be taken, if appropriate.
2. To determine if courier services are provided to competing institutions upon their request if courier services are not otherwise available.

3190.0.2 INSPECTION PROCEDURES

1. Determine whether the company makes known to its customers its minimum rate schedule for services and its general pricing policies.
2. Determine whether the company maintains for a period of two years or more the records of each request for service which it has denied to firms competing with the banking and data processing subsidiaries of its parent company. The reasons for the denial must also be recorded and maintained for a like period.
3. Review income statements of the company to ascertain whether the company is operating profitably, without a subsidy in any manner from any entity within the holding company system. Any operating losses sustained over an extended period of time are inconsistent with continued authority to engage in courier services.
4. Determine whether the materials transported by the company are restricted to those which would normally be exchanged among banks and banking institutions, including audit and accounting media of a banking or financial nature, and other business records or documents used in processing such media.

3190.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Courier activities of bank holding companies		225.28(b)(10)		1973 *Fed. Reg.* 32136 1975 *Fed. Reg.* 36309
Conditions of entry into courier activities		225.129	4–180	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

On February 26, 1974, the Board amended Regulation Y to permit bank holding companies to engage in the activity of providing bank management consulting services to nonaffiliated commercial banks. The advisee institution must be a ''bank'' as that term is defined by section 2(c) of the BHC Act or an operations subsidiary of such an institution. (See 12 C.F.R. 250.141.) Effective April 20, 1982, the Board expanded this activity by permitting holding companies to provide management consulting advice to nonbank depository institutions. When expanding the activity to include management consulting advice to nonbank depository institutions, the Board indicated that the advisory services provided to nonbank institutions should generally be the services that were then being provided to banks.

Effective April 21, 1997, management consulting was expanded in Regulation Y (section 225.28(b)(9)) to allow bank holding companies to provide management consulting services to any customer on any matter so long as the total annual revenue derived from third-party management consulting services by a nonbank subsidiary of the bank holding company is less than 30 percent of the subsidiary's total annual revenues derived from all management consulting activities. The Board continues to view ''management consulting'' as including, but not limited to, providing analysis or advice as to a firm's—

1. purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints;
2. production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards;
3. market operations, such as market testing, advertising programs, market development, packaging, and brand development;
4. planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals;
5. personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations;
6. internal operations, such as taxes, corporate organization, budgeting systems, budgeting control, evaluation of data processing systems, and efficiency evaluations; and
7. research operations, such as product development, basic research, and product design and innovation.

By interpretation, the Board previously determined that it considers bank management consulting advice to include, but not be limited to, advice concerning (1) bank operations, systems, and procedures; (2) computer operations and mechanization; (3) implementation of electronic funds transfer systems; (4) site planning and evaluation; (5) bank mergers and the establishment of new branches; (6) operation and management of a trust department; (7) international banking and foreign-exchange transactions; (8) purchasing policies and practices; (9) cost analysis, capital adequacy, and planning; (10) auditing; (11) accounting procedures; (12) tax planning; (13) investment advice as authorized in section 225.28(b)(6) of Regulation Y; (14) credit policies and administration, including credit documentation, evaluation, and debt collection; (15) product development, including specialized lending provisions; (16) marketing operations, including research, market development, and advertising programs; (17) personnel operations including recruiting, training, evaluation, and compensation; and (18) security measures and procedures. Providing management consulting advice on compliance with laws and regulations may be accomplished only when these activities are incidental to a primary consulting activity and when such advice would not constitute the rendering of legal advice.

In general, those consulting services that correspondent banks traditionally have provided to their respondents (both bank and nonbank depository institutions) are considered to be included within the scope of Regulation Y as permissible services to be provided by nonbank holding company subsidiaries to nonaffiliated bank and nonbank depository institutions.

3200.0.1 MANAGEMENT CONSULTING LIMITATIONS

Recognizing the potential for conflict-of-interest situations, such as the possibility for anticompetitive cooperative arrangements, improper use of confidential information, and similar abuses that this activity could entail, the Board incorporated in Regulation Y a few restrictions on a bank holding company. With regard to affiliation status, neither the bank holding company nor any of its subsidiaries may own or control directly or indirectly more than 5 percent of the voting securities of the client institution. The prohibition would not apply when the shares were acquired in satisfaction of a debt previously contracted or to shares acquired in a fiduciary capacity without sole discretionary voting authority. A bank holding company may offer consulting advice to a client institution whose shares it holds in a fiduciary capacity with sole discretionary voting rights if said holding company does not hold more than 5 percent of the voting shares of that institution. Bank holding companies are permitted to have common management officials with the client institution to which they provide management consulting services if such interlocks would be permissible under exceptions found in the Board's Regulation L (Management Official Interlocks) that apply to such institutions in need of management or operating expertise (12 C.F.R. 212.4(b)).

Management consulting services may not be provided to a client on a daily or continuing basis except where necessary to instruct the client on how to perform the services for itself. The Board has informed bank holding companies that their management consulting subsidiaries should refrain from entering relationships on a daily or continuing basis even when the client institution may be experiencing financial or managerial difficulties. Particular caution should be exercised when a bank holding company contemplates the subsequent acquisition of the client institution. However, when a bank holding company is attempting to acquire a troubled depository institution, limited management consulting services may be offered via an on-premises bank holding company employee. Nevertheless, the representative should not have the authority to lend or make personnel decisions. Failure to heed these guidelines not only would cause the bank holding company to exceed the permissible bounds of the activity, but also could cause the BHC to acquire control of the client institution that might constitute an acquisition of a subsidiary within the meaning of section 3(a) of the BHC Act. Section 225.31(d)(2)(i) of Regulation Y indicates that a rebuttable presumption of control shall exist when a company enters into an agreement, such as a management contract, with a bank or other company pursuant to which the first company or any of its subsidiaries exercises significant influence over the general management or overall operations of the bank or other companies. Reserve Bank personnel are encouraged to contact the Board's applications section to discuss the restrictions on this activity whenever a BHC proposes to have its personnel assist a troubled or problem institution.

When evaluating a BHC's application to engage in management consulting, it is important to note whether the applicant bank holding company has exhibited the necessary expertise in operating its own subsidiaries—and whether this expertise qualifies it to offer advice to others.

3200.0.2 INSPECTION OBJECTIVES

1. To verify that the bank holding company is performing only those types of management consulting services at the locations for which it received prior regulatory approval.
2. To verify that the advice being provided is within the scope of the approval and consistent with the activities of the interpretation (12 C.F.R. 225.131) and section 225.28(b)(9) of Regulation Y.
3. To determine that the bank holding company does not own or control, directly or indirectly, securities of its client depository institutions except for shares acquired as the result of a default on a debt previously contracted or shares held in a fiduciary capacity (within certain limits), provided the holding company does not have sole discretionary authority to vote more than 5 percent of the client's shares. (See 12 C.F.R. 225.131.)
4. To determine that the bank holding company does not control the activities of a client institution by virtue of nonexempt interlocking directors.
5. To determine that services rendered to the client institutions are not being provided on a daily or continuing basis.
6. To determine that disclosure is made to each client of (1) the names of all depository institutions that are affiliates of the consulting company and (2) the names of all existing client institutions located in the same county (or counties) or standard metropolitan statistical area (or areas) (SMSA) as the client institution.

3200.0.3 INSPECTION PROCEDURES

A thorough review of pertinent records, contracts, lists of clients, and documentation of the services being provided to clients should be undertaken to determine that adequate management information systems and detailed revenue and other reports are available to verify the BHC's compliance with the Board's rule on the revenue limitations in section 225.28(b)(9) of Regulation Y. Determine that services are being provided to the appropriate customer base and within the scope of the Board's approval. Further, the examiner should ascertain the existence of procedures to inform each potential client of the names of all depository and client institutions that are affiliates of the consulting company and of the names of all existing clients located in the same market area as the prospective client.

For management consulting services that do not involve any financial, economic, accounting, and auditing matters, verify that the revenues earned are within the limits permitted by the Board's regulations and interpretations. The basis for any fee structure should be determined to ascertain that the advice is being rendered on an explicit-fee basis, such as an hourly or daily rate. Such fees should not be affected by factors not directly related to the service, such as balances maintained by the client at any subsidiary depository institution of the bank holding company. The extent of the consultant company's involvement in the day-to-day affairs and operation of the client should also be reviewed.

The absence of parent company control, direct or indirect, over the clients of the management consulting subsidiary should be established. The examiner should compare listings of directors and principal officers of the bank holding company, its various affiliates, and the clients with due regard to exempt interlocks. The examiner should determine the extent of ownership or control by the bank holding company and its affiliates of any equity securities in its clients by requesting a listing of all shares owned in outside organizations. Overall conclusions, including recommendations concerning the operation, apparent violations, and any possible control of client institutions and conflicts of interest, should be discussed with parent company management and detailed in the inspection report.

3200.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Orders, interpretation preceding permissibility of bank management consulting	225.131 225.113		4–194	1972 FRB 676 1972 FRB 674
Bank management consulting authorized as permissible nonbank activity		225.28(b)(9)	4–181	1974 FRB 226 1974 FRB 675
Presumption of control		225.31(d)		
Exemption from section 8 of Clayton Act for banks in low-income areas			3–830	
Bank management consulting as possible rendering of legal advice				39 *Fed. Reg.* 41586
Other approvals				39 *Fed. Reg.* 39106 39 *Fed. Reg.* 36508 1976 FRB 725

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Justice Department concern over possible conflicts of interest				1977 FRB 950
Limitations on activity when acquisition of bank is involved				1976 FRB 699 1977 FRB 1088
Permissible interlocking directors		212.4(a)(1)		1979 FRB 654
Deferral of decision to consider offering of management consulting advice to unaffiliated savings banks as a permissible activity				42 *Fed. Reg.* 22560
Expanding activity to include non-bank depository institutions				1982 FRB 237 and 238
Management consulting to failed savings associations				1988 FRB 771
Expansion of the activity to include— 1. services regarding financial, economic, accounting, or audit matters to any company; 2. the ability of the BHC's non-bank subsidiary to provide limited management consulting services to any third-party customer on any matter.		225.28(b)(9)(i)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Within Regulation Y (section 225.28(b)(9)(ii)), management consulting and counseling activities include employee benefits consulting services. These employee benefits consulting services include providing consulting services to employee benefit, compensation, and insurance plans, including designing plans, assisting in the implementation of plans, providing administrative services to plans, and developing employee communication programs for plans.

The initial Board orders that were issued to permit employee benefit consulting services are summarized here as historical examples of the nonbanking activity. Commitments made in those Board orders should not be relied upon. Refer only to the provisions within the current Regulation Y, as cited above.

3202.0.1 BOARD ORDERS INVOLVING EMPLOYEE BENEFITS CONSULTING

A bank holding company (the applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and Regulation Y to acquire 100 percent of the voting shares of a company that provides a full range of services involving employee benefits plans. The services are divided into four basic types of activities:

1. *Plan design.* Designing employee benefit plans, including determining actuarial funding levels and cost estimates.
2. *Plan implementation.* Providing assistance in implementing plans, including assistance in the preparation of plan documents and in the implementation of employee benefit administration systems.
3. *Administrative services.* Providing administrative services with respect to plans, including recordkeeping services, calculating and certifying employment reports and government filings pursuant to ERISA, and providing information to a client's legal counsel in labor relations and negotiations.
4. *Employee communications.* Developing employee communication programs with respect to plans for the benefit of the client.

The applicant represented that all of the proposed activities were included in trust company or financial or investment advisory service activities permissible under Regulation Y. Although certain employee benefits consulting activities (as conducted by the company being acquired, particularly activities involving plan administration) are conducted by trust companies or trust departments of banks in their capacities as trustees or custodians of employee benefit plans and investment managers of plan assets, it was not apparent that the *complete range* of employee benefits consulting services were generally conducted by trust companies or authorized by the Board as permissible trust company activities under Regulation Y.

The Board believed that employee benefits consulting was essentially a financial planning activity involving preparing and conveying financial data to a client, which it had previously determined to be closely related to banking and permissible under Regulation Y in the areas of investment advisory services, data processing services, and courier services. The record did not indicate, however, that employee benefits consulting is wholly encompassed within *any or all* of those activities. The Board, therefore, did not agree with the applicant that *all* of the proposed activities were currently authorized for bank holding companies under existing provisions of Regulation Y.

A review of the four basic types of activities revealed that many of the proposed employee benefits consulting activities either were already specifically engaged in by banks and trust companies, or were functionally related to activities in which banks and trust companies were regularly engaged. The Board recognized, however, that the actuarial aspect of the employee benefits consulting activities is not generally included in trust company or bank activities. Such activities are limited in scope and purpose in that they are conducted primarily as a means to ensure adequate funding of defined benefits plans. In this case, they were performed solely as a means for the applicant to provide a full range of benefits-planning activities for its clients. The acquired company's actuarial services would not be conducted as an independent activity, but only as a necessary and integrally related component of employee benefits consulting.[1]

1. As part of its acquisition, the bank holding company proposed to assist firms in IRS audits of plans; inform clients of developments in employee benefit programs through newsletters and other correspondence and through participation in seminars, public programs, and other forums; and engage in professional actuarial activities and other activities incidental

In *Association of Data Processing Organizations, Inc. v. Board of Governors,* 745 F.2d 277 (D.C. Cir. 1984), the court of appeals held that the Board may permit those activities that are ''a part of'' the overall permissible activity where, as here, ''in both market contemplation and technological reality, the service is a unitary one.'' Based on this ruling, the Board concluded that the applicant's proposed activities are permissible as closely related to banking, and were approved on June 19, 1985 (1985 FRB 656).

Another Board order permitting the provision of employee benefits consulting services, which is slightly different from the order cited above, is found in 1986 FRB 337. See also 1986 FRB 729 and 1987 FRB 158, 681.

to the actuarial profession. The activities are generally related to the type of actuarial activities performed for purposes of engaging in employee benefits consulting and that would not generate any significant income. Such activities were, therefore, permissible as incidental to the bank holding company's approved activities. The applicant also proposed to provide expert actuarial opinions of a general nature for purposes such as divorce actions and personal injury litigation. The Board believed that such activities were beyond the scope of incidental activities and were not permissible.

Career counseling services may be provided to—

1. a financial organization[1] and individuals currently employed by, or recently displaced from, a financial organization;
2. individuals who are seeking employment at a financial organization; and
3. individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.

The initial Board order that was issued to permit the provision of career counseling services is summarized below as a historical example on the origination of this nonbanking activity. Commitments made in the Board order should not be relied upon. See the current provisions of Regulation Y (section 225.28(b)(9)(iii)) for that purpose.

3204.0.1 CAREER COUNSELING—INITIAL BOARD ORDER

A bank holding company (the applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and the Board's Regulation Y to provide career counseling services to unaffiliated parties through its wholly owned nonbank subsidiary. The applicant proposed to expand its employee benefits consulting services to include career counseling activities. The nonbank subsidiary currently provides these services to the applicant and its affiliates under section 4(c)(1)(C) of the BHC Act. It plans to expand the provision of these services nationwide to unaffiliated companies and individuals in a wide array of industries. The services would provide assistance to individuals who are employed and seeking advancement in their careers and to unemployed individuals who are seeking new employment. The nonbank subsidiary plans to provide these services directly to companies and advise these companies on effective methods of providing career counseling services to their employees.

The nonbank subsidiary will advise unaffiliated organizations on the advantages of including career counseling services as part of a comprehensive employee benefits plan. It will assist these organizations in establishing their own facilities to implement career counseling services for their current or former employees. If the organization does not want to operate its own counseling facility, the nonbank subsidiary will provide the services directly to the organization's current or former employees at the nonbank subsidiary's career assistance center.

The proposed career counseling services include (1) assessing an individual's education, prior business experience, salary history, interests, and skills to aid in finding employment or evaluating opportunities for career development; (2) assisting in the preparation of résumés and cover letters; (3) contacting employers regarding employment opportunities and making this information available to clients; (4) conducting general workshops on the financial aspects of unemployment, current economic trends, the process of finding a job, and alternative career options; and (5) providing individual counseling on setting and obtaining employment goals.

The issue presented to the Board was whether the proposed activities are closely related to banking. The Board had not previously determined whether providing career counseling services to unaffiliated parties is closely related to banking under section 4 of the BHC Act and permissible for bank holding companies. The Board viewed the applicant's proposal in four parts: (1) career counseling services for financial organizations (that is, banks, bank holding companies and their subsidiaries, thrift institutions, and thrift holding companies and their subsidiaries) and employees of financial organizations; (2) career counseling services for individuals who are unemployed or employed outside the banking industry and who seek employment at banks and other financial institutions; (3) career counseling for individuals seeking financial positions (such as chief financial officer, cash management positions, and accounting and auditing personnel); and (4) career counseling services generally for any individual seeking any type of employment at any type of company.

The Board determined that career counseling services are closely related to banking when they are provided for (1) financial organizations and individuals currently employed at, or recently displaced from, a financial organization; (2) individuals who seek employment at a financial organization; and (3) individuals who

1. Financial organization means insured depository institution holding companies and their subsidiaries, other than nonbanking affiliates of diversified savings and loan holding companies that engage in activities not permissible under section 4 (c)(8) of the BHC Act.

are currently employed in, or who seek, financially related positions at any company. The Board concluded that the record does not presently support a finding that general career counseling services are otherwise closely related to banking.[2]

The applicant will provide career counseling services on a fee basis with no guarantee of employment. The Board approved the order on November 8, 1993. As a condition to its approval, the applicant must comply with all commitments made in connection with the application, as well as with other conditions stated within Regulation Y and the Board's order. (1994 FRB 51)

2. When providing career counseling for an individual within one of the three proposed categories, the applicant was permitted to provide limited career counseling services regarding positions outside of these categories as ''incidental'' to the proposed career counseling services. However, the applicant is not permitted to hold itself out as a provider of general career counseling services for individuals seeking career opportunities outside the banking or financial industries. Regulation Y and judicial decisions construe ''incidental activities'' as activities that must be necessary to the provision of a closely related activity in order to be considered incidental. (See 12 C.F.R. 225.21(a)(2) and *National Courier Association v. Board of Governors,* 516 F.2d 1229, 1240–41 (D.C. Cir. 1975).)

The Board has included in Regulation Y (see section 225.28(b)(13)) the authority to issue and sell at retail money orders and similar consumer-type payment instruments; the sale of U.S. savings bonds; and the issuance and sale of travelers' checks. Previously, the Board, through various orders, had authorized over time various nonbanking activities in this regard. Initially, it permitted by order and then the Board had included in the list of permissible activities the sale and issuance at retail of money orders having a face value of not more than $1,000, the sale of U.S. savings bonds, and the issuance and sale of travelers' checks. In its original order, effective February 26, 1979, the Board did not include the issuance of travelers' checks. However, after overwhelmingly favorable responses to its proposal to include the issuance of travelers' checks to the list of permissible activities, the Board included this activity effective December 21, 1981. As part of the Board's regulatory review of Regulation Y, and its subsequent overhaul, which was finalized and made effective February 4, 1984, the *issuance* of money orders was listed as a permissible activity. On March 16, 1984, the Board, by order, increased the face value of the payment instruments that the bank holding company could issue to $10,000, if the bank holding company agreed to meet certain weekly reporting requirements (1984 FRB 364). Also, by order dated December 16, 1985, the Board allowed the sale of official checks with no maximum limitation as long as the proceeds of checks in excess of $10,000 were deposited in a demand account and the bank holding company made weekly reports of these checks as well as money orders that had a face value of up to $10,000 (1986 FRB 148). The Board later authorized the issuance and selling of variably denominated payment instruments without limitation as to face value. (See 1993 FRB 42.) As part of the comprehensive revision of Regulation Y, effective April 21, 1997, the Board removed the limitation of the face amount of payment instruments. (See section 225.28(b)(13) of Regulation Y.)

3210.0.1 INSPECTION OBJECTIVES

1. To determine that the scope of the activity is within the parameters established by the Board.
2. To determine if there is any loss exposure due to the lack of systems and controls.

3210.0.2 INSPECTION PROCEDURES

In determining whether a significant degree of risk exposure to the BHC exists, the examiner should address the following questions to management, when considered appropriate:

1. Are there written agreements between the bank and its parent concerning the obligations of each for the sale of money orders and U.S. savings bonds and for the issuance and sale of travelers' checks? Do the agreements provide information on the fees, reimburseable expenses, sharing of overhead expenses, and taxes?
2. Who prints the travelers' checks and money orders?
3. Is the printer bonded or covered by insurance?
4. Is the newly printed inventory of travelers' checks and money orders received in dual custody?
5. If check inventory sent to outlets is on a consignment basis, does the consignee acknowledge receipt on a "trust receipt"?
6. Does the consignment "inventory invoice" describe, in complete detail, the number of checks, serial numbers, and denominations?
7. How are inventories and sales monitored at the outlet level?
8. What are the maximum dollar shipments for the day, per outlet and per package?
9. Does the subsidiary bank maintain the settlement account?
10. What procedures are in effect to establish the checks that have been sold?
11. What are the remittance requirements for the agents for checks sold?
12. If losses and redemptions exceed proceeds from sales, who makes up the deficiency?
13. Does the parent invest the settlement account's float, generated by the excess of proceeds received over checks redeemed, in long-term investments?
14. If a nonbank subsidiary acts as agent on behalf of its parent, what fee is paid by the parent other than commissions on the sale of checks?
15. Is the subsidiary reimbursed for its expenses?
16. What has been the history of losses?
17. How long are losses carried in suspense accounts before being charged off?
18. Does the subsidiary bank maintain compensating balances in financial institutions as

an inducement for the financial institutions to carry the holding company's travelers' checks? If so, does the parent compensate the bank for lost income?

19. What internal audit procedures are in place? Discuss frequency, scope, and follow-up.

3210.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Adding activity to permissible list (excluding issuance of travelers' checks)		225.28(b)(13)		1979 FRB 265
Adding the issuance of travelers' checks to permissible list		225.28(b)(13)		1981 FRB 912
Increased face value or payment instruments to $10,000, if weekly reports provided				1984 FRB 364
Sale of official checks with no maximum amount, if checks in excess of $10,000 deposited in demand deposit account, if weekly reports of checks made as well as money orders with face value up to $10,000				1984 FRB 148
Sale of official checks with no maximum limitation provided the proceeds of checks in excess of $10,000 were deposited in a demand account and that weekly reports of the official checks were made as well as the total value of official checks with face values exceeding $10,000				1986 FRB 148
Issuing and selling drafts and wire transfers in foreign currencies				1988 FRB 252
Issuing and selling variably denominated payment instruments without limitation as to face value				1993 FRB 42
Removal of the limitation on the face amount of payment instruments		225.28(b)(13)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

As noted in section 3210.0, the Board has authorized the issuance and sale of various payment instruments. This section provides brief historical summaries of the initial Board orders that led to the incorporation of the activity into the Regulation Y "laundry list." Provisions within the Board orders, including commitments and any regulatory references, should not be relied upon as provisions that are currently authorized. For the current regulatory authorization, see section 225.28(b)(13) of Regulation Y, effective April 1997.

3210.1.1 ISSUING CONSUMER-TYPE PAYMENT INSTRUMENTS HAVING A FACE VALUE OF NOT MORE THAN $10,000

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23 of the Board's Regulation Y to engage de novo in the issuance and sale of variably denominated payment instruments with a maximum face value of $10,000. The instruments would be sold in U.S. dollars and foreign currency by the holding company's subsidiaries and unaffiliated financial institutions and would consist of domestic and international money orders and official checks. They would also be used for certain internal transactions, such as payroll. The Board had recently amended Regulation Y to include on the list of permissible nonbanking activities the issuance or sale of money orders and other similar consumer-type instruments with a face value not exceeding $1,000. The Board concluded that an increase in the denomination of such instruments would not affect their fundamental nature.

As a condition to its approval, the Board required the bank holding company to file with the Board weekly reports of daily data on the activity. The issuance of such instruments with a face value of more than $1,000 could have an adverse effect on the bank holding company's reserve base. Because reserve requirements serve as an essential monetary policy tool, the Board was concerned that the proposal might result in adverse effects resulting from an erosion of reservable deposits within the banking system (1984 FRB 364).

3210.1.2 ISSUING AND SELLING OFFICIAL CHECKS WITH NO MAXIMUM FACE VALUE

Effective December 16, 1985, the Board approved by order a bank holding company's application to sell official checks with no maximum limitation on the face value, so long as the proceeds of checks in excess of $10,000 were deposited in a demand account at its subsidiary until the respective payment instrument was paid. To address the Board's monetary policy concerns about the activity potentially causing a significant reduction in the reserve base or resulting in other adverse effects on the conduct of monetary policy, the bank holding company agreed to make weekly reports of all outstanding instruments (including money orders and official checks) with face values of up to $10,000, and also the aggregate value of all official checks with face values exceeding $10,000 (1986 FRB 148).

3210.1.3 ISSUING AND SELLING DRAFTS AND WIRE TRANSFERS PAYABLE IN FOREIGN CURRENCIES

A foreign bank subject to the BHC Act applied for the Board's approval under section 4(c)(8) of the act and section 225.23(a)(3) of Regulation Y to engage de novo through a wholly owned subsidiary in the issuance and sale of foreign drafts and wire transfers with unlimited face amounts that are payable in foreign currencies. The applicant proposed to conduct these activities through the subsidiary as well as through a nationwide network of unaffiliated selling agents, including commercial banks, thrift institutions, and others.

The Board previously determined that the issuance and sale of money orders and similar payment instruments with a maximum face value of $1,000 is closely related to banking. (See former section 12 C.F.R. 225.25(b)(12).)[1] The Board also approved by order a limited number of applications to engage in the issuance and sale of (1) payment instruments with a $10,000 maximum face amount (see 1987 FRB 727) and

1. Effective April 21, 1997, the $1,000 limit was eliminated. The revised Regulation Y (see section 225.28(b)(13)) authorizes the issuance of payment instruments of any amount.

(2) payment instruments with unlimited face amounts, subject to certain operational and reporting requirements (see 1986 FRB 148).

In considering the previous applications, the Board expressed concern that the issuance of payment instruments in denominations larger than $1,000[2] would have an adverse effect on the reserve base because such instruments are not subject to the transaction reserve account requirements of the Board's Regulation D. The Board noted that because reserve requirements serve as an essential monetary policy tool, the conduct of monetary policy could be adversely affected by the erosion of reservable deposits in the banking system.

To address the concerns expressed in previous Board orders, the applicant committed that the proceeds of all sales of foreign-currency-denominated instruments will be held in demand deposit accounts at U.S. commercial banks. Deposits stemming from the sale of instruments with denominations of $10,000 or less are to be swept daily into nonreservable instruments. The total proceeds of the sale of any payment instruments with denominations greater than $10,000 will be deposited in a demand deposit account at a U.S. depository institution, to be used to purchase foreign currency for each particular payment instrument at the time of the transaction. The Board determined that these commitments and other procedures outlined in the order adequately addressed its concerns about the potential adverse effects on the reserve base. The Board approved the application on February 3, 1988, subject to the continued evaluation of its potential for adverse effects on the conduct of monetary policy (1988 FRB 252).

3210.1.4 ISSUING AND SELLING VARIABLY DENOMINATED PAYMENT INSTRUMENTS WITHOUT LIMITATION AS TO FACE VALUE

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act to engage both directly and indirectly through a bank holding company nonbank subsidiary in the issuance and sale of variably denominated payment instruments without limitation as to face value and without the reporting and reservable deposit requirement previously imposed by the Board on issuers of such instruments.

The Board previously determined by regulation that the issuance and sale of money orders and other similar consumer-type payment instruments with a face value not exceeding $1,000[3] is an activity that is closely related to banking and is therefore permissible for bank holding companies (see former section 225.25(b)(12) of Regulation Y (12 C.F.R. 225.25(b)(12))).

Effective December 22, 1992, the Board amended Regulation D to impose reserve requirements on teller's checks. The Board's notice amending Regulation D stated that bank holding companies that had received prior approval under section 4(c)(8) of the BHC Act to issue and sell variably denominated payment instruments—subject to the demand deposit requirement, reporting requirement, or limits on the denomination of payment instruments—could request relief by letter from those conditions. The Board believes that the adverse effect of erosion of the reserve base is addressed in the Regulation D revisions, and special reporting and demand deposit requirements previously imposed by the Board in connection with approvals to engage in the issuance and sale of variably denominated payment instruments in amounts over $10,000 are no longer needed. As a result, the Board determined not to impose those requirements on the applicant and to grant the applicant's request for relief from the reporting requirement to which it was subject. The Board approved the application on November 12, 1992, subject to the Regulation D effective date of December 22, 1992, and the conditions and commitments stated in the order (1993 FRB 42).

2. See footnote 1.

3. See footnote 1.

Section 4(c)(8) of the BHC Act (Arranging Commercial Real Estate Equity Financing) Section 3220.0

Effective September 1, 1982, the Board approved an application of a bank holding company to engage in, through a nonbank subsidiary, the activity of arranging equity financing for certain types of income-producing properties (1982 FRB 647). The Board limited the activity by requiring that the holding company act only as an intermediary between developers and investors to arrange financing, and imposed certain other conditions to prevent the holding company from engaging in real estate development or syndication. At that time, however, the Board did not expand the Regulation Y list of permissible activities for bank holding companies to include this activity.

In February 1984, the Board added the arranging of commercial real estate equity financing to the list of permissible nonbanking activities in Regulation Y (section 225.28(b)(2)(ii)). Regulation Y incorporated the limitations placed on the activity by the Board's 1982 order, which is discussed below.

Equity financing involves arranging for the financing of commercial or industrial income-producing real estate through the transfer of the title, control, and risk of the project from the owner or developer to one or more investors. In performing the equity-financing activity for commercial or industrial income-producing real estate, consultations should be made with the owner or developer to determine the nature, objectives, and financing arrangements for the property or project. The project's concept, architectural design, building layout, suitability for its purpose and prospects, traffic flow, as well as competing projects, source(s) of customers, nature of the market, projected rentals and income flows, timetables for completion, and the availability of construction and long-term financing for the property, have to be carefully reviewed. Financing alternatives, including equity financing, should be predetermined.

The Board has found that the particular expertise and analysis required to provide equity financing for large commercial or industrial income-producing properties is functionally and operationally similar to the analysis and expertise that is required when a bank provides traditional mortgage financing services for such properties. This finding is supported by the fact that equity financing can be viewed as an economic substitute for long-term mortgage financing. The Board's view is that equity financing, subject to the limitations described below, bears a functional relationship to investment advisory services that are traditionally and lawfully performed by commercial banks with respect to commercial and industrial real estate.

The Board therefore, in 1984, approved adding the arranging of commercial real estate equity financing to the list of permissible nonbanking activities in Regulation Y. On April 21, 1997, the comprehensive revision of Regulation Y removed certain restrictions from this nonbanking activity. The activity currently consists of acting as an intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of title, control, and risk of such a real estate project to one or more investors, if the bank holding company and its affiliates do not have an interest in, or participate in, managing or developing a real estate project for which it arranges equity financing, and do not promote or sponsor the development of the property.

3220.0.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Application to engage in equity-financing activities				1982 FRB 647 1983 FRB 817 1984 FRB 50
Adding activity to permissible list		225.28(b)(2)(ii)		1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section has been revised to incorporate a name change to the Financial Industry Regulatory Authority, or FINRA (formerly, the National Association of Securities Dealers, or NASD).

3230.0.1 OVERVIEW OF SECURITIES BROKERAGE AS A NONBANKING ACTIVITY

In addition to providing a full panoply of financial services to their customers, banks and bank holding companies seek ''off-balance-sheet'' or non-asset-building sources of revenue. Securities brokerage is one type of endeavor perceived to have growth and profit potential. The main reasons for this are easy market entry, low start-up costs, and maximum use of a branch system and customer base.

After the deregulation of brokerage commissions in 1975, certain brokers began to compete for securities business by drastically reducing their commissions. In order to reduce operating expenses, yet still remain profitable at reduced commission rates, these firms ceased investment research and offered their customers a reduced level of service by ''unbundling'' brokerage services and offering only the execution of securities transactions. Brokers who offer this reduced level of service have come to be known as ''discount brokers.''

The Board, in 1983, added ''securities brokerage'' to the list of permissible activities for bank holding companies shortly after it approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., as discussed below. In 1984, the U.S. Supreme Court sustained the Board's approval order and ruled that it is not a violation of the Glass-Steagall Act for banks and bank-affiliated brokers to buy and sell securities as agent for customers (SIA v. Board of Governors, 104 S. Ct. 3003). For additional historical information regarding the expansion of securities brokerage nonbank activities by Board order or by incorporation into Regulation Y, see sections 3230.1 through 3230.3.

Before April 21, 1997, Regulation Y differentiated between securities brokerage services provided alone (that is, discount brokerage services) and securities brokerage services provided in combination with investment advisory services (that is, full-service brokerage activities). Regulation Y no longer distinguishes between discount and full-service brokerage activities.

Regulation Y currently authorizes securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services and incidental activities (including such related activities as securities credit, custodial services, individual retirement accounts, and cash-management services), if the services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing. In addition to the information and examiner guidance provided in this section, see the American Institute of Certified Public Accountants' *Audit and Accounting Guide—Brokers and Dealers in Securities.*[1] The guide includes detailed information about the securities industry, broker-dealer functions, activities and operations, books and records, accounting and auditing standards and considerations, and other topics such as internal controls and regulatory considerations.

3230.0.2 INITIAL BOARD ORDER APPROVAL FOR SECURITIES BROKERAGE

On January 7, 1983, the Board approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., which engaged in retail discount securities brokerage, securities credit lending, and certain incidental activities (1983 FRB 105). None of the proposed activities was among those the Board had previously designated in Regulation Y as being closely related to banking.

In its order approving the application, the Board found that the brokerage and securities credit activities were closely related to banking for purposes of section 4(c)(8) of the Bank Holding Company Act (''BHC Act''). That decision was based on the fact that many banks provide various types of securities brokerage services as an accommodation to customers and as an agent for trusts and other accounts managed by banks.

Banks also administer employee stock purchases, dividend reinvestment, and automatic

1. Issued as of May 1, 2007.

investment service plans, which involve the periodic purchase of a particular security or securities from a fixed list of securities, on behalf of the customer. Banks often execute orders involving securities not listed on an exchange by dealing directly with dealers making a market in a particular security or with other third parties. In performing these services, banks exercise the same type of discretion and judgment with respect to the best method of execution as brokers do with respect to similar types of orders. Further, national banks are expressly authorized by statute to purchase and sell securities without recourse, solely upon the order, and for the account of, customers (12 U.S.C. 24 (Seventh)).

The Board, in summary, noted that banks in fact had generally provided securities brokerage to some extent. The company that was acquired, pursuant to the January 1983 order, provided several other services incidental to its discount brokerage activities.

3230.0.2.1 Margin Lending

Historically, banks have had a significant amount outstanding in loans to borrowers for the purpose of purchasing or carrying securities. The extension of such credit secured by stock and other collateral, or margin lending, has long been an important bank activity. The Board, therefore, ruled that this activity was closely related to banking and incidental to the securities brokerage activities of the company being acquired.

3230.0.2.2 Maintenance of Customer Securities Accounts

Charles Schwab & Co. offered various services to its brokerage customers. These services included individual retirement accounts for which an unaffiliated savings and loan association served as a trustee; a "sweep" arrangement, pursuant to which idle customer balances exceeding a certain minimum were automatically invested in an unaffiliated money market mutual fund; the payment of interest on net free balances awaiting investment; and a specially named account that combined the payment of interest on free credit balances with customer access to such balances through a debit card and checking account offered under an arrangement with an unaffiliated commercial bank. Increasingly, these types of services were being offered by other brokerage firms. The Board found that each of these services was identical, or functionally and operationally equivalent to, services generally offered by banks to customers directly or through bank trust departments. Based on that finding, the Board found that the provision of those accounts was closely related to banking as well as an incidental activity in connection with securities brokerage and margin lending activities.

3230.0.2.3 Custodial Services

The brokerage firm also provided various types of securities custodial services involving the safekeeping of customers' securities, accounting for dividends or interest received on such securities, and other ancillary services. Banks generally offer securities custodial services in connection with their trust departments and other securities transaction services. Furthermore, in extending margin credit, a lender is required to maintain custody of the securities pledged to the lender as collateral to secure the loan. Accordingly, the Board found that the provision of securities custodial services was closely related to banking and that it was a necessary incident to permissible margin lending activities.

3230.0.3 MARGIN CREDIT ACTIVITIES AND SECURITIES BROKERAGE

When securities brokerage was added to the permissible activities within Regulation Y, it was contemplated that a bank holding company, or its nonbank subsidiary performing the permitted securities brokerage activities, would be required to register as a broker–dealer with the Securities and Exchange Commission and that its margin credit activities would therefore be subject to the Board's Regulation T. Regulation T governs securities credit by broker–dealers (12 C.F.R. 220).

3230.0.4 ACTIVITY ADDED TO REGULATION Y

On August 10, 1983, the Board adopted a final rule deeming securities brokerage and margin lending "closely related" to banking, consistent with the Glass-Steagall Act, and are, therefore, generally permissible for bank holding companies. To clarify that services incidental to brokerage services are permissible, the Board did include a list of permissible incidental services. The list included services such as offering custodial services, furnishing individual retirement accounts, and cash-management services, provided that the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting.

As for cash-management services, such services are intended to include customer-account-related functions, such as paying interest on net free balances awaiting investment, providing arrangements under which free credit balances are automatically invested in money market mutual funds, and establishing arrangements under which access to such balances is provided by debit card or checking accounts.

The list of incidental activities in the regulation is not intended to be exhaustive. The Board believes that to compete effectively with other brokers, bank holding companies should have the flexibility to provide a full range of customer-account and custodial services, provided such services meet the test for permissible incidental activities under section 4(c)(8) of the BHC Act and are consistent with the Glass-Steagall Act.

As previously noted, Regulation Y, effective April 21, 1997, permits securities brokerage without distinguishing between discount and full-service brokerage activities. The previous regulatory requirement for certain disclosures has been eliminated. Those disclosure requirements are in an interagency policy statement that governs the sale of securities and other nondeposit investment products on bank premises (see sections 2010.6.1.3.1 and 2010.6.2.9), as well as in SEC rules. Similar disclosure requirements are required by the Board's policy statement that governs a bank holding company's sale of shares of mutual funds and other investment companies that it advises (see section 225.125 of Regulation Y).

3230.0.5 MARKET ENTRY INTO SECURITIES BROKERAGE

There are three general methods of market entry available to bank holding companies or nonbank subsidiaries of bank holding companies wishing to offer securities brokerage services: (1) become associated with a brokerage firm, (2) purchase an existing firm, or (3) establish their own brokerage operations. The most common mode is broker association, which is less costly and the most rapid form of entry. The following broker relationships are presently established:

1. *Introducing broker*. The first level of involvement occurs when a BHC or a nonbank subsidiary of a BHC serves as an "introducing broker" in effecting securities transactions by accepting the customers' orders and transmitting the orders to the executing broker.[2] Order tickets and records of original entry are prepared by the BHC or nonbank subsidiary. In this situation, the executing broker generally produces customer confirmations and account statements. These documents often prominently display the BHC or the bank holding company's nonbank subsidiary's name and logo. The executing broker, the bank holding company, and/or its nonbank subsidiaries may offer safekeeping services and margin credit.
2. *Omnibus account*. A higher level of bank holding company nonbank subsidiary involvement occurs when the broker "carries" customer accounts by accepting and transmitting orders for execution, producing the customer confirmation, and maintaining all customer records. When carrying customers' accounts, the bank holding company's nonbank subsidiary may maintain a single customer account, called an omnibus account, with the executing broker. Safekeeping and margin credit services may be offered.
3. *Separately incorporated broker–dealer subsidiary affiliate*. The highest level of involvement occurs when a bank holding company organizes or acquires a separately incorporated broker–dealer subsidiary or affiliate, which transacts business like any other broker–dealer. This would include its own customer lists, both retail and wholesale; possible exchange membership; and executing and clearing its own transaction.

3230.0.6 PURPOSE OF INSPECTION OF SECURITIES BROKERAGE ACTIVITIES

The purpose of the inspection is to evaluate

2. There is a lower level of involvement wherein the BHC or nonbank subsidiary is responsible for making the brokerage services available to customers by advertising the distributing customer account applications. Account acceptances are generally made by the unaffiliated broker who will receive orders directly from customers.

any potential liability due to wrongful or negligent performance of responsibilities, to assess the level of management expertise, and to determine the degree of compliance with legal and policy parameters necessary to protect investors.

3230.0.7 INSPECTION OBJECTIVES

1. To determine the scope and nature of services provided.
2. To evaluate operations, audits, and controls.
3. To review the sufficiency of administrative policies and procedures.
4. To determine the level of responsibility.
5. To appraise the quality of management and staff.
6. To ascertain earnings, volume of business, and prospects.
7. To review compliance with applicable laws, regulations, and policies.

3230.0.8 SCOPE OF INSPECTION

The scope of inspection will vary depending on the nature of the brokerage operation. In defining the scope of inspection, it is first necessary to determine the extent of activities performed and the corporate structure. Any bank holding company subsidiary (that is not a bank), which functions as a securities broker, is required to register as a broker–dealer with the Securities and Exchange Commission (SEC).[3]

In developing the scope of inspection, it is emphasized that Reserve Bank examiners can rely on the applicable self-regulatory organization's examination with respect to investor protection, compliance with SEC and SRO rules, and Regulation T. The self-regulatory organizations do not furnish an examination report, but instead furnish a registered broker–dealer with a letter pertaining to examination findings. Hence, the scope of inspection for a registered broker–dealer will commence with a review of a self-regulatory organization's most recent letter dealing with its examination of brokerage activities. A broker–dealer belonging to more than one self-regulatory organization will be examined only once in each examination cycle. Serious violations that could endanger a banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits) or significant violations that have not yet been corrected, should be noted in the bank holding company inspection report. Reserve Bank staff are responsible for evaluating all other aspects of securities brokerage activities.

The actual scope of this portion of the inspection will range from a brief visit for a limited service "arranger" relationship to extensive review for an omnibus relationship or registered broker–dealer.

3. A broker–dealer registered with the SEC (registered broker–dealer) is subject to SEC recordkeeping and confirmation rules, fair practice rules, professional qualification rules for individuals associated with securities firms, and the uniform net capital rule. Registered broker–dealers are also required to pay for insurance coverage on customers' assets by the Securities Investor Protection Corporation (SIPC) and are required to be members and subject to the rules of the Financial Industry Regulatory Authority (FINRA), or other self-regulatory organizations, such as the New York Stock Exchange. These self-regulatory organizations (SROs) also test for broker compliance with Regulation T (12 C.F.R. 220).

3230.0.9 MATERIALS REQUIRED FOR INSPECTION

When commencing the securities brokerage portion of a bank holding company or its nonbank subsidiary inspection, the following material should be obtained:

1. contractual agreement with the executing and/or clearing broker
2. recent activity report (for at least six months)
3. income and expense reports
4. written policies and procedures regarding—
    a. order processing,
    b. settlements,
    c. account reconciliations,
    d. audit coverage, and
    e. trust department relationship
5. account application forms
6. customer disclosure documents
7. organization chart
8. fee schedule
9. internal and external audit reports
10. a copy of the contingency plan for continuance in emergencies
11. the most recent SRO letter pertaining to the last brokerage examination

3230.0.10 INSPECTION PROCEDURES

If applicable, the following areas should be covered during the inspection.

3230.0.10.1 Organization and Management

Review carefully the contractual agreement with the executing and/or clearing broker and list all duties and obligations of the respective parties. Determine that the agreement contains an indemnification clause insulating against broker error. Once the review is completed, the examiner can identify the type of relationship and plan the scope of the inspection.

Review the organization chart and match responsibilities and operational functions to the appropriate section. Evaluate management and staff based upon their education, experience, performance, and the profitability and efficiency of operations and any other relevant factors.

3230.0.10.2 Operations

A securities brokerage operation is organized along functional lines including—

1. execution,
2. settlement,
3. delivery,
4. custody,
5. recordkeeping, and
6. audits and controls.

Before review, prepare a flow chart of the operation to quickly overview the operational areas and to locate control points and identify potential weaknesses.

3230.0.10.2.1 Execution

This area processes client orders. The orders may be received by telephone at the nonbank subsidiary or directly by the executing broker. When the nonbank subsidiary accepts customer orders, they can be transmitted by direct wire to the executing broker. Completed transactions initiated by the nonbank subsidiary are confirmed back to the nonbank subsidiary, which in turn sends a confirmation to the client. Examiners should determine that proper safeguards are in place to ensure valid orders are received, pending orders are controlled, and completed orders are reported for customer notification and record update. The examiner should also determine that the following are in place:

1. use of code numbers, names, or other verification devices when accepting orders
2. maintenance and reconcilement of a trade log (orders received) and execution report (orders completed)
3. taping of telephone orders
4. confirmation of completed orders are confirmed to clients in a timely fashion
5. preparation and transmittal of input media for record update

3230.0.10.2.2 Settlement

This area receives payments and proceeds, collects dividends and interest, and, in some instances, effects margin calls on broker instruction. Settlements are effected in two stages:

1. *Broker vs. customer*. Before settlement date, the customer must send cash or securities to the broker as requested in the broker's customer confirmation. Cash or securities are required to effect payment against delivery or delivery against payment in accordance with industry securities settlement procedures.
2. *Broker vs. broker*. When physical delivery of securities is required, it is generally done on a firm-to-firm basis or to a firm's safekeeping agent. Major equity securities, and an ever-increasing number of debt securities, are eligible for net settlement and securities immobilization with depositories. Usually, a net settlement account is used for cash and securities transactions; these accounts should be reconciled daily. The settlement process should include a procedure that verifies execution price and fees.

3230.0.10.2.3 Delivery

Securities are delivered to the executing broker and purchased securities to clients. The examiner should determine that safeguards provide adequate control over certificates in process. Proper fail-to-deliver/receive and completed transaction records should be maintained.

The securities broker that accepts customer orders generally is exposed to *delivery risk* by customers. Basically, customers can take advantage of the broker by placing an order to buy securities when the customer has no funds available to purchase securities or by placing an order to sell securities that are not owned by the customer. Either type of transaction is permissible in a *margin account,* provided that the customer has the resources available to properly margin the transaction. If the customer does not have a margin account, the broker should not purchase a security for the customer unless (1) there are sufficient funds in the customer's account or (2) the customer represents and the broker ascertains that the customer will promptly make full cash payment for the security before selling it and that the customer does not contemplate selling it before making payment. Alternatively, the broker should not sell a security for a customer unless (1) the security is held in the customer's account, or (2) the broker accepts in good faith the customer's statement that the security is owned by the customer and that it will be promptly deposited into the account.

By not executing a purchase or sale until the customer has deposited cash or securities, customer-default risks can be avoided on cash transactions. However, for competitive reasons, many brokers would not wish to place such stringent restrictions upon their customers—especially with respect to the purchase of securities. Lack of proper account supervision can lead to the fraudulent customer practice of "free riding," wherein the customer will buy securities in anticipation of a price rise. Before settlement date, the customer will sell the securities to take the profits. If the market price of the securities declines, the customer will dishonor the trade, and thus attempt to leave the broker holding the depreciated securities. Securities brokerage procedures should be designed to look for generally abusive practices by customers.

3230.0.10.2.4 Recordkeeping

Any records that must be prepared by the broker under inspection are subject to the Securities and Exchange Commission's recordkeeping and confirmation rules 17a-3 and 17a-4. Compliance with those recordkeeping rules will be verified by stock exchange or FINRA examiners during their routine compliance inspections.

3230.0.10.2.5 Audits and Controls

Complete the "Securities Brokerage/Internal Controls Checklist" to determine whether operations are satisfactorily controlled and audited by the bank holding company's or nonbank subsidiary's audit staff. All significant administrative and operational aspects should be covered. Management should receive reports of audit findings and respond in writing as to actions taken.

3230.0.10.3 Conflicts of Interest

Determine that policies have been effectively implemented covering relationships with affiliated trust departments, self-dealing, fee-splitting or rebate arrangements, and officer/employee transactions.

3230.0.10.3.1 Relationship with Affiliated Trust Departments

Questions may arise concerning the permissibility of a securities broker's executing securities transactions for an affiliated trust department. In general, the receipt of commission income for securities brokerage transactions entered into on behalf of a trust account (in addition to the fee received for account administration) raises conflict-of-interest considerations to which traditional prohibitions of fiduciary law are directed. When a securities broker affiliate is used, the trust institution may be considered to share indirectly in the commission income of the affiliate even when there is no direct remittance of the fee to the bank. The staff letter at 3–447.11 of the *Federal Reserve Regulatory Service* provides guidance in determining whether and in what circumstances use of affiliated discount brokerage services may or may not be permissible. If questionable trust department use of affiliated broker services is disclosed, appropriate trust examiner(s) should be notified.

3230.0.10.4 Earnings, Volume Trends, and Prospects

Determine the present and future impact that the securities brokerage activities may have on the bank holding company and its subsidiaries. If possible, a separate profit center should be established, thus providing a useful management tool that facilitates analysis of current profitability, business volume, fixed and variable costs, and degree of goal actualization. Periodic review of these factors will enable management to direct available resources, aid in the budget process, and provide a basis for business planning. Prospects for profitable growth should be assessed by noting changes in aggregate account levels and trade activity. The local competitive environment should be gauged and market-share information noted. In considering these factors, the examiner should attempt to determine what level of activity must be maintained or attained in order for the securities brokerage function to break even. Present a summary statement expressing an overall view on the current state and future viability of the operation.

3230.0.10.5 Compliance

The examiner should determine whether any additional state regulations must be complied with. Also determine that staff is aware of and complying with applicable regulations and laws, which may be outside the scope of an examination conducted by a self-regulatory organization.

3230.0.10.6 Presentation of Findings

The scope of inspection within the report should note that securities brokerage activities were reviewed. It should be noted that in order to avoid duplication of examination procedures, the inspection did not focus upon securities laws compliance (as verified by FINRA, or stock-exchange examiners), but instead focused upon financial and safety-and-soundness considerations. Appropriate nonbank subsidiary pages should be completed. Present a summary comment in the confidential section reflecting an overall appraisal of the operation. The self-regulatory organization responsible for examining the securities brokerage operation should be identified. Identify also the associated broker, if any, with whom the organization conducts business. Any material exceptions should be noted with management's responses under an appropriate caption within the open section. Matters of importance should be brought forward to the Examiner's Comments and Matters Requiring Special Board Attention page. In addition, any other significant problems, detrimental practices, or potential liabilities that could have a negative impact on the organization should be commented upon.

3230.0.11 EXAMINATION CHECKLISTS

Two checklists are provided for use by the examiner to aid in evaluating securities brokerage activities:

1. Securities Brokerage Inspections
2. Securities Brokerage/Internal Controls

All questions are not applicable for each brokerage subsidiary. The nature and scope of brokerage activities determine the applicability of specific questions. The term ''banking organization'' refers to a bank holding company and any of its nonbank subsidiaries.

3230.0.11.1 Securities Brokerage Inspection Checklist

	Yes	*No*
1. Is a contractual agreement between the banking organization and the executing and/or clearing broker on file?	____	____*
2. Does the agreement indemnify the banking organization against broker error?	____	____*
3. Does the agreement clearly define respective responsibilities of the banking organization and broker?	____	____*
4. Was the agreement reviewed by the banking organization's counsel?	____	____*
5. Was the agreement approved by the board of directors? If not, by whom?	____	____*
6. Are written procedures covering brokerage activities in effect?	____	____*
7. Have job descriptions been prepared?	____	____*
8. Have specific policies been developed regarding—		

*Response may require report comment.

		Yes	*No*
• relationships with affiliated bank trust depts?		____	____*
• conflicts of interest?		____	____*
• investment advice?		____	____*
9. Are investment advice or research services being offered?		____	____*
10. Are income and expense records separately maintained?		____	____*
11. Are brokerage activities included in the audit program?		____	____*
12. Are customer orders placed with banking organization personnel?		____	____*
If so, is customer authorization on file?		____	____*
Are telephone conversations tape recorded?		____	____*
Are transaction records maintained by traders?		____	____*
13. How are payments effected?	(check one)		
direct charge to customer account	____		
payment through the mail	____		
other ______________________________			
14. What is the timeframe of payment?			
prior to execution	____		
upon verbal notification of execution	____		
upon customer's receipt of confirmation	____		
after settlement date	____*		
15. What is the frequency of settlement-account reconcilements?			
daily	____		
biweekly	____		
weekly	____*		
other ____________________			
16. Does an affiliated trust department use the discount brokerage service?		____	____*
If yes, what type account? ____________________			
discretionary trust	____**		
discretionary agency	____**		
custody	____		
employee benefit	____**		
17. Is sufficient insurance coverage in effect?		____	____*
Describe types and limits. ______________________________ ______________________________			
18. Does a review of records confirm that the broker functions solely as an agent, i.e., does not engage in underwriting or taking positions for its own account?		____	____*
19. Do monitoring and internal reporting procedures adequately track profitability and operating impact for management consideration?		____	____*

*Response may require report comment.

**If available documentation reveals that affiliated trust departments use brokerage services to execute transactions for this type of account, the appropriate federal regulator of trust activities should be notified.

3230.0.11.2 Securities Brokerage/Internal Control Checklist

The following questions should be answered, to the extent applicable, in reviewing a securities brokerage operation. Few brokers will perform all of the activities discussed below.

	Yes	*No*
1. Do internal audit procedures include the securities brokerage function?	____	____*
2. Has the banking organization adopted procedures for the periodic review of insurance coverage relating to securities brokerage activities (e.g., errors and omissions, fidelity bonding, and securities in transit)?	____	____*
3. Has the banking organization adopted procedures with respect to the accounts of directors, officers, or employees or their immediate families?	____	____*
4. Are procedures in place to prevent internally generated credits to the securities brokerage customers' accounts from being automatically recorded as collected funds?	____	____*
5. Are procedures in place to ensure that acceptance of a relatively large order will not be effected unless the order taker verifies that the customer placing the order has internal authorization to engage in large trades?	____	____*
6. Has the banking organization adopted written procedures prohibiting employees from furnishing investment advice?	____	____*
7. Are customer telephone orders tape recorded?	____	____*
8. Are tape recordings of telephone orders reviewed periodically to verify that employees have *not* made securities recommendations or furnished investment advice?	____	____*
9. Are persons responsible for taking and transmitting orders precluded from preparing accounting entries?	____	____*
10. Is there adequate separation of duties between persons responsible for making initial accounting entries and those responsible for making subsequent adjusting entries to prevent a concealment of theft or fraud?	____	____*
11. Does the securities brokerage function monitor and reconcile safekeeping, clearing, payment, and income expense accounts on a regular basis?	____	____*
12. Has management developed a contingency plan to ensure continued brokerage operations of the securities brokerage operation in the event of fire, flood, power failure, or some other unforeseen event?	____	____*
13. With respect to termination of brokerage accounts, does the securities brokerage operation have procedures in place to prevent an account from being closed while an open securities order is outstanding?	____	____*
14. Does the credit-approval process require a credit decision to be made by someone who routinely makes credit decisions—as opposed to a manager of a securities brokerage operation?	____	____*
15. If securities received from customers are registered in the name of a third party, are procedures in place to ensure that such securities are accepted only upon satisfactory proof of ownership?	____	____*

*Response may require report comment.

	Yes	*No*
16. Are procedures in place to ensure that customers delivering securities registered in a "street name" have title to such securities (i.e., they are not lost or stolen securities)?	____	____*
17. Is only a limited number of responsible employees authorized to execute or guarantee security assignments?	____	____*
18. Is the use of facsimile signature devices adequately controlled?	____	____*
19. Are procedures in place to control cash, securities, and documents pertaining to securities shipped for "delivery against payment"?	____	____*
20. Are adequate physical controls maintained over securities on hand (e.g., restricted access to the "cage area")?	____	____*
21. Are detail records pertaining to securities in transfer and those pledged as collateral to borrowings agreed periodically (at least quarterly) with the securities record?	____	____*
22. Are security positions (and related general-ledger amounts) in suspense accounts investigated and resolved on a timely basis?	____	____*
23. Are fails to receive and fails to deliver periodically reviewed and reconciled?	____	____*

*Response may require report comment.

3230.0.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Board's authority for rulemaking and jurisdiction over BHCs	1843(c)(8), 1844(b)			
Order approving the application of a BHC to acquire a retail discount securities broker				1983 FRB 105
Order approving acquisition of retail discount broker by a BHC				1983 FRB 565
Securities brokerage as a permissible activity		225.28(b)(7)(i)		
Credit by brokers and dealers—Regulation T	220			
Order approving the provision of combined securities brokerage, investment advisory, and research services				1986 FRB 584
Securities brokerage subsidiary can exchange customer lists with affiliates and confidential customer information (with customer approval)				1988 FRB 571

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Securities brokerage with discretionary investment managment and investment advisory services				1988 FRB 700 1987 FRB 930 1987 FRB 810
Full-service brokerage for institutional and retail customers—bank-ineligible securities				1989 FRB 396 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

4(c)(8)—Securities Brokerage (Board Decisions)

Section 3230.05

This section serves as a prelude to the securities brokerage sections that follow. Sections 3230.1 through 3230.3 provide brief historical summaries of Board decisions on securities brokerage; these authorizations are now incorporated into Regulation Y for this activity. The summaries provide the reader with some historical perspective as to how and why the current provisions of Regulation Y evolved. The conditions and commitments within these orders may no longer apply to the current provisions of Regulation Y. Therefore, reference must be made to Regulation Y, section 225.28(b)(7)(i).

Before the 1997 revisions of the Board's Regulation Y (12 C.F.R. 225), the Board's rules differentiated between securities brokerage services provided alone (that is, discount brokerage services) and securities brokerage services provided in combination with investment advisory services (that is, full-service brokerage activities). The revisions to Regulation Y that became effective in April 1997 permit securities brokerage without distinguishing between discount and full-service brokerage activities.

Another major change for securities brokerage activities concerns the types of disclosures required of bank holding companies. Before the 1997 revisions, bank holding companies providing full-service brokerage services were required to make certain disclosures to customers regarding the uninsured nature of securities and were not permitted to disclose confidential customer information without the customer's consent. Effective in April 1997, these disclosure requirements were eliminated. The disclosure requirements—along with a number of other requirements that specifically address the potential for customer confusion, training requirements, suitability requirements, and other matters—are already contained in an interagency policy statement that governs the sale of securities and other nondeposit investment products on bank premises, as well as in rules adopted by the SEC. In addition, similar disclosure requirements are required by the Board's policy statement governing the sale by bank holding companies of shares of mutual funds and other investment companies that the bank holding company advises.

Banking organizations and their affiliates, in general, are becoming more effective in implementing the regulatory disclosure requirements. Customers are also becoming increasingly aware that such investment products purchased at banking organizations and their affiliates are not federally insured. Moreover, the Board and the SEC have adequate supervisory authority to ensure that bank holding companies comply with the applicable regulatory disclosure requirements. To the extent that disclosures to customers are appropriate in areas not covered by the regulatory policy statements or SEC regulations, the Board will consider whether to develop supervisory guidance.

Two bank holding companies jointly applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to form a de novo subsidiary that would engage in the following nonbanking activities:

1. providing portfolio investment advice to "institutional customers"
2. providing securities execution (brokerage) services, related securities credit activities pursuant to the Board's Regulation T, and incidental activities
3. furnishing general economic information and advice, general economical statistical forecasting services, and industry studies to institutional customers
4. serving as an investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940) to investment companies registered under that act

Separate fees are to be charged for the advisory services and the securities brokerage services. The company would also provide incidental services such as custodial and cash-management services and acting as a registered investment adviser. The services are to be provided throughout the United States. The providing of advisory services to retail clients was not authorized by the Board. The applicant committed to create a "Chinese Wall" between the affiliated bank and the securities affiliate.

The Board determined that the activities would not violate Glass-Steagall Act prohibitions. Board approval was conditioned with the requirement that the standards of care and conduct applicable to fiduciaries would be observed. The applicant would not allow the exchange of confidential information between the de novo subsidiary and its affiliates. The applicant further committed that employees of the de novo subsidiary would not be given customer lists and other confidential information obtained by its affiliates in connection with commercial banking operations. Transmission of advisory research and recommendations to the commercial lending department of any of the bank holding company's affiliates was not permitted.

The proposal represented the combination of activities, previously determined to be closely related to banking, in such a way that the functional nature and scope of the combined activities conducted would not be altered. By Board order, the applicants' application was approved on June 13, 1986 (see 1986 FRB 584), subject to the conditions stated therein. Other orders were approved by the Board on August 5, 1987 (1987 FRB 810), and October 1, 1987 (1987 FRB 930), which also authorized a bank holding company to engage in combined investment advisory and securities brokerage activities. In this order, the Board lowered the threshold for defining an "institutional investor" from $5 million to $1 million.

The Board, effective September 10, 1992, added this nonbanking activity to those activities that are permissible by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y, subject to the disclosure requirements, restrictions on exchanging confidential customer information, and other limitations stated therein.

4(c)(8)—Securities Brokerage with Discretionary Investment Management and Investment Advisory Services Section 3230.2

A bank holding company applied to the Board to expand the authority of its subsidiary to engage in offering investment advisory services for "institutional customers" and its affiliates[1] in conjunction with its previously approved brokerage services. The Board previously approved by order (1986 FRB 584) an application for a different bank holding company to offer the combination of investment advice and securities execution services for institutional customers.

The proposed activities in this order (1987 FRB 810) are similar except that the subsidiary would additionally exercise limited investment discretion at a customer's specific request. Under this plan, the subsidiary would offer as a service, within defined parameters established by the client, discretion in buying and selling securities on behalf of the client.

Such investment discretion would be exercised only at the request of a client; the subsidiary does not plan to market or solicit managed accounts. Each client will receive confirmation of each transaction, as well as monthly statements which would indicate in detail the terms of each transaction executed on its behalf. Each client would always be aware of the scope of the subsidiary's activity for its account. The subsidiary would receive a single fee for the combined activities of providing investment advice and exercising limited investment discretion.

The application was approved on August 5, 1987, subject to the commitments made by the applicant and the conditions (whether explicitly stated or incorporated by reference) in the order.

The Board approved another order on October 1, 1987 (1987 FRB 930), similar to the August 5, 1987, order, except that (1) the applicant proposed to lower the test for institutional customers from the $5 million threshold to $1 million; (2) the applicant's wholly owned brokerage subsidiary would share customer lists with its affiliates, but not confidential information obtained from the customer; and (3) the brokerage subsidiary would have officer and director interlocks with the parent bank holding company, but not with its bank affiliates. In the Board's view, these modifications did not alter the underlying rationale of its earlier decision.

The Board approved another order on August 10, 1988 (1988 FRB 700). The principal difference between the August 5, 1987, order and this proposal was the provision of such combined services to *retail* as well as *institutional* customers. The provision of services to retail customers does not include discretionary investment management. To further ensure the separation of the BHC and its bank affiliates and to avoid potential conflicts of interests, the applicant made several commitments, as detailed within the order.

The Board, effective September 10, 1992, added the providing of discretionary investment management to the nonbanking activities that are permitted by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y.

1. The provision of such services by the subsidiary to other affiliates is a permissible servicing activity under section 225.22(a) of Regulation Y.

4(c)(8) of the BHC Act—Offering Full Securities Brokerage Services for Bank-Ineligible Securities Section 3230.3

A bank holding company (applicant) applied for the Board's permission for its subsidiary to provide investment advisory and brokerage services on a combined basis (''full-service brokerage'') to institutional and retail customers and to engage, to a limited extent, in underwriting and dealing in one- to four-family mortgage-related securities and consumer receivable–related securities (herein referred to as ''ineligible securities''). The applicant committed to conduct its ineligible securities underwriting and dealing activities subject to the revenue test and the prudential limitations established by the Board in 1987 FRB 473, except for a market-share limitation which the Board decided not to require for this BHC.

The Board determined previously that full-service brokerage for both institutional and retail customers is closely related and a proper incident to banking under section 4(c)(8) of the BHC Act and does not violate the Glass-Steagall Act (1988 FRB 700 and 1986 FRB 584). This BHC's proposal differs from prior cases in that the subsidiary will provide full-service brokerage to retail customers for ineligible securities that it may hold as principal. The BHC has committed that the subsidiary will provide full and appropriate disclosure of its interest in the transaction as required by the securities laws, the National Association of Securities Dealers, and fiduciary principles.

The Board had previously authorized an underwriting subsidiary to provide full-service brokerage with respect to ineligible securities that it holds as principal, *but only to institutional customers* (1988 FRB 695). Applicant made the same commitments regarding disclosures as found in 1988 FRB 695. The BHC committed further that its subsidiary would prominently disclose in writing to each customer, at the commencement of the relationship, that it is not a bank; that it is separate from any affiliated bank; and that the securities sold, offered, or recommended by the subsidiary are not deposits, are not insured by the FDIC, are not guaranteed by an affiliated bank, and are not otherwise an obligation of an affiliated bank, unless such is in fact the case. The Board emphasized that confirmations sent to customers will state whether the subsidiary is acting as agent or principal with respect to a security. The Board concluded that such disclosure commitments would be adequate. It recognized that in performing the full-service brokerage activity, the underwriting subsidiary would be operating under a more extensive framework of prudential limitations than would be the case if the full-service brokerage activity were conducted by a bank, a subsidiary of a bank, or by another holding company subsidiary. Based on the commitments made, the Board decided on March 14, 1989, to approve the proposed activities (see 1989 FRB 396) subject to all the terms and conditions found in 1987 FRB 473, except for the market-share limitation.

Effective September 10, 1992, the Board added this nonbanking activity to the activities permitted by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y and subject to the Board's disclosure and other requirements and the limitations on exchanging confidential information, as stated therein.

This section discusses and provides a historical reference of previous Board orders that initially authorized, by order, a bank holding company's acting as agent in the private placement of securities and engaging in riskless-principal nonbanking activities. *With the Board's incorporation of private-placement and riskless-principal activities into its adoption of changes to Regulation Y, effective April 21, 1997, the majority of the previous private-placement and riskless-principal commitments are not effective. Only those current requirements listed for private-placement and riskless-principal activities in section 225.28(b)(7) of Regulation Y (the laundry list of permissible nonbanking activities) should be used by the examiner in conducting the supervision and inspection of bank holding companies and their subsidiaries.*

3230.4.1 ENGAGING IN COMMERCIAL-PAPER PLACEMENT ACTIVITIES TO A LIMITED EXTENT

A bank holding company (the applicant) applied pursuant to section 4(c)(8) of the Bank Holding Company Act and section 225.23(a) of the Board's Regulation Y to act as an agent and adviser to issuers of commercial paper in connection with the placement of commercial paper with institutional purchasers. The commercial-paper-placement activity, as proposed, is to be conducted from a wholly owned commercial finance subsidiary (the company) of the applicant's direct subsidiary.

The Board concluded that the proposed commercial-paper-placement activity was so functionally and operationally similar to the role of a bank that arranges a loan participation or syndication as to be a proper incident thereto and that banking organizations are particularly well suited to perform the commercial-paper-placement function. The Board found that the proposal, as limited by the applicant, was consistent with section 20 of the Glass-Steagall Act, and could reasonably be expected to result in public benefits that would outweigh possible adverse effects. The Board found, further, that the applicant could conduct the proposed activities to the extent and in the manner described in the order. The Board's approval (1987 FRB 138) extended only to the activities conducted within the limitations proposed by the applicant for company and the BHC's subsidiary banks and other subsidiaries. The placement of commercial paper in any manner other than as described within the limitations and conditions of the order would not be within the scope of the Board's approval. The Board also required that no lending affiliate of the company would disclose to the company any nonpublic customer information concerning an evaluation of the financial condition of an issuer whose paper is placed by the company or of any other customer of the company, except as expressly required by securities law or regulation.

On May 25, 1988, the Board approved an order (1988 FRB 500) for a bank holding company to engage de novo, through a subsidiary, in acting as an agent and adviser to issuers of commercial paper in connection with the placement of commercial paper with institutional customers, as well as to engage in certain other securities and financial advisory activities. The applicant proposed to place commercial paper in accordance with all the terms and conditions of the above order (1987 FRB 138), except one. The applicant did not propose any quantitative limitations on its placement activity. The Board concluded that the proposed commercial-paper placement did not constitute underwriting or distributing under the Glass-Steagall Act and that the quantitative limitations on the activity were not necessary to ensure compliance with that act. (See section 3230.4.2, in which a subsidiary of a bank holding company was authorized to privately place all types of debt and equity securities.)

3230.4.2 ACTING AS AGENT IN THE PRIVATE PLACEMENT OF ALL TYPES OF SECURITIES AND ACTING AS RISKLESS PRINCIPAL

A bank holding company (the applicant) applied for the Board's approval to transfer the private-placement business of its commercial bank subsidiary to its designated nonbanking subsidiary for securities underwriting and dealing. The subsidiary would act as agent in the private placement of all types of securities, including the providing of related advisory services, and buy and sell all types of securities on the order of investors as a riskless principal.

Because the section 20 subsidiary would be affiliated through common ownership with a member bank, it may not be "principally engaged'' in the ''issue, flotation, underwriting, public sale, or distribution'' of securities within the meaning of the former section 20 of the Glass-Steagall Act. In an earlier decision (1989 FRB 751), the Board determined that a subsidiary is not engaged principally in section 20 activities if revenues from underwriting and dealing in securities that banks are not authorized to underwrite and deal in directly (bank-ineligible securities) do not exceed 10 percent of the subsidiary's gross revenues (25 percent, effective March 6, 1997). The applicant contended that the proposed private-placement and riskless-principal activities are not the kind of securities activities described in section 20 and, thus, should not be subject to the revenue limit on bank-ineligible securities activities.

The private-placement market involves the placement of new issues of securities with a limited number of sophisticated purchasers in a nonpublic offering. In private-placement transactions, a financial intermediary acts solely as agent of the issuer in finding purchasers. The intermediary does not purchase the securities and then try to resell them.

Privately placed securities are *not* subject to the registration requirements of the Securities Act of 1933. Such securities are only offered to financially sophisticated institutions and individuals,[1] not to the public. The applicant stated that all of the individuals with whom the securities would be placed will qualify as ''accredited investors'' under SEC rules. The Board concluded that the subsidiary's private placement of debt and equity securities within the limits proposed did not involve the underwriting or public sale of securities and that the revenues from the proposed activities should not be subject to the 10 percent revenue limitation (25 percent, effective March 6, 1997) on bank-ineligible securities activities.

The Board noted that other limitations on the activity should ensure that securities would not be offered to the public. First, the applicant agreed that the subsidiary would not make any general solicitation or advertisement to the public regarding the placement of particular securities. Second, the minimum denomination of securities to be placed would be $100,000. Third, the applicant agreed that the subsidiary would not privately place securities that are registered under the Securities Act of 1933 and that the subsidiary would be compelled to honor all provisions of that act, particularly those that limit the scope of private placements to nonpublic transactions. Fourth, the subsidiary agreed not to privately place as agent the securities of investment companies which are sponsored or advised by the applicant or its subsidiaries. Fifth, the subsidiary will not purchase or repurchase for its own account the securities being placed or will not inventory unsold portions of such securities. Sixth, the applicant further agreed to consult with its Federal Reserve Bank staff before transferring its private-placement activities from the subsidiary to any other nonbank subsidiary of the applicant to ensure that the transfer did not evade any of the firewall provisions committed to.

1. The subsidiary would not only place securities with institutional customers but with individuals whose net worth (or joint net worth with a spouse) exceeds $1 million. Such placement activities with individuals would not, in the Board's opinion, result in a public offering.

3230.4.3 INCORPORATION OF PRIVATE-PLACEMENT NONBANKING ACTIVITIES INTO REGULATION Y

The Board has added the activity of acting as agent in the private placement of securities to the laundry list of nonbanking activities (see 12 C.F.R. 225.28(b)(7)(ii)). Regulation Y adopts the definition of private-placement activities that is used by the SEC and the federal securities laws. In taking this action, the Board removed all but one restriction on private placement. The remaining restriction prohibits a bank holding company from purchasing for its own account the securities being placed or holding in inventory unsold portions of issues of these securities. This restriction prevents a bank holding company from classifying its securities underwriting activities as private-placement activities.

3230.4.4 RISKLESS PRINCIPAL

''Riskless principal'' is a broker-dealer that, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a simultaneous sale to (or purchase from) the customer.

3230.4.4.1 Description of Riskless-Principal Transactions

When acting as a dealer, the securities firm maintains an inventory of securities for its own account and buys and sells securities as principal. Riskless-principal transactions are usually undertaken as an alternative method of executing orders by customers to buy or sell securities on an agency basis. In this situation, when a customer places an order to purchase securities that the broker-dealer does not maintain in its inventory, the firm must purchase the securities from a third party. At this point, the broker-dealer has the option of acting either as the agent for the customer or a riskless principal in making the purchase. If the decision is made to act as a riskless principal, the broker-dealer will purchase the securities from a third-party dealer at the dealer's "inside price" (confirming the transaction for its customer) and then, acting as principal, resell them to the customer, adding a markup over cost. If the broker-dealer does not complete the purchase of the securities ordered by the customer, it is not obligated to provide the securities.

3230.4.4.2 Underwriting and Riskless Principal

In riskless-principal transactions, the subsidiary would execute orders by an investor and would not act on behalf of an issuer of new securities. The subsidiary would not be involved in making any public offering of securities as agent for the issuer. Thus, these activities would not constitute underwriting for Glass-Steagall purposes.

3230.4.4.3 Summary of Board Action on Acting as Agent in Private Placement and as Riskless Principal in Buying and Selling Securities

The Board concluded that the securities underwriting and dealing of the subsidiary's riskless-principal activity did not constitute an underwriting of securities. The riskless-principal activity would not be a public sale or underwriting of securities and would not be viewed as a bank-ineligible securities activity for purposes of the current 25 percent revenue test. As a condition for the approval of the riskless-principal activity, the Board required the subsidiary to maintain specific records that would clearly identify such transactions so that examiners will be able to trace the resulting revenue. The riskless-principal activity was found to be closely related to banking. The Board further concluded that the placement activity differed only slightly in scope from those approved previously and that the operational limitations agreed to by the applicant would ensure that the subsidiary would not become involved in the public offering of any securities. The Board approved the application on October 30, 1989 (1989 FRB 829). (See also 1997 FRB 146; 1996 FRB 350, 748; 1995 FRB 49, 880, 1133; 1994 FRB 554, 1014; 1993 FRB 1166; 1992 FRB 294, 335, 552, 868; 1991 FRB 61; and 1990 FRB 26, 79, 545, 567, 568 (footnote 7), 653, 659, 663, 667, 672, 674, 766, 857, 864.)

3230.4.4.4 1996 Changes to the Underwriting Conditions for Riskless-Principal Activities

In connection with a bank holding company proposal considered by the Board on June 10, 1996, the Board reviewed the continued appropriateness of applying the underwriting conditions to the conduct of riskless-principal activities. In that case, the Board determined, based on its experience in monitoring and examining the conduct of riskless-principal activities by bank holding companies, that the underwriting conditions were not necessary to address identifiable adverse effects. Accordingly, the Board permitted the bank holding company to engage in riskless-principal transactions through a nonbank subsidiary without conducting this activity in accordance with the underwriting conditions (See 1996 FRB 748). The Board noted that riskless-principal transactions are essentially equivalent to securities brokerage transactions and, therefore, must be conducted in compliance with federal securities laws. The Board concluded that the definitional limitations (see section 225.28(b)(7)(ii) of Regulation Y) would be all that is needed to purchase (or sell) securities as a riskless principal. The conditions are designed to ensure that bank holding companies do not avoid the Glass-Steagall Act by classifying underwriting and dealing activities as riskless-principal activities. In the June 10 order, the bank holding company agreed that, if riskless-principal services were provided in combination with its advisory services, it would provide its customers with the disclosures established by the Board for full-service brokerage activities of bank holding companies. With respect to its decision, the Board decided to grant identical relief to other bank holding companies that had been previously approved to conduct riskless-principal nonbanking activities.

3230.4.4.5 Incorporation of Riskless-Principal Transactions into Regulation Y

As part of the Board's February 19, 1997, adoption of the final amendments to Regulation Y, it retained the requirement that riskless-principal transactions be conducted in the secondary market. It further determined to eliminate all but two restrictions with respect to riskless-principal transactions. A bank holding company may thus buy and sell in the secondary market all types of securities on the order of customers as a riskless principal, to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. This does not include—

1. selling bank-ineligible securities at the order of a customer that is the issuer of the securities, or selling in any transaction in which the bank holding company has a contractual agreement to place the securities as agent of the issuer; or
2. acting as riskless principal in any transaction involving a bank-ineligible security for which the bank holding company or any of its affiliates acts as an underwriter (during the period of the underwriting or for 30 days thereafter) or dealer. A bank holding company or its affiliates may not enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with the bank holding company's riskless-principal transactions, except that the company or its affiliate may enter bid or ask quotations, or publish ''offering wanted'' or ''bid wanted'' notices on trading systems other than NASDAQ or an exchange, if the company or its affiliate does not enter price quotations on different sides of the market for a particular security for any two-day period. (See 12 C.F.R. 225.28(b)(7)(ii).)

A BHC applied for the Board's approval, pursuant to section 4(c)(8) and 225.23(a) of the Board's Regulation Y, to acquire, through a securities brokerage subsidiary, a 49 percent interest in a joint venture partnership. The applicant was a one-bank holding company formed over a bankers' bank. The shareholders comprised several hundred banks. The joint venture partnership (the company) proposed to engage in the activity of acting as a municipal securities brokers' broker.[1] This consisted of providing municipal securities brokerage services to other registered securities brokers and dealers, including dealer banks. The company would act as an undisclosed agent in the purchase and sale of municipal securities, including revenue bonds, for the account of its customers.

The applicant's proposal involved the purchase and sale of municipal securities as agent only and did not include dealing or otherwise taking a position in such securities. The activity fell within the third-party securities activities permitted for member banks under section 16 of the Glass-Steagall Act (12 U.S.C. 24), which allows banks to purchase and sell securities "without recourse, solely upon the order, and for the account of, customers." National banks had been permitted to engage in the activity of acting as municipal securities brokers' brokers.

The Board found the activity to be functionally similar to the retail securities brokerage activities performed by banks for their customers as permitted under section 16 of the Glass-Steagall Act. The Board thus concluded that the activity was closely related to banking. The Board's approval of the order was based on several commitments made by the applicant and the other joint venturer. The Board approved the application by order on June 26, 1985 (1985 FRB 651).

1. Rule 15c3-1(a)(8)(ii) implementing section 15(c)(3) of the Securities and Exchange Act of 1934 defines a municipal securities brokers' broker as a "municipal securities broker or dealer who acts exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker dealer or registered municipal securities dealer" who has "no retail customers" and "maintains no municipal securities in its proprietary or other accounts." Municipal securities brokers' brokers are subject to the federal securities laws applicable to securities brokers and are governed by the rules of the Municipal Securities Rulemaking Board.

A foreign bank holding company (the applicant), and its wholly owned subsidiary (the company), a commercial banking organization located in New York state, applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y for prior approval to engage de novo on a domestic and international basis, through the company, in the following activities:

1. providing investment advisory services and financial advisory services, including advice regarding mergers, acquisitions, and capital-raising proposals by institutional customers, pursuant to section 225.28(b) of Regulation Y
2. providing securities brokerage services on an individual basis as well as in combination with investment advisory services (''full-service brokerage''), including exercising limited investment discretion on behalf of institutional customers
3. purchasing and selling all types of securities on the order of institutional and retail customers as a ''riskless principal''
4. engaging in securities credit activities under section 225.28(b)(6) of Regulation Y, including acting as a ''conduit'' or ''intermediary'' in securities borrowing and lending

The Board previously determined by regulation that engaging in the above-listed nonbanking activities (1) and (2) is closely related to banking under section 4(c)(8) of the BHC Act (see section 225.28(b)(6) and (7) of the Board's Regulation Y). The Board previously determined by order that, subject to certain prudential limitations, the proposed riskless-principal activities (item 3) are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. The applicant has committed that the company will conduct its riskless-principal activities using the same methods and procedures and subject to the same prudential limitations established by the Board in its orders that are found at 1989 FRB 829 and 1990 FRB 26.

Banks and BHCs are permitted to borrow and lend securities held in their own portfolios (see the FFIEC's 1985 Supervisory Policy Statement on Securities Lending, *Federal Reserve Regulatory Service* 3–1579.5). In this case, the applicant proposed that the company borrow and lend the securities of noncustomer third parties. The company would seek out counterparties to securities borrowing and lending transactions and would assume much the same risk in these transactions as if it was borrowing or lending its own securities or its customers' securities. In this capacity, it would act as a ''conduit'' or ''intermediary'' in securities borrowing and lending. The company would supply—upon the request of another broker-dealer who is unable to obtain securities needed to satisfy customer or investment or operational needs—securities not available in the company's accounts or customer accounts by seeking out third-party non-customer lenders. In addition to locating the securities, the company proposes to coordinate, on behalf of the borrower and lender, the exchange of securities and collateral that is necessary to the transaction.[1]

The Board, in its review of this application, believed that banks generally perform services that are operationally or functionally similar to the proposed conduit services. The proposed conduit activity was believed to be similar to the securities borrowing and lending activities that banks conduct. National and state banks are permitted to lend securities from their own portfolio, and with the customer's consent, from the accounts of customers, and banks regularly borrow securities to meet their needs and the needs of customers. The fact that a third party is substituted in place of a trust or other customer of a bank would not change significantly the way in which the securities lending activity would be conducted. The same steps and procedures that would be necessary to effectuate the loan of a customer's securities would be followed in loaning the securities of a noncustomer third party.

The risk associated with the proposed activity is the same risk that a bank would incur in managing the lending of securities from its own portfolio or the portfolio of a customer. The risk to the company, in acting as a conduit, is limited to ensuring that the collateral posted by the

1. The company agreed to coordinate this exchange through accounts established at a specifically named, privately held national clearinghouse for the settlement of transactions in corporate and municipal securities. Once the company had located the desired securities, the securities would be transferred to an account maintained by it at the clearinghouse and simultaneously delivered to an account of the borrower, also at that clearinghouse. At the same time, the borrower would be required to post collateral, which the company would receive into its clearinghouse account and simultaneously deliver to an account maintained by the lender at the clearinghouse.

borrower continuously reflects the market value of the securities loaned. The company committed to mark this collateral to market on a daily basis and to make calls for supplemental collateral where necessary.[2] The company also represented that it would not provide any indemnification to noncustomer third-party lenders of securities.

The Board determined, for the above reasons, that the proposed conduit activity is closely related to banking for the purposes of section 4(c)(8) of the BHC Act and approved the order on October 9, 1992 (1992 FRB 955).

The Board's approval was subject to the following specified conditions:

1. To minimize risk, the company is to act as a conduit only when the potential borrower and lender are matched before the transaction. In addition, it will take various measures to minimize operational risks, including conducting its conduit activities in accordance with the collateral requirements imposed on the borrowers by the Board's Regulation T.[3] A conduit transaction will commence only when a broker-dealer approaches the company and needs to borrow securities. Securities will not be borrowed in anticipation of a transaction.
2. At the end of each day, the company will mark to market the collateral posted by the borrower in all transactions in which it loaned securities or acted as an intermediary for a lender. As proposed, the company would establish credit lines for potential borrowers and lenders.[4]
3. The applicant committed that the company will conduct its conduit activities in compliance with the FFIEC Supervisory Policy Statement on Securities Lending (*Federal Reserve Regulatory Service* 3–1579.5).

2. If the price of the borrowed securities increases, the borrower is required under the Board's Regulation T to provide additional collateral to the company. The company, in turn, through transactions at the clearinghouse, will pass the collateral to the initial lender of the securities. If the borrower is unable to satisfy this requirement, the company is to have the contractual right to terminate the borrowing transaction by purchasing the securities in the open market and delivering them to the lender, who will then be obligated to return the borrower's collateral to the company. Because the borrowed securities will be marked to market daily by the company, the maximum exposure to the company in directly or indirectly borrowing or lending securities is one day's change in the price of the borrowed securities.

3. The applicant committed that the Board's Regulation T—which requires that all securities borrowing and lending transactions be collateralized by at least 100 percent of the value of the securities as computed on a daily basis—shall be the company's minimum guideline for posting collateral, and that the company will require many transactions to be collateralized in excess of 100 percent of the value of securities marked to market.

4. These credit policies are to include a review of all lenders and borrowers and the establishment of a credit committee that will determine limits on the credit exposure of any single borrower. The applicant proposed that the company would transact its business only with a select group of well-capitalized broker-dealers that will not be brokerage customers of the company.

The Board has authorized bank holding company subsidiaries to engage in investment or trading transactions as principal to underwrite and deal in certain securities and money market instruments that are eligible for bank underwriting and dealing by state member banks. Basically, the Board has subjected dealer subsidiaries to the same restrictions that govern underwriting and dealing by state member banks pursuant to 12 U.S.C. 24 and 335. Permissible activities include underwriting and dealing in type I securities as defined in 12 C.F.R. 1, including obligations of the United States, general obligations of states and their political subdivisions,[1] and type I municipal bonds; type II securities as defined in 12 C.F.R. 1, including, in part, municipal revenue obligations for housing, university, or dormitory purposes that do not qualify as type I securities; and banker's acceptances and certificates of deposit. In addition, such dealer subsidiaries are subject to the applicable capital restrictions (10 percent of the lead bank's capital and surplus) on dealing in type II securities in 12 C.F.R. 1.7. These underwriting and dealing activities were added to the permissible activities section of Regulation Y, effective February 6, 1984. Furthermore, dealer subsidiaries are permitted to furnish investment advice with respect to these bank-eligible securities.

The Board has authorized bank-affiliated securities dealers to underwrite, deal in, or privately place type III securities in separately capitalized nonbank subsidiaries subject to prudential limitations and restrictions to preclude such subsidiaries from being principally engaged in the underwriting and distribution of securities. In addition, the Board has authorized broker-dealer subsidiaries and brokerage subsidiaries to privately place any type of debt or equity security.

3240.0.1 HISTORY OF BOARD APPROVALS OF UNDERWRITING AND DEALING IN GOVERNMENT OBLIGATIONS AND MONEY MARKET INSTRUMENTS

On February 27, 1978, the Board approved an application to engage de novo in underwriting and dealing activities then being conducted by the bank holding company's only subsidiary bank. Thus, the formation of the subsidiary transferred these operations from the bank to the nonbank subsidiary. The activity included the underwriting and dealing in obligations of the United States and general obligations of various states and of political subdivisions. The Board determined that this activity is closely related to banking. The Board also approved, on February 27, 1978, another application of a bank holding company that would permit it to retain shares in a firm engaged in U.S. government securities underwriting activities.

On March 20, 1979, the Board approved an application of a bank holding company to acquire a company that would engage de novo in the activities of underwriting and dealing in certain government and municipal securities and in providing portfolio investment advice to individuals, associations, corporations, state and local governments, and financial institutions (''nonbank entities'') and to unaffiliated commercial banks. The Board determined that the proposed activities were closely related to banking.

On March 2, 1982, the Board approved an application of a bank holding company to form an incorporated securities company subsidiary that would engage de novo in the activities of soliciting, underwriting, dealing in, purchasing, and selling obligations of the United States, general obligations of various states, and money market instruments such as banker's acceptances and certificates of deposit. The Board regarded the government securities activities that the bank holding company proposed to engage in as substantially the same as the activities that the Board had approved in previous orders. Insofar as its proposal to deal in banker's acceptances, certificates of deposit, and other money market instruments that state member banks may from time to time be authorized to underwrite and deal in (such instruments are not regarded as ''securities'' subject to the prohibitions in sections 16 and 21 of the Glass-Steagall Act), the Board regarded such activities as closely related to banking because banks engage in such functions. The Board's approval of the bank holding company's application was subjected to the same restrictions and prudent limitations as if the activity were conducted in the affiliate's lead bank. For example, the nonbank subsidiary could not underwrite, deal in, or hold type II

1. The Gramm-Leach-Bliley Act authorized well-capitalized state member banks to deal in, underwrite, purchase, and sell all type I municipal securities and revenue bonds without any limitations relative to the bank's capital. See section 2020.1 of the *Commercial Bank Examination Manual* and SR-01-13.

securities of any issuer in amounts that would not be permitted if such activities were conducted by the subsidiary national bank, nor would it be permitted to sell securities to trust accounts of affiliated banks, except as permitted by regulations of the Comptroller of the Currency. Type II securities can consist of certain types of public housing and dormitory bonds of states and municipalities. The amount of such securities, of a single issue held by the bank, may not exceed 10 percent of the bank's capital and surplus (12 U.S.C 24 (seventh) and (12 C.F.R. 1.3(d)). The Board further ruled that any purchase of securities from the bank holding company's nonbank subsidiary by any of the bank holding company's subsidiary banks at other than current market values would constitute an unsafe or unsound practice.

3240.0.2 ADDING THE ACTIVITY TO REGULATION Y

Effective February 6, 1984, underwriting and dealing in U.S. government obligations and certain money market instruments was added to the list of permissible activities of Regulation Y. The regulation, which was amended in 1997, continues to place the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks. (See Section 225.28(b)(8)(i) of Regulation Y.)

3240.0.3 REGULATION OF DEALER ACTIVITIES

While municipal securities dealers and dealers in government/agency securities are required to register as broker-dealers pursuant to the Securities Exchange Act of 1934, there are at present no registration requirements for firms that deal only in money market instruments. Regardless of whether a bank holding company subsidiary is registered as a broker-dealer with the Securities and Exchange Commission (SEC), Federal Reserve System examiners will conduct inspections to determine whether the subsidiary is in compliance with the provisions of Regulation Y or any specific conditions in a bank holding company order pertaining to the organization under inspection. In addition, examiners will need to focus on financial, managerial, and safety-and-soundness considerations in any bank holding company dealer subsidiary. In the event a firm is a registered broker-dealer subject to examination by the National Association of Securities Dealers (NASD), the inspection should be designed to prevent duplication of effort, relying on work performed by NASD examiners to the greatest extent possible, yet still evaluate the factors discussed above that are relevant for either registered or unregistered dealers.

Effective May 20, 1985, the Federal Reserve Bank of New York adopted a *Capital Adequacy Guideline for U.S. Government Securities Dealers.* The Federal Reserve Bank of New York recommends that U.S. government securities dealers that are not subject to federal oversight agree to comply voluntarily with the capital adequacy guideline. Hence, it is expected that any government securities dealer subject to System inspection will comply with the SEC's Uniform Net Capital Rule (17 C.F.R. 240.15c3-1).

3240.0.4 DEALER ACTIVITIES

A firm operates as a dealer when it underwrites or deals in securities or money market instruments. Those activities are usually distinguished as separate activities from normal investment activities. If the firm holds itself out to other dealers or investors as a dealer or engages in a repetitive pattern of short-term purchases and sales, the firm may be engaged in dealer activities, regardless of its stated investment activities.

As noted previously, when the Board added to the Regulation Y list of permissible activities the activities of underwriting and dealing in U.S. government securities, certain money market instruments, and municipal securities, the Board added a restriction that such nonbank activities be subject to the same restrictions as securities and money market instrument activities of member banks. Accordingly, the following discussion focuses upon *permissible securities activities of all member banks.*

3240.0.5 GOVERNMENT AND MUNICIPAL SECURITIES

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 U.S.C. 24). That authority is restricted by limitations on percentage holding of classes of securities as found in 12 C.F.R. 1.3. That regulation allows banks to deal in, underwrite, purchase, and sell type I securities without limit and type II securities limited to 10 percent of its capital and unimpaired surplus. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. (See section 2020.1 of the *Commercial Bank Examination Manual* for further information on type I, II, and III securities.)

There are three major types of securities transactions in which banks are involved. First, the bank may buy and sell securities on behalf of a customer. Those are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. Second, as a dealer, the bank buys and sells securities for its own account. That is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction. The third type of securities transaction frequently executed by banks is a contemporaneous ''riskless-principal trade.'' The dealer buys and sells qualified securities as a principal, with the purchase and sale originating almost simultaneously. Exposure to market risks is limited by the brief period of actual ownership, and profits result from dealer-initiated markup, the difference between the purchase and sale prices.

Dealers' securities transactions involve customers and other securities dealers. The word ''customer,'' as used in this section, means an investor. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes. The following subsections include general descriptions of significant areas of permissible trading and underwriting activities.

3240.0.6 U.S. GOVERNMENT SECURITIES TRADING

U.S. government security trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. The size of a transaction, the dealer efforts extended, and the nature of the security are common factors that affect the markup differential. Markups on government securities generally range between one and four thirty-seconds of a point. Long maturity issues may have higher markups.

The market risk inherent in U.S. government trading portfolios should be controlled by policy. Standards should be established to limit the total securities inventory and the amount of securities with similar yield or maturity characteristics. Limits imposed by policy should include commitments to purchase new governments on a when-issued basis.

Payments for and deliveries of U.S. government and most agency securities are settled on the business day following the trade. Government dealers and customers can negotiate same-day or delayed settlement for special situations, but the industry recognizes standard settlement as occurring on the trade date plus one business day.

3240.0.6.1 ''When-Issued'' Trading

A significant source of risk to dealers involves ''when-issued'' (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security issuance and payment date. The Dealer Surveillance Staff at the Federal Reserve Bank of New York began to require WI position reports from primary government securities dealers and request voluntary WI reports from certain other government securities dealers in 1984. At the time the reporting requirements were adopted, a senior official stated, ''The opportunity to trade with several dealers simultaneously without making payment could result in trading losses which exceed a participant's ability to settle.'' In essence, the fact that settlement date can extend to almost two weeks—as opposed to the ordinary next-day settlement—presents an opportunity for firms to engage in a large volume of trading without drawing on the firm's ability to purchase securities or effect delivery against short positions. Hence, there is increased credit risk in such transactions. Consequently, the dealer's trading position limits should include WI limits to protect against the increased credit risk associated with WI trading.

3240.0.6.2 Due Bills

A ''due bill'' is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and, alternatively, due bills received should be considered as lending transactions.

Registered broker-dealers are subject to the SEC's rule 15c3-3 (17 C.F.R. 240.15c3-3), ''Customer Protection—Reserves and Custody of Securities.” Basically, this rule states the principle that a broker-dealer needs to safeguard customer assets and cannot use such assets to fund its own business activities. While this rule is not directly applicable to unregistered U.S. government securities or money market instrument dealers, the principle is transferable. Dealers should not issue due bills as a means of obtaining operating funds or where the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe the collateral, if any, securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

3240.0.6.3 Clearance

Securities clearance services for the bulk of U.S. government and federal-agency security transactions are provided by the Federal Reserve as part of its telegraphic securities transfer system. The various Federal Reserve Banks will wire transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve’s systems also are used to facilitate security borrowings, loans, and pledges. Hence, the securities firm will need to use the services of a clearing bank.

3240.0.6.4 Short Sales

Another area of U.S. government security activity involves short-sale transactions. A short sale is the sale and delivery of a security that the seller does not own. It is accomplished by borrowing the security for delivery. The borrowed security is collateralized by an appropriate amount of a similar security. Short sales are conducted to accommodate customer orders, to obtain funds by leveraging existing assets, to hedge the market risk of other assets, or with the expectation that the market price of the sold security will decline sufficiently to allow the bank to complete the transaction by purchasing an equivalent security at a later date and a lower price.

3240.0.6.5 Arbitrage

Arbitrage is the coordinated purchase and sale of two securities or of a security and a futures or options contract in which there is a relative market imbalance. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage opportunities take many forms and can exist whenever segments of the securities markets are subject to a yield variance.

Exposure on arbitrage and/or short sales should be closely monitored for compliance with predetermined objectives. Risk should be controlled by point-spread limits coordinated with stop-loss buy provisions or sell provisions and by guidelines on the length of time a short position can remain uncovered.

3240.0.7 MONEY MARKET TRADING

Aside from short-term securities, banks customarily trade a substantial volume of other money market instruments such as banker’s acceptances. It should be noted that the Supreme Court has opined that commercial paper is a Glass-Steagall security.

3240.0.7.1 Banker’s Acceptances

Banker’s acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year.

3240.0.7.2 Certificates of Deposit

Negotiable certificates of deposit (CDs) issued by money-center banks are actively traded in denominations of $100,000 to $1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like domestic CDs except their yields are usually higher and their maturities often longer.

Money market instruments trade with the same-day or one-day settlement. Publicly quoted yields or dollar prices are usually based on round lot trades of $1 million, except for commercial paper, which trades in round lots of $250,000. Odd-lot prices may vary, but because of the large dollar volume of most trades, the percentage spread between the acquisition cost and sale price is characteristically modest.

Management should attempt to minimize market risk by establishing a maximum holding limit for each class of money market instrument. Policy guidelines also should establish concentration limits for money market instruments issued by a single obligor. Such limits should include commitments.

A sound money market trading policy recognizes the need for a qualitative analysis of the issuers of instruments. Credit approvals should be obtained before trading in CDs and acceptances, and reviews should be conducted on a regular schedule.

Banks dealing in money market instruments are subject to a number of legal restrictions. The sale of federal funds by a member bank to a bank affiliate is limited under section 23A (12 U.S.C. 371(c)) and subject to the restrictions of section 23B of the Federal Reserve Act (12 U.S.C. 371(c-1)). The acquisition, as principal, of a certificate of deposit issued by an affiliate bank also is subject to section 23A limitations and section 23B restrictions. These restrictions do not apply to transactions between bank subsidiaries that are 80 percent or more commonly owned by a bank holding company. These transactions must be conducted on terms that are consistent with safe and sound banking practices.

3240.0.8 REPURCHASE AGREEMENTS AND SECURITIES LENDING

The overwhelming majority of a government security dealer's inventory is financed by repurchase agreements. In addition, many dealers operate a "matched book" repo operation whereby they finance the acquisition or carrying of securities by customers through reverse repurchase agreements and contemporaneously obtain funding for such transactions through the sale of the same or similar securities under a repurchase agreement. In addition, securities dealers often lend or borrow specific issues to effect delivery against short positions or because of failure to receive securities required to be delivered. For prudential guidelines that have been issued to financial institutions in connection with repurchase agreements and securities lending, see the FFIEC supervisory policy statements at sections 2140.0 and 2150.0, which have been adopted by the Federal Reserve Board.

Firms enter into "reverse repos" to finance the U.S. government securities inventory of other dealers or mortgage bankers who have originated pools of mortgages to back federal housing agency securities. Repos are sold to customers in lieu of certificates of deposit. Customers find them attractive because interest can be paid on repos having maturities of less than seven days and because customer funds are collateralized by the security underlying the repurchase transaction.

The rate of interest received and paid is generally dictated by prevailing market rates. Profits are based on a modest positive spread between interest earned and interest paid. A dealer may attempt to improve that modest profit by increasing the volume of such transactions, using the proceeds to finance or pyramid the acquisition of reverse repos or securities to be used in additional repo arrangements.

A common dealer strategy is to vary resale and repurchase maturities in anticipation of interest-rate movements. If an upward rate trend is expected, the dealer will attempt to lock in a cheaper source of funds at the current low rate by negotiating longer maturities for repos and shorter maturities for reverse repos. Conversely, if interest rates are expected to decline, the dealer attempts to negotiate longer-maturity reverse repos to ensure continuing higher earnings, while negotiating shorter-maturity repos to take advantage of cheaper future sources of funds. Care should be taken to limit exposure by instituting policy guidelines that—

1. limit the aggregate amounts of reverse repo and repo positions,
2. specify acceptable amounts of funds for unmatched or extended maturity transactions,
3. determine maximum time gaps for unmatched maturity transactions and minimally acceptable interest-rate spreads for various maturity agreements, and
4. follow the prudential guidelines in the FFIEC's policy statement on repurchase agreements and securities lending. (See sections 2140.0 and 2150.0.)

3240.0.9 POLICY SUMMARY

The legal responsibilities of directors require that they ensure that dealer activities are conducted on a sound and legal basis that can only be accomplished if the directors endorse a written trading policy that addresses each area of market and legal risk. Written policy guidelines should be distributed to each individual engaged in trading activities.

3240.0.10 SCOPE OF THE INSPECTION

The scope of inspection will vary depending on the types of securities or money market instrument underwriting, dealing, and brokerage activities conducted by the subsidiary. Examiners may encounter situations in which a securities subsidiary is an SEC-registered broker-dealer because the subsidiary also executes transactions in municipal securities.

Registered broker-dealers are required to become members of the NASD or some other "self-regulatory organization." To avoid unnecessary regulatory overlap, examiners can rely on the NASD's compliance examination with respect to investor protection, including compliance with rules of the SEC, NASD, and Municipal Securities Rulemaking Board (MSRB), and the Board's Regulation T governing securities credit (if applicable). Consequently, in commencing such an inspection, examiners should begin by requesting and reviewing the NASD's most recent examination letter to the broker-dealer and serious violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits). Significant violations that have not yet been corrected should be noted in the bank holding company report.

Federal Reserve examiners retain responsibility for inspecting certain areas of registered broker-dealer operations regardless of whether the NASD reviews them. Specifically, System examiners should still evaluate management, financial results, and safety-and-soundness considerations, including internal controls. In addition, examiners still need to verify that registered broker-dealer subsidiaries comply with the provisions of Regulation Y, section 225.28(b)(8)(i), or specific Board orders pertaining to the firm under inspection. Finally, the examiner should be prepared to review in-depth any activities or money market instruments that are not securities that might not have been reviewed by the NASD because the activities are outside their scope of examination.

3240.0.11 INSPECTION OBJECTIVES

1. To determine if the policies, practices, procedures, and internal controls regarding dealer activities are adequate.
2. To determine if officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit-compliance functions.
5. To determine compliance with applicable laws and regulations, including 12 C.F.R. 225.28(b)(8)(i).
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.

3240.0.12 INSPECTION PROCEDURES

1. Review the adequacy of the dealer's internal controls. (See section 3240.0.13.)
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the inspection.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal and External Audits," and determine if corrections have been accomplished.
4. Obtain a copy of the latest letter received from the self-regulatory organization responsible (if applicable) for examining broker-dealer activities of this subsidiary.
5. Request that the firm provide the following schedules:
   a. aged schedule of securities that have been acquired as a result of underwriting activities
   b. aged schedule of trading-account securities and money market instruments held for trading or arbitrage purposes, which should reflect commitments to purchase

and sell securities and all joint-account interests

c. schedule of short-sale transactions
d. aged schedule of due bills
e. list of bonds borrowed
f. aged schedule of "fails" to receive or deliver securities on unsettled contracts
g. schedule of approved securities borrowers and approved limits
h. schedule of loaned securities
i. schedule detailing account names and/or account numbers of the—
   - affiliated banks' permanent portfolio accounts;
   - personal accounts maintained at the firm by its employees;
   - accounts of brokers or other dealers; and
   - personal accounts of employees of other brokers, dealers, or municipal securities dealers
j. list of all joint accounts entered into since the last examination
k. list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid
l. list of all financial advisory relationships

6. Compare balances of appropriate schedules to the general ledger and review reconciling items for reasonableness.
7. Determine the extent and effectiveness of trading-policy supervision by—
   a. reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee,
   b. determining that proper authorization for the trading officer or committee has been made,
   c. ascertaining the limitations or restrictions on delegated authorities,
   d. evaluating the sufficiency of analytical data used in the most recent board or committee trading-department review,
   e. reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law, and
   f. reaching a conclusion about the effectiveness of director supervision of the trading policy. Prepare a memo for the examiner assigned "Duties and Responsibilities of Directors" stating your conclusions. All conclusions should be supported by factual documentation.

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)

8. Ascertain the general character of underwriting and direct-placement activities and ascertain the effectiveness of department management by reviewing underwriter files and ledgers, committee reports, and offering statements to determine—
   a. the significance of underwriting activities and direct placements of securities as reflected by the volume of sales and profit or loss on operations (compare current data to comparable prior periods);
   b. whether there is a recognizable pattern in—
      - the extent of analysis of material information relating to the ability of the issuer to service the obligation,
      - rated quality of offerings,
      - point spread of profit margin for unrated issues,
      - geographic distribution of issuers, and
      - syndicate participants, and
   c. the volume of outstanding bids. Compare current data to comparable prior periods.
9. Determine the general character of trading-account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets, and position records for various categories of trading activity and determining—
   a. the significance of present sales volume compared to comparable prior periods and departmental budgets;
   b. whether the firm's objectives are compatible with the volume of trading activity;
   c. significant inventory positions taken since the prior examination and determining if—
      - the quality and maturity of the inventory position was compatible with prudent practices, and
      - the size of the position was within prescribed limits and compatible with a sound trading strategy
   d. the exposure on offsetting repurchase transactions by—
      - reviewing the maturities of offsetting "repo" and "reverse repo" agreements to ascertain the existence, duration, amounts, and strategy used to manage unmatched maturity "gaps" and extended (over 30 days) maturities;
      - reviewing records since the last inspection to determine the aggregate amounts of—

— matched repurchase transactions and
— "reverse repo" financing extended to one or related firms(s); and
- performing credit analyses of significant concentrations with any single or related entities.

10. Determine the extent of risk inherent in trading-account securities which have been in inventory in excess of 30 days.
    a. Determine the dollar volume in extended holdings.
    b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.
    c. Determine the current market value for individual issues which show an internal valuation markdown of 10 percent or more.
    d. Perform credit analyses on the issuers of nonrated holdings identified as significant positions.
    e. Perform credit analyses on those issues with valuation writedowns considered significant relative to the scope of trading operations.
    f. Discuss plans for disposal of slow-moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.
11. Using an appropriate technique, select issues from the schedule of trading-account inventory. Test valuation procedures by—
    a. reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed;
    b. comparing dealer-prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date "bid" prices); and
    c. investigating any price differences noted.
12. Using an appropriate technique, select transactions from the schedule of short sales and determine—
    a. the degree of speculation reflected by basis-point spreads,
    b. present exposure shown by computing the cost to cover short sales, and
    c. if transactions are reversed in a reasonable period of time.
13. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items (fail to receive securities and fail to deliver securities) that are a week or more beyond settlement date and determine—
    a. the amount of extended fails,
    b. the planned disposition of extended fails,
    c. if the control system allows a timely, productive follow-up on unresolved fails,
    d. the reasons for cancellations, and
    e. the planned disposition of securities that have been inventoried before the recognition of a fail or a cancellation.
14. Determine compliance with applicable laws, rulings, and regulations by performing the following:
    a. *12 C.F.R. 1.3—eligible securities.*
       - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the affiliated lead bank's capital and unimpaired surplus are type I securities.
       - Determine that the total par value of type II investments does not exceed 10 percent of the affiliated lead bank's capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
       - Elicit management's comments and review underwriting records on direct placement of type II securities and determine if the broker-dealer is dealing or engaging in impermissible direct placement of type III securities.
    b. *Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371(c) and 375)—preferential treatment.* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, including securities-clearance services, involving affiliates, insiders, or their interests are on terms less favorable to the bank than those transactions involving unrelated parties.
15. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by—
    a. reviewing transactions, including U.S. government tender-offer subscription files, involving employees and directors of dealer or other banks, and determining if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans,
    b. reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an addi-

tional markup and that gains were not recognized a second time,

c. reviewing securities position records and customer ledgers with respect to large-volume repetitive purchase and sales transactions and—
   - independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties, and
   - investigating the purchase of large blocks of securities from dealer firms just prior to month-end and their subsequent resale to the same firm just after the beginning of the next month

d. reviewing customer-complaint files and determining the reasons for such complaints.

16. Discuss with an appropriate officer and prepare report comments concerning—
    a. the soundness of trading objectives, policies, and practices;
    b. the degree of legal and market risk assumed by trading operations;
    c. the effectiveness of analytical, reporting, and control systems;
    d. violations of law;
    e. internal control deficiencies;
    f. apparent or potential conflicts of interest; and
    g. other matters of significance.
17. Reach a conclusion regarding the quality of department management and state your conclusions on the appropriate inspection report pages.
18. Update workpapers with any information that will facilitate future inspections.

3240.0.13 REVIEW OF INTERNAL CONTROLS

As a part of carrying out the inspection procedures for this activity, the examiner is expected to review the dealer's system of internal controls. The examiner should concentrate the internal controls review on the policies, practices, and procedures of the firm.

The system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. *Items marked with asterisks require substantiation by observation or testing.*

3240.0.13.1 Securities Underwriting Trading Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that—
   a. outline objectives?
   b. establish limits and/or guidelines for the following:
      - price markups?
      - quality of issues?
      - maturity of issues?
      - inventory positions (including when-issued (WI) positions)?
      - amounts of unrealized loss on inventory positions?
      - length of time an issue will be carried in inventory?
      - amounts of individual trades or underwriter interests?
      - acceptability of brokers and syndicate partners?
   c. recognize possible conflicts of interest and establish appropriate procedures regarding—
      - deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
      - deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
      - transfers made between trading-account inventory and affiliated investment portfolio(s)?
      - the affiliated bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
   d. state procedures for periodic, monthly or quarterly, valuation of trading inventories to market value?
   e. state procedures for periodic independent verification of valuations of the trading inventories?
   f. outline methods of internal review and reporting by department supervisors and internal auditors to ensure compliance with established policy?
   g. identify permissible types of securities?
2. Are the underwriting/trading policies reviewed at least quarterly by the board of directors to determine their adequacy in light of changing conditions?

3. Is there a periodic review by the board to ensure that the underwriting/trading department is in compliance with its policies?

3240.0.13.2 Offsetting Resale and Repurchase Transactions

1. Has the board of directors, consistent with its duties and responsibilities, adopted written offsetting repurchase transaction policies that—
   a. limit the aggregate amount of offsetting repurchase transactions?
   b. limit the amounts in unmatched or extended (over 30 days) maturity transactions?
   c. determine maximum time gaps for unmatched maturity transactions?
   d. determine minimally acceptable interest-rate spreads for various maturity transactions?
   e. determine the maximum amount of funds to be extended to any single or related firms through "reverse repo" transactions involving unsold (through forward sales) securities?
   f. require firms involved in reverse repo transactions to submit corporate resolutions stating the names and limits of individuals who are authorized to commit the firm?
   g. require submission of current financial information by firms involved in reverse repo transactions?
   h. provide for periodic credit reviews and approvals for firms involved in reverse repo transactions?
   i. specify types of acceptable offsetting repurchase transaction collateral?
   j. require receipt of assurance letters that unregulated securities dealers comply with the Federal Reserve Bank of New York's "Capital Adequacy Guideline for U.S. Government Securities Dealers?"
2. Are written collateral-control procedures designed so that—
   a. collateral assignment forms are used?
   b. collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner, and are registered securities registered in the dealer or dealer's nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse repo transactions?
   c. funds are not disbursed until reverse repo collateral is delivered into the physical custody of the dealer or an independent safekeeping agent?
   d. funds are only advanced against predetermined collateral margins or discounts?
   e. collateral margins or discounts are predicated upon the following:
      - the type of security pledged as collateral?
      - maturity of collateral?
      - historic and anticipated price volatility of the collateral?
      - creditworthiness of the counterparty?
      - maturity of the reverse repo agreements?
      - accrued interest?
   f. maintenance agreements are required to support predetermined collateral margin or discount by daily mark to market of repurchase agreement securities?
   g. maintenance agreements are structured to allow for obtaining additional securities or cash calls in the event of collateral price declines?
   h. collateral market value is frequently checked to determine compliance with margin and maintenance requirements?

3240.0.13.3 Custody and Movement of Securities

*1. Are the dealer's procedures such that persons do not have sole custody of securities in that—
   a. they do not have sole physical access to securities?
   b. they do not prepare disposal documents that are not also approved by authorized persons?
   c. for the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
   d. no person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
2. Are securities physically safeguarded to prevent loss, unauthorized disposal, or use?
   a. Are negotiable securities kept under dual control?
   b. Are securities counted frequently on a surprise basis and reconciled to the securities record? Are the results of such counts reported to management?
   c. Does the dealer periodically test for

compliance with provisions of its insurance policies regarding custody of securities?

d. For securities in the custody of others—
   - are custody statements agreed periodically to position ledgers, and any differences followed up to a conclusion?
   - are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
   - are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?

3. Are trading-account securities segregated from other dealer-owned securities or securities held in safekeeping for customers?

*4. Is access to the trading-securities vault restricted to authorized employees?

5. Do withdrawal authorizations require countersignature to indicate security count verifications?
6. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?
7. Are prenumbered forms used to control securities trades, movements, and payments?
8. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?
9. Do alterations to forms governing the trade, movement, and payment of securities require—
   *a. signature of the authorizing party?
   b. use of a change-of-instruction form?
10. With respect to negotiability of registered securities—
    a. are securities kept in non-negotiable form whenever possible?
    b. are all securities received and not immediately delivered transferred to the name of the dealer or its nominee and kept in non-negotiable form whenever possible?
    c. are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

3240.0.13.4 Purchase and Sales Transactions

1. Are all transactions promptly confirmed in writing to the actual customers or dealers?
2. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)? Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
3. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated? Are comparisons approved by a designated individual?

3240.0.13.5 Customer and Dealer Accounts

1. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
2. Are letters mailed to customers requesting confirmation of changes of address?
3. Are separate customer-account ledgers maintained for—
   a. employees?
   b. affiliates?
   c. affiliated bank's trust accounts?
4. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

3240.0.13.6 Other

1. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
2. Are subsidiary records reconciled, at least monthly, to the appropriate general-ledger accounts, and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
3. Are fails to receive and deliver under a separate general-ledger control?
   a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?

b. Are periodic aging schedules prepared?
c. Are stale fail items confirmed and followed up to a conclusion?
d. Are stale items valued periodically, and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?

4. With respect to securities loaned and borrowed positions—
   a. are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
   b. are positions confirmed periodically?
   c. are all policies and procedures in conformance with the FFIEC policy on securities lending contained section 2140.0?

3240.0.14 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Authorization for state member banks of the Federal Reserve System to underwrite and deal in obligations of the United States, various states, and political subdivisions and other authorized obligations for state member banks	24 (7), 335	250.120 250.121 250.122 250.123 250.142	3–414.94 3–414.95 3–414.96 3–414.97 3–415.2 2–425.11	
Initial October 19, 1976, order stating that the activity of underwriting and dealing in certain government and municipal securities was closely related to banking			41 *Federal Register* 47083 (1976)	
Order approving application to engage de novo in underwriting and dealing in municipal securities				1978 FRB 222
Order approving application of a BHC that would permit it to retain shares in a government and municipal securities dealer to engage in underwriting government securities				1978 FRB 222 1978 FRB 223
Order approving application of a BHC to acquire a company that would engage de novo in underwriting and dealing in government and municipal securities and providing investment portfolio advice to associations, state and local governments, and financial institutions ("nonbank entities"), and to unaffiliated banks				1979 FRB 363

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Order approving an application of a BHC to form an incorporated securities company that would engage de novo in the activities of underwriting and dealing in, purchasing, and selling U.S. government and municipal obligations, and money market instruments such as banker's acceptances and certificates of deposit. Securities company limited to permissible BHC activities.				1982 FRB 249
Adding of the activity to the list of permissible activities per Regulation Y		225.28(b)(8)(i)		1984 FRB 121 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

4(c)(8)—Agency Transactional Services (Futures Commission Merchants and Futures Brokerage) Section 3250.0

A futures commission merchant (FCM) is an entity referred to in the Commodity Exchange Act to denote a registered firm that is in the business of soliciting or accepting orders, as broker, for the purchase or sale of any exchange-traded futures contract and options thereon. For the purposes of this examiner guidance, the term ''FCM activities'' is used in a broad context and refers to all futures brokerage activities, operations, and their associated risks that are subject to the Federal Reserve System's supervision. In connection with these activities, banking organizations may hold customer funds, assets, or property and may be members of futures exchanges and their associated clearinghouses. They may also offer related advisory services as registered commodity trading advisers (CTAs). The guidance addresses the expanding scope of futures activities conducted by different types of banking organizations worldwide and implements supervisory initiatives to effect more risk-focused and burden-sensitive approaches to the supervision of FCM activities. The guidance is designed to help examiners (1) assess how well a consolidated financial organization manages one or more discrete futures brokerage operations and (2) make a broader assessment of the organization's overall risk management.

The guidance pertains to FCM subsidiaries of bank holding companies (BHCs), but it is also applicable to FCM subsidiaries of state member banks, Edge Act corporations, and foreign banking organizations. It addresses the broader scope of permissible futures brokerage activities articulated within Regulation Y[1] and, by extension, in Regulation K, and focuses on the adequacy of management and the management processes used to control the credit, market, liquidity, reputation, and operations risks entailed in these activities, including brokerage, clearing, funds management, and advisory services.

The guidance takes a global line-of-business supervisory approach to the inspection of FCM activities rather than using the traditional full-scope inspections of individual FCM subsidiaries, many of which are primarily supervised by functional regulators. Reviews and reports of functional regulators should be used to the fullest extent when planning and conducting inspections of FCM activities of bank holding companies and other banking organizations to avoid duplication and minimize supervisory burdens. However, in conducting an inspection of various aspects of an FCM's activities, a review of various functions, derived from a sample of the organization's FCM subsidiaries, may be necessary and appropriate to determine the extent of the risks these operations pose to the banking organization and to determine whether management of those risks is satisfactory. The examiner should pay particular attention to activities conducted in FCM subsidiaries that have not been subject to a regular inspection by their functional regulator and to FCM activities of foreign affiliates in which there is uncertainty concerning the level of local supervision.

BHC subsidiaries, banks (generally through operating subsidiaries), Edge Act corporations, and foreign banking organizations (FBOs) operating in the United States may operate futures brokerage and clearing services involving a myriad of financial and nonfinancial futures contracts and options on futures. These activities can involve futures exchanges and clearinghouses throughout the world. In general, most organizations conduct these activities as FCMs.

The Federal Reserve has a supervisory interest in ensuring that the banking organizations subject to its oversight conduct their futures brokerage activities in a safe and sound manner consistent with Regulations Y and K (and with any terms and conditions in Board orders for a particular organization). Accordingly, a review of futures brokerage activities is an important element for inspections of BHCs, examinations of state member banks, and reviews of FBO

1. The Board broadened the scope of permissible FCM nonbanking activities for a bank holding company with the revision of Regulation Y, effective April 21, 1997. For example, the following activities are permissible:

- Derivative contracts can be executed and cleared on a broad range of nonfinancial commodities.
- Derivative contracts can be cleared without simultaneously providing execution services. Likewise, execution services can be provided without also providing clearing services.
- Foreign-exchange transactional services can be provided in the same FCM subsidiary that provides advice regarding foreign exchange.
- Bank holding companies can engage in FCM activities through a section 20 subsidiary.
- An FCM nonbanking subsidiary can trade for its own account.
- An FCM nonbanking subsidiary may act on exchange-traded futures contracts and on options on futures contracts based on a financial or nonfinancial commodity.
- A bank holding company may combine FCM activities and incidental activities. For example, FCM activities may be combined with futures-related financing to customers, such as financing to cover margin obligations (note: such financing may be prohibited by some exchanges).

operations. The following guidance on evaluating the futures brokerage activities of bank holding company subsidiaries, branches and agencies of foreign banks operating in the United States, or any operating subsidiaries of state member banks provides a list of procedures that may be used to tailor the scope of an inspection of these activities.

3250.0.1 SCOPE OF GUIDANCE

Examiners are to use a risk-based inspection approach to evaluating FCM activities—including brokerage, clearing, funds management, and advisory activities. Significant emphasis should be placed on evaluating the adequacy of management and the management processes used to control the credit, market, liquidity, legal, reputation, and operations risks entailed in these operations. Both the adequacy of risk management and the quantitative level of risk exposures should be assessed, as appropriate to the scope of the FCM's activities. The objectives of a particular inspection should dictate the FCM activities to be reviewed and set the scope of the inspection.

Examiners are to use a functional-regulatory approach (consistent with section III of the Gramm-Leach-Bliley Act) to minimize duplicative inspection and supervisory burdens. Reviews and reports of functional regulators should be used to their fullest extent. For the examination authority and limitations on the examination of a functionally regulated subsidiary, see section 1040.0 and 12 U.S.C. 1844(c).

When futures brokerage occurs in more than one domestic or foreign affiliate, examiners should assess, using a functional-regulatory approach (consistent with section III of the Gramm-Leach-Bliley Act), the adequacy of the management of the futures brokerage activities of the consolidated financial organization to ensure that the parent organization recognizes and effectively manages the risks posed by its various futures brokerage subsidiaries. Accordingly, in reviewing futures brokerage operations, examiners should identify all bank holding company, bank operating, or FBO subsidiaries that engage in FCM activities and the scope of those activities. Not all subsidiaries may need to be reviewed to assess the risk management of the consolidated organization. Selection of the particular FCM subsidiaries to be reviewed should be based on an assessment of the risks their activities pose to the consolidated organization.

This guidance primarily addresses the assessment of activities associated with futures brokerage operations. Any proprietary trading that occurs at an FCM should be assessed in connection with the review of proprietary trading activities of the consolidated financial organization, using the appropriate guidance in the Federal Reserve's *Trading and Capital-Markets Activities Manual.* Similarly, when a review of futures advisory activities is planned, examiners should refer to investment, financial, and futures advisory inspection guidance in this manual (sections 3130.0 and 3130.4), as appropriate.

3250.0.2 EVALUATION OF FCM RISK MANAGEMENT

Consistent with existing Federal Reserve policies, examiners should evaluate the risk-management practices of FCM operations and ensure that this evaluation is incorporated appropriately in the rating of risk management under the bank CAMELS, BHC RFI/C(D), or FBO ROCA rating systems. Accordingly, examiners should place primary consideration on findings related to the adequacy of (1) board and senior management oversight; (2) policies, procedures, and limits used to control risks; (3) systems for measuring, monitoring, and reporting risk; and (4) internal controls and audit programs.

3250.0.2.1 Board and Senior Management Oversight

The board of directors has the ultimate responsibility for the level of risks taken by the organization. Accordingly, the board, a designated subcommittee of the board, or a high level of senior management should approve overall business strategies and significant policies that govern risk-taking in the organization's FCM activities. In particular, the board or a committee thereof should approve policies that identify authorized activities and managerial oversight and should articulate risk tolerances and exposure limits of FCM activities. The board should also actively monitor the performance and risk profile of its FCM activities. Directors and senior management should periodically review information that is sufficiently detailed and timely to allow them to understand and assess the various risks involved in these activities. In addition, the board or a delegated committee should periodically reevaluate the business strategies and major risk-management policies and procedures, emphasizing the organization's financial objectives and risk tolerances.

The FCM's senior management is responsible for ensuring that policies and procedures for conducting FCM activities on both a long-range and day-to-day basis are adequate. Senior management or a designated subcommittee of the board should review and approve these policies and procedures annually. The consistency of these policies with parent company limits or other directions pertaining to the FCM's activities should be confirmed. Management must also maintain (1) clear lines of authority and responsibility for managing operations and the risks involved, (2) appropriate limits on risk-taking, (3) adequate systems and standards for measuring and tracking risk exposures and measuring financial performance, (4) effective internal controls, and (5) a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the risk profile of FCM activities. Examiners should review reports given to senior management and evaluate whether they consist of good summary information and sufficient detail that will enable management to assess and manage the FCM's risk. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound.

Management should also ensure that activities are conducted by competent staff whose technical knowledge and experience are consistent with the nature and scope of the organization's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to effectively manage and control risks. Functions for measuring, monitoring, and controlling risk should have clearly defined duties. There should be adequate separation of duties in key elements of the risk-management process to avoid potential conflicts of interest. The nature and scope of these safeguards should be in accordance with the scope of the FCM's activities.

3250.0.2.2 Policies, Procedures, and Limits

FCMs should maintain written policies and procedures that clearly outline their approach for managing futures brokerage and related activities. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. Policies, procedures, and limits should address the relevant credit, market, liquidity, reputation, and operations risks in light of the scope and complexity of the FCM's activities. Policies and procedures should establish a logical framework for limiting the various risks involved in an FCM's activities and should clearly delineate lines of responsibility and authority over these activities. They should also address the approval of new product lines, strategies, and other activities; conflicts of interest, including transactions by employees; and compliance with all applicable legal requirements. Procedures should incorporate and implement the parent company's relevant policies and should be consistent with applicable statutes, Federal Reserve Board regulations, interpretations, Board orders, and supervisory policies and guidance.

A sound system of integrated limits and risk-taking guidelines is an essential component of the risk-management process. Such a system should set boundaries for organizational risk-taking and ensure that positions that exceed certain predetermined levels receive prompt management attention so they can be either reduced or prudently addressed.

3250.0.2.3 Risk Measurement, Monitoring, and Reporting

An FCM's system for measuring the credit, market, liquidity, and other risks involved in its activities should be as comprehensive and accurate as practicable and should be commensurate with the nature of its activities. Risk exposures should be aggregated across customers, products, and activities to the fullest extent possible. Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to accurately reflect the different types of risks facing the organization. Clear standards for measuring risk exposures and financial performance should be established. The standards should provide a common framework for limiting and monitoring risks and should be understood by all relevant personnel.

An accurate, informative, and timely management information system is essential to the prudent operation of an FCM. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk-management process. Appropriate mechanisms should exist for reporting risk exposures and the financial performance of the FCM to its board and parent company, as well as for internal management purposes. FCMs must establish management-reporting policies to apprise their boards of directors and senior management of material developments, the adequacy of risk management, operating and financial performance, and material deficiencies identified during reviews by regulators and by internal or external audits. The FCM should also provide reports to the parent company (or in the case of foreign-owned FCMs, to its U.S. parent organization, if any) on financial performance; adherence to risk parameters and other limits and controls established by the parent for the FCM; and any material developments, including findings of material deficiencies by regulators. Examiners should determine the adequacy of an FCM's monitoring and reporting of its risk exposure and financial performance to appropriate levels of senior management and to the board of directors.

3250.0.2.4 Internal Controls

An FCM's internal control structure is critical to its safe and sound functioning in general and to its risk-management system in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and appropriate separation of duties—such as trading, custodial, and back office—is one of management's more important responsibilities. Appropriately segregating duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice, possibly leading to serious losses or otherwise compromising the financial integrity of the FCM.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and helps to ensure compliance with relevant laws, regulations, and organizational policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the entity's board of directors or its designated committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that will allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee (for example, a board audit committee).

3250.0.3 FUTURES EXCHANGES, CLEARINGHOUSES, AND FCMs

Futures exchanges provide auction markets for standardized futures and options on futures contracts. In the United States and most other countries, futures exchanges and FCMs are regulated by a governmental agency. Futures exchanges are membership organizations and impose financial and other regulatory requirements on members, particularly those that do business for customers as brokers. In the United States and most other countries, futures exchanges also have quasi-governmental (self-regulatory) responsibilities to monitor trading and prevent fraud, with the authority to discipline or sanction members that violate exchange rules. FCMs may be members of the exchange on which they effect customers' trades. When they are not members, FCMs must use other firms that are exchange members to execute customer trades.[2]

Each futures exchange has an affiliated clearinghouse responsible for clearing and settling trades on the exchange and for managing associated risks. When a clearinghouse accepts transaction information from its clearing members, it generally guarantees the performance of the transaction to each member and becomes the counterparty to the trade (that is, the buyer to every seller and the seller to every buyer). Daily cash settlements are paid or collected by clearing members through the clearinghouse. The cash transfers represent the difference between the original trade price and the daily official closing settlement price for each commodity futures contract. The two members settle their sides of the transaction with the clearinghouse,

2. A firm or trading company that maintains only a proprietary business may become a member of an exchange without registering as an FCM.

usually by closing out the position before delivery of the futures contract or the expiration of the option on the futures contract.

An exchange member that wishes to clear or settle transactions for itself, customers, other FCMs, or commodity professionals (locals or market makers) may become a member of the affiliated clearinghouse (clearing member) if it is able to meet the clearinghouse's financial-eligibility requirements. In general, these requirements are more stringent than those required for exchange membership. For example, a clearing member usually is required to maintain a specified amount of net capital in excess of the regulatory required minimum and to make a guaranty deposit as part of the financial safeguards of the clearinghouse. The size of the deposit is related to the scale of the clearing member's activity. If it is not a member of the clearinghouse for the exchange on which a contract is executed, an FCM must arrange for another FCM that is a clearing member to clear and settle its transactions.[3]

Margin requirements are an important risk-management tool for maintaining the financial integrity of clearinghouses and their affiliated exchanges. Clearinghouses require that their members post initial margin (performance bond) on a new position to cover potential credit exposures borne by the clearinghouse. The clearing firm, in turn, requires its customers to post margin. At the end of each day, and on some exchanges on an intraday basis, all positions are marked to the market. Clearing members with positions that have declined in value pay the amount of the decline in cash to the clearinghouse, which then pays the clearing members holding positions that have increased in value on that day. This process of transferring gains and losses among clearing-member firms, known as collecting variation margin, is intended to periodically eliminate credit-risk exposure from the clearinghouse.[4] In volatile markets, a clearinghouse may call for additional variation margin during the trading day, sometimes with only one hour's notice, and failure to meet a variation (or initial) margin call is treated as a default to the clearinghouse.

Some clearinghouses also require that their members be prepared to pay loss-sharing assessments to cover losses sustained by the clearinghouse in meeting the settlement obligations of a clearing member that has defaulted on its (or its customers') obligations. Such assessments arise when losses exceed the resources of defaulting members, the guaranty fund, and other surplus funds of the clearinghouse. Each clearinghouse has its own unique loss-sharing rules.[5] At least one U.S. and one foreign exchange have unlimited loss-sharing requirements. Most U.S. clearinghouses relate loss-sharing requirements to the size of a member's business at the clearinghouse. Given the potential drain on a banking organization's financial resources, the exposure to loss-sharing agreements should be a significant consideration in the decision to become a clearing member. A parent bank holding company may not provide a guarantee or become liable to an exchange or clearing association other than for trades conducted by the subsidiary for its own account or for the account of any affiliate. (See section 225.28(b)(6)(iv) of Regulation Y.)

3250.0.4 COMMODITY EXCHANGE ACT, COMMODITY FUTURES TRADING COMMISSION, AND SELF-REGULATORY ORGANIZATIONS

In the United States, the primary regulator of exchange-traded futures activities is the Commodity Futures Trading Commission (CFTC), which was created by and derives its authority from the Commodity Exchange Act (CEA). The CFTC has adopted registration,[6] financial responsibility, antifraud, disclosure, and other rules for FCMs and CTAs, and has general enforcement authority over commodities firms and professionals that buy or sell exchange-traded futures contracts.

3. The nonmember FCM opens an account, usually on an omnibus basis, with the clearing-member FCM. Separate omnibus accounts have to be maintained for customer and noncustomer or proprietary trading activity. If the FCM does not carry customer accounts by holding customer funds and maintaining account records, the clearing member will carry the customer's account on a fully disclosed basis and issue confirmations, account statements, and margin calls directly to the customer on behalf of the introducing FCM. In such cases, the introducing FCM operates as an introducing broker (IB) and could have registered with the Commodity Futures Trading Commission as such.

4. Some foreign exchanges do not allow the withdrawal of unrealized profits as mark-to-market variation.

5. Clearinghouses usually (1) retain the right to use assets owned by clearing members, but under the control of the clearinghouse (for example, proprietary margin); (2) require additional contributions of funds or assets or require the member to purchase additional shares of the clearinghouse; or (3) perfect a claim against the member for its share of the loss.

6. Many FCMs also are SEC-registered as broker-dealers and are subject to SEC and CFTC financial-responsibility rules.

The futures exchanges, in addition to providing a marketplace for futures contracts, are deemed to be self-regulatory organizations (SROs) under the CEA. For example, a number of SROs have adopted detailed uniform practice rules for FCMs, including ''know your customer'' recordkeeping rules and other formal customer-disclosure requirements. The National Futures Association (NFA) also is an SRO, although it does not sponsor a futures exchange or other marketplace. The NFA has adopted sales-practice rules applicable to members who do business with customers. All FCMs that wish to accept orders and hold customer funds and assets must be members of the NFA.

The CEA and rules of the CFTC require the SROs to establish and maintain enforcement and surveillance programs for their markets and to oversee the financial responsibility of their members.[7] The CFTC has approved an arrangement under which a designated SRO (DSRO) is responsible for performing on-site audits and reviewing periodic reports of a member FCM that is a member of more than one futures exchange. The NFA is the DSRO for FCMs that are not members of any futures exchange.

Oversight of FCMs is accomplished through annual audits by the DSRO and the filing of periodic financial statements and early warning reports by FCMs, in compliance with CFTC and SRO rules. In summary, this oversight encompasses the following three elements:

1. *Full-scope audits at least once every other year of each FCM that carries customer accounts.* Audit procedures conform to a Uniform Audit Guide developed jointly by the SROs. The full-scope audit focuses on the firm's net capital computations, segregation of customer funds and property, financial reporting, recordkeeping, and operations.[8] The audit also reviews sales practices (including customer records, disclosures, advertisements, and customer complaints) and the adequacy of employee supervision. The audit's scope should reflect the FCM's prior compliance history as well as the examiner's on-site evaluation of the firm's internal controls. During the off-year, the DSROs perform limited-scope audits of member FCMs. This audit is limited to financial matters such as a review of the FCM's net capital computations, segregation of customer funds, and its books and records.
2. *FCM quarterly financial reporting requirements.* FCMs are required to file quarterly financial statements (form 1-FR-FCM) with their DSROs. The fourth-quarter statement must be filed as of the close of the FCM's fiscal year and must be certified by an independent public accountant. The filings generally include statements regarding changes in ownership equity, current financial condition, changes in liabilities subordinated to claims of general creditors, computation of minimum net capital, segregation requirements and funds segregated for customers, secured amounts and funds held in separate accounts, and any other material information relevant to the firm's financial condition. The certified year-end financial report also must contain statements of income and cash flows.
3. *Early warning reports.* FCMs are required to notify the CFTC and the SROs when certain financial weaknesses are experienced.[9] For example, if an FCM's net capital falls to a specified warning level, it must file a written notice within five business days and file monthly financial reports (form 1-FR-FCM) until its net capital meets or exceeds the warning level for a full three months. If an FCM's net capital falls below the minimum required, it must cease doing business and give telegraphic notice to the CFTC and any commodities or securities SRO of which it is a member. Similar notices must be given by a clearing organization or carrying FCM when it determines that a position of an FCM must be liquidated for failure to meet a margin call or other required deposit.

3250.0.5 FEDERAL RESERVE REGULATION OF FCMs AND CTAs

Bank holding companies are permitted, under Regulation Y (section 225.28(b)(7)(iv)), to engage

7. CFTC Rule 1.51, contract market program for enforcement, requires that SROs monitor market activity and trading practices in their respective markets, perform on-site examinations (audits) of members' books and records, review periodic financial reports filed by members, and bring disciplinary and corrective actions against members for violations of the CEA and CFTC and SRO rules.

8. If an FCM is also a broker-dealer, the DSRO is not required to examine the FCM for compliance with net capital requirements if the DSRO confers with the broker-dealer's examining authority at least annually to determine that the FCM is in compliance with the broker-dealer's net capital requirements and receives the DSRO copies of all examinations.

9. CFTC Rule 1.12 requires the maintenance of minimum financial requirements by FCMs and introducing brokers. These requirements are similar to those applicable to broker-dealers under SEC rules.

in FCM and CTA activities on both domestic and foreign futures exchanges through separately incorporated nonbank subsidiaries. As a general matter, the nonbank subsidiaries of bank holding companies (and some foreign banks) provide services to unaffiliated customers in the United States under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and to unaffiliated customers outside the United States under Regulation K.[10] Banks and the operating subsidiaries of banks usually provide futures-related services to unaffiliated parties in the United States under the general powers of the bank and to unaffiliated parties outside the United States under Regulation K. These various subsidiaries may provide services to affiliates under section 4(c)(1)(C) of the BHC Act.

Regulation Y permits a bank holding company subsidiary that acts as an FCM to engage in other activities in the subsidiary, including futures advisory services and trading, as well as other permissible securities and derivative activities as defined in sections 225.28(b)(6) (financial and investment advisory activities) and 225.28(b)(7) (agency transactional services for customer investments). Section 225.28(b)(7) specifically authorizes FCMs to provide agency services for unaffiliated persons in execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States and abroad. It also includes the authority to engage in other agency-type transactions (for example, riskless principal) involving a forward contract, an option, a future, an option on a future, and similar instruments. Furthermore, this section codifies the long-standing prohibition against a parent bank holding company's issuing any guarantees or otherwise becoming liable to an exchange or clearinghouse for transactions effected through an FCM, except for the proprietary trades of the FCM and those of affiliates.

A well-capitalized and well-managed bank holding company, as defined in section 225.2(r) and (s) of Regulation Y, respectively, may commence activities as an FCM or a CTA by filing a notice prescribed under section 225.23(a) of Regulation Y. Bank holding companies that are not eligible to file notices or that wish to act in a capacity other than as an FCM or CTA, such as a commodity pool operator (CPO), must follow the specific application process for these activities. Examiners should ensure that all of these activities are conducted in accordance with the Board's approval order.

A bank holding company, bank, or FBO parent company of an FCM is expected to establish specific risk parameters and other limits and controls on the brokerage operation. These limits and controls should be designed to manage financial risk to the consolidated organization and should be consistent with its business objectives and overall willingness to assume risk.

3250.0.6 PARTICIPATION IN FOREIGN MARKETS

FCMs frequently transact business on foreign exchanges as either exchange or clearinghouse members or through third-party brokers that are members of the foreign exchange. The risks of doing business in foreign markets generally parallel those in U.S. markets; however, some unique issues of doing business on foreign futures exchanges must be addressed by the FCM and its parent company to ensure that the activity does not pose undue risks to the consolidated financial organization.

Before doing business on a foreign exchange, an FCM should understand the legal and operational differences between the foreign exchange and U.S. exchanges. For example, the FCM should know about local business practices and legal precedents that pertain to business in the foreign market. In addition, the FCM should know how the foreign exchange is regulated and how it manages risk, and should develop policies and the appropriate operational infrastructure of controls, procedures, and personnel to manage these risks. Accordingly, examiners should confirm that, in considering whether and how to participate in a foreign market, an FCM performs due diligence on relevant legal and regulatory issues, as well as on local business practices. Foreign-exchange risks should be understood and authorized by the FCM's parent company, and any limits set by the parent company or FCM management should be carefully monitored. The FCM and its parent company also should assess the regulatory and financial risks associated with exchange and clearinghouse membership in a foreign market, including an understanding of the extent to which the

10. Those nonbank subsidiaries that operate in the United States may open offices outside the United States if (1) the bank holding company's authority under Regulation Y is not limited geographically, (2) the foreign office is not a separately incorporated entity, and (3) the activities conducted by the foreign office are within the scope of the bank holding company's authority under Regulation Y. In addition, a bank holding company may operate a limited foreign-based business in the United States under Regulation K. (See 12 C.F.R. 211.6.)

foreign clearinghouse monitors and controls day-to-day credit risk and its loss-sharing requirements.

3250.0.7 SPECIFIC RISKS AND THEIR RISK-MANAGEMENT CONSIDERATIONS

In general, FCMs face five basic categories of risk—credit risk, market risk, liquidity risk, reputation risk, and operations risk. The following discussions highlight specific considerations in evaluating the key elements of sound risk management as they relate to these risks. The compliance and internal-controls functions provide the foundation for managing the risks of an FCM.

3250.0.7.1 Credit Risk

FCMs encounter a number of different types of credit risks. The following discussions identify some of these risks and discuss sound risk-management practices applicable to each.

3250.0.7.1.1 Customer Credit Risk

Customer credit risk is the potential that a customer will fail to meet its variation-margin calls or its payment or delivery obligations. An FCM should establish a credit-review process for new customers that is independent of the marketing and sales function. It is not unusual for the FCM's parent company (or banking affiliate) to perform the credit evaluation and provide the necessary internal approvals for the FCM to execute and clear futures contracts for particular customers. In some situations, however, the FCM may have the authority to perform the credit review internally. Examiners should determine how customers are approved and confirm that documentation in the customer's credit files is adequate even when the approval is performed by the parent. Customer credit files should indicate the scope of the credit review and contain approval of the customer's account and credit limits. For example, customer credit files may contain recent financial statements, sources of liquidity, trading objectives, and any other pertinent information used to support the credit limits established for the customer. In addition, customer credit files should be updated periodically.

FCM procedures should describe how customer credit exposures will be identified and controlled. For example, an FCM could monitor a customer's transactions, margin settlements, or open positions as a means of managing the customer's credit risk. Moreover, procedures should be in place to handle situations in which the customer has exceeded credit limits. These procedures should give senior managers who are independent of the sales and marketing function the authority to approve limit exceptions and require that such exceptions be documented.

3250.0.7.1.2 Customer-Financing Risk

Several exchanges, particularly in New York and overseas, allow FCMs to finance customer positions. These exchanges allow an FCM to lend initial and variation margin to customers subject to taking the capital charges under the CFTC's (or SEC's) capital rules if the charges are not repaid within three business days. In addition, some exchanges allow FCMs to finance customer deliveries, again subject to a capital charge.

An FCM providing customer-financing services should adopt financing policies and procedures that identify customer-credit standards. The financing policies should be approved by the parent company and should be consistent with the FCM's risk tolerance. In addition, an FCM should establish overall lending limits for each customer based on a credit review that is analogous to that performed by a bank with similar lending services. The process should be independent of the FCM's marketing, sales, and financing functions, but it may be performed by the FCM's banking affiliate. Examiners should determine how customer-financing decisions are made and confirm that documentation is adequate, even when an affiliate approves the financing. In addition, the FCM should review financial information on its customers periodically and adjust lending limits when appropriate.

3250.0.7.1.3 Clearing-Only Risk

FCMs often enter into agreements to clear, but not execute, trades for customers. Under a "clearing-only" arrangement, the customer gives its order directly to an executing FCM. The executing FCM then gives the executed transaction to the clearing FCM, which is responsible for accepting and settling the transaction. Customers often prefer this arrangement because it provides the benefits of centralized clearing (recordkeeping and margin payments) with the flexibility of using a number of specialized brokers to execute transactions.

FCMs entering into clearing-only arrangements execute written give-up agreements, which are triparty contracts that set forth the responsibilities of the clearing FCM, the executing FCM, and the customer. Most FCMs use the ''uniform give-up agreement'' prepared by the Futures Industry Association, although some FCMs still use their own give-up contracts. The uniform give-up agreement permits a clearing FCM, upon giving prior notice to the customer and the executing FCM, to place limits or conditions on the transactions it will accept to clear or terminate the arrangement. If an executed transaction exceeds specified limits, the FCM may decline to clear the transaction unless it is acting as the qualifying or primary clearing FCM for the customer and has not given prior notice of termination.

Clearing-only arrangements can present significant credit risks for an FCM. An FCM's risk-management policies and procedures for clearing-only activities should address the qualifications required of clearing-only customers and their volume of trading, the extent to which customer-trading activities can be monitored by the clearing-FCM at particular exchanges, and how aggregate risk will be measured and managed.

The FCM should establish trading limits for each of its clearing-only customers and have procedures in place to monitor their intraday trading exposures. The FCM should take appropriate action to limit its liability either by reviewing and approving a limit exception or by rejecting the trade if a clearing-only customer has exceeded acceptable trading limits. Examiners should confirm that the FCM formally advises (usually in the give-up agreement) its customers and their executing FCMs of the trading parameters established for the customer. Examiners should also confirm that the FCM personnel responsible for accepting or rejecting an executed trade for clearance have sufficient current information to determine whether the trade is consistent with the customer's trading limits. Prudent give-up agreements (or other relevant documents such as the customer account agreement) should permit the FCM to adjust the customer's transaction limits when appropriate in light of market conditions or changes in the customer's financial condition.

Some FCMs act as the primary clearing firm (also referred to as the sponsoring or qualifying firm) for customers.[11] A primary clearing firm guarantees to the clearinghouse that it will accept and clear all trades submitted by the customer or executing FCM, even if the trade is outside the agreed-on limits. Because an FCM is obligated to accept and clear all trades submitted by its primary clearing customers, the FCM must be able to monitor its customers' trading activities on an intraday basis for compliance with agreed-on trading limits. Monitoring is especially important during times of market stress. The FCM should be ready and able to take immediate steps to address any unacceptable risks that arise, for example, by contacting the customer to obtain additional margin or other assurances, approving a limit exception, taking steps to liquidate open customer positions, or giving appropriate notice of termination of the clearing arrangement to enable the FCM to reject future transactions.

Intraday monitoring techniques will vary depending on the technology available at the particular exchange. A number of the larger, more automated U.S. exchanges have developed technologies that permit multiple intraday collection, matching, and reporting of trades—although the frequency of such reconciliations varies. On exchanges that are less automated, the primary clearing FCM must develop procedures for monitoring clearing-only risks. For example, the FCM could maintain a significant physical presence on the trading floor to monitor customer trading activities and promote more frequent collection (and tallying) of trade information from clearing-only customers. The resources necessary for such monitoring obviously will depend on the physical layout of the exchange—the size of the trading floor and the number of trading pits, the floor population and daily trading volumes, and the level of familiarity the FCM has with the trading practices and objectives of its primary clearing customers. The FCM should be able to increase its floor presence in times of market stress.

3250.0.7.1.4 Carrying-Broker Risk

An FCM may enter into an agreement with another FCM to execute and clear transactions

11. Primary clearing customers include institutions and individuals, as well as other nonclearing futures professionals (locals or floor traders), who execute their own trades on the exchange and other nonclearing FCMs that execute trades for unaffiliated customers.

on behalf of the first FCM (typically, when the first FCM is not an exchange or clearing member of an exchange). In such cases, the FCM seeking another or carrying FCM to execute its transactions should have procedures for reviewing the creditworthiness of the carrying FCM. If the FCM reasonably expects that the carrying FCM will use yet another FCM to clear its transactions (for example, if the carrying FCM enters into its own carrying-broker relationship with another firm for purposes of executing or clearing transactions on another exchange), the first FCM should try to obtain an indemnification from the carrying FCM for any losses incurred on these transactions.[12] When carrying transactions occur on a foreign exchange, an FCM should know about the legal ramifications of the carrying relationship under the rules of the exchange and the laws of the host country. Moreover, it may be appropriate for an FCM to reach an agreement with its customers that addresses liabilities relative to transactions effected on a non-U.S. exchange by a carrying broker.

3250.0.7.1.5 Executing-FCM Risk

When an FCM uses an unaffiliated FCM to execute customer transactions under a give-up arrangement, the clearing firm that sponsors the executing FCM guarantees its performance. Therefore, the first FCM should review the subcontracting risk of its executing FCMs and their sponsoring clearing firms. However, unlike the clearing risk inherent in a carrying-broker relationship, the subcontracting risk for an FCM using an executing FCM is limited to transaction risk (execution errors). An FCM's management should approve each executing broker it uses, considering the broker's reputation for obtaining timely executions and the financial condition of its sponsoring clearing firm.

3250.0.7.1.6 Pit-Broker Risk

Usually, FCMs will subcontract the execution of their orders to unaffiliated pit brokers who accept and execute transactions for numerous FCMs during the trading day. The risk associated with using a pit broker is similar to that of using an executing broker: the risk is limited to the broker's performance in completing the transaction. If the pit broker fails, then the primary clearing firm is responsible for completing the transaction. Therefore, an FCM should approve each pit broker it uses, considering the pit broker's reputation for obtaining timely executions and the resources of its sponsoring clearing firm.

3250.0.7.1.7 Clearinghouse Risk

Clearinghouse risk is the potential that a clearinghouse will require a member to meet loss-sharing assessments caused by another clearing member's failure. Before authorizing membership in an exchange or clearinghouse, an FCM's board of directors and its parent company must fully understand the initial and ongoing regulatory and financial requirements for members. The FCM's board of directors should approve membership in a clearinghouse only after a thorough consideration of the financial condition, settlement and default procedures, and loss-sharing requirements of the clearinghouse.

Particularly when it is considering membership in a foreign exchange or clearinghouse, an FCM's board should examine any regulatory and legal precedents related to how the exchange, clearinghouse, or host country views loss-sharing arrangements. As in the United States, some foreign clearinghouses have unlimited loss-sharing requirements, and some have "limited" requirements that are set at very high percentages. However, the loss-sharing provisions of some of the foreign clearinghouses have not yet been applied, which means that there are no legal and regulatory precedents for applying the stated requirements. In addition, the board should be apprised of any differences in how foreign accounts are viewed, for example, whether customer funds are considered separate from those of the FCM, whether the relationship between an FCM and its customer is viewed as an agency rather than a principal relationship, and whether there are material differences in the way futures activities are regulated.

The board also should be apprised of any material changes in the financial condition of every clearinghouse of which the FCM is a member. Senior management should monitor the financial condition of its clearinghouses as part of its risk-management function.

12. The CFTC takes the position that an FCM is responsible to its customers for losses arising from the failure of the performance of a carrying broker. The industry disagrees with this position, and the issue has not been resolved by the courts.

3250.0.7.1.8 Guarantees

FCM parent companies often are asked to provide assurances to customers and clearinghouses that warrant the FCM's performance. These arrangements may take the form of formal guarantees or less formal letters of comfort.

Under Regulation Y (section 225.28(b)(7)(iv)(B)), a bank holding company may not provide a guarantee to a clearinghouse for the performance of the FCM's customer obligations. A bank holding company may provide a letter of comfort or other agreement to the FCM's customers that states the parent (or affiliate) will reimburse the customers' funds on deposit with the FCM if they are lost as a result of the FCM's failure or default. Customers may seek this assurance to avoid losses that could arise from credit exposure created by another customer of the FCM, since the clearinghouse may use some or all of the FCM's customer-segregated funds in the event of a default by the FCM stemming from a failing customer's obligations.[13] Examiners should note any permissible guarantees for purposes of the consolidated report of the parent bank holding company, as they are relevant to calculating the consolidated risk-based capital of the bank holding company.

3250.0.7.2 Market Risk

When an FCM acts as a broker on behalf of customers, it generally is only subject to market risk if it executes customers' transactions in error. In this regard, operational problems can expose the FCM to market fluctuations in contract values. However, when an FCM engages in proprietary trading, such as market making and other position-taking, it will be directly exposed to market risk. Potential market-risk exposure should be addressed appropriately in an FCM's policies and procedures.

An FCM that engages in proprietary trading should establish market-risk and trading parameters approved by its parent company. The FCM's senior management should establish an independent risk-management function to control and monitor proprietary trading activities. Finally, the FCM should institute procedures to control potential conflicts of interest between its brokerage and proprietary trading activities.

13. The letter of comfort would protect customers whose funds were used to cover other customer losses by the clearinghouse. U.S. clearinghouses also have guarantee funds that can be used to reimburse customers at the clearinghouse's discretion.

3250.0.7.3 Liquidity Risk

Liquidity risk is the risk that the FCM will not be able to meet its financial commitments (end-of-day and intraday margin calls) to its clearing FCM or clearinghouse. Clearing FCMs are required to establish an account at one of the settlement banks used by the clearinghouse for its accounts and the accounts of its clearing members. In some foreign jurisdictions, the central bank fulfills this settlement function. An FCM should establish and monitor daily settlement limits for its customers and should ensure that there are back-up liquidity facilities to meet any unexpected shortfalls in same-day funds. To ensure the safety of its funds and assets, an FCM should also monitor the financial condition of the settlement bank it has chosen and should be prepared to transfer its funds and assets to another settlement bank, when necessary.

To control other types of liquidity risks, an FCM should adopt contingency plans for liquidity demands that may arise from dramatic market changes. An FCM, to the extent possible, should monitor the markets it trades in to identify undue concentrations by others that could create an illiquid market, thereby creating a risk that the FCM could not liquidate its positions. Most U.S. clearinghouses monitor concentrations and will contact an FCM that holds more than a certain percentage of the open interest in a product. In some situations, the exchange could sanction or discipline the FCM if it finds that the FCM, by holding the undue concentration, was attempting to manipulate the market. These prudential safeguards may not be in place on foreign exchanges; consequently, an FCM will have to establish procedures to monitor its liquidity risk on those exchanges.

3250.0.7.4 Reputation Risk

FCMs should have reporting procedures in place to ensure that any material events that harm its reputation, and the reputations of its bank affiliates, are brought to the attention of senior management; the FCM's board of directors; and, when appropriate, its parent company. Reports of potentially damaging events should be sent to senior management at the parent bank holding company, who will evaluate their effect on the FCM to determine what, if any, steps should be taken to mitigate the impact of the event on the whole organization.

3250.0.7.4.1 Commodity Trading Adviser

Acting as a commodity trading adviser (including providing discretionary investment advice to retail and institutional customers or commodity pools) may pose reputation and litigation risks to a CTA or an FCM, particularly when retail customers are involved. Accordingly, the FCM's board should adopt policies and procedures addressing compliance with CFTC and NFA sales-practice rules (including compliance with the "know your customer" recordkeeping rules).

3250.0.7.5 Operations Risk, Internal Controls, Internal Audits, and Compliance

3250.0.7.5.1 Operations Risk

Operations risk is the potential that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk at FCMs include inadequate procedures, human error, system failure, or fraud. For FCMs, failure to assess or control operating risks accurately can be a likely source of problems. Back-office or transaction-processing operations are an important source of operations-risk exposures. In conducting reviews of back-office operations, examiners should consult the appropriate chapters of the *Trading and Capital-Markets Activities Manual* for further guidance.

Operations risk also includes potential losses from computer and communication systems that are unable to handle the volume of FCM transactions, particularly in periods of market stress. FCMs should have procedures that address the operations risks of these systems, including contingency plans to handle systems failures and back-up facilities for critical parts of risk-management, communications, and accounting systems.

When FCMs execute or clear transactions in nonfinancial commodities, they may have to take delivery of a commodity because a customer is unable or unwilling to make or take delivery on its contract. To address this situation, the FCM should have in place the procedures it will follow to terminate its position and avoid dealing in physical commodities.

3250.0.7.5.2 Internal Controls

Adequate internal controls are the first line of defense in controlling the operations risks involved in FCM activities. Internal controls that ensure the separation of duties involving account acceptance, order receipt, execution, confirmation, margin processing, and accounting are particularly important. Internal controls should also be established to record, track, and resolve errors and discrepancies with customers and other parties.

FCMs should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents, consistent with legal requirements and internal policies. Relevant personnel should fully understand documentation requirements. Examiners should also consider the extent to which entities evaluate and control operations risks through internal audits, contingency planning, and other managerial and analytical techniques.

3250.0.7.6 Internal Audits and Their Review

An FCM should be subject to regular internal audits to confirm that it complies with its policies and procedures and is managed in a safe and sound manner. In addition, the internal audit function should review any significant issues raised by compliance personnel to ensure that they are resolved. Other staff within the FCM (i.e., compliance personnel) should be able to reach internal audit staff to discuss any serious concerns they might have. Internal audit reports should be forwarded to the FCM's senior management. Material findings and management's plan to resolve the audit issues should be reported to the FCM's board of directors, the parent company, and any designated board committee (for example, an audit committee). Frequently, the internal audit function is located at the parent company, and audit reports are routinely sent to senior management at the parent company and to the audit committee designated by the board of directors.

3250.0.8 INSPECTION GUIDANCE

The review of an FCM's functions should take a functional-regulatory approach, using the findings of the FCM's primary regulators as much as possible. Examiners should especially focus on the significant risks that the FCM poses to the parent company and affiliated banks. These risks should be assessed by reviewing the adequacy of the FCM's policies and procedures, internal controls, and risk-management functions. Compliance with policies and procedures, and with any conditions on the FCM's activities imposed by regulatory authorities (including the Federal Reserve Board), should be fully reviewed.

Bank holding companies, banks, and FBOs may have more than one subsidiary that acts as an FCM in the United States or that engages in futures transactions for customers in foreign markets. To ensure that the FCM/CTA activities of a banking organization are evaluated on a consolidated basis, a cross-section of affiliated futures brokerage and advisory firms should be reviewed periodically—particularly those that present the greatest risk to the consolidated financial organization. Relevant factors to consider when identifying firms for review include (1) the volume of business; (2) whether the FCM has unaffiliated customers; (3) the number of customers; (4) whether the firm provides customer financing; (5) the number of brokers effecting transactions; (6) whether exchange or clearinghouse memberships are involved; (7) whether the FCM provides clearing-only services; and (8) the date and scope of the last review conducted by the Federal Reserve, SRO, or other regulator.

The scope of any review to be conducted depends on the size of the FCM and the scope of its activities. The draft first-day letter should provide an overview of an FCM's authorized activities and conditions, as well as a description of the actual scope of its business. Examiners should review the most recent summary of management points or other inspection results issued by the FCM's SRO or other regulator, as well as any correspondence between the FCM and any federal agency or SRO. If examiners have any questions about the findings of an SRO's or a regulator's results, they should contact the organization to determine whether the matter is material and relevant to the current inspection. The status of any matters left open after the SRO's or regulator's review should also be inquired about.

An important factor in determining the scope of the inspection is whether the FCM has unaffiliated customers or conducts transactions solely for affiliates. Other factors include whether (1) the FCM is a clearing member of an exchange, particularly of a non-U.S. exchange; (2) it acts as a carrying broker on behalf of other FCMs; (3) it has omnibus accounts with other brokers in markets in which it is not a member (U.S. or foreign); (4) it provides advisory or portfolio management services, including discretionary accounts, or has been authorized to act as a commodity pool operator (CPO); (5) it provides clearing services to locals or market-makers; and (6) it provides financing services to customers.[14]

Examiners are not expected to routinely perform a front- or back-office inspection unless (1) the FCM's primary regulator found material deficiencies in either office during its most recent examination or (2) if front- or back-office operations have not been examined by the primary regulator within the last two years. However, examiners may still choose to review a small sample of accounts and transactions to confirm that appropriate controls are in place. In addition, net capital computations of U.S. FCMs do not need to be reviewed; they are reviewed by the FCM's DSRO, and the FCM is subject to reporting requirements if capital falls below warning levels. Examiners should perform a front- and back-office review of the FCM's operations outside of the United States.[15]

Review of audit function. Examiners may rely on well-documented internal audit reports and workpapers to verify the adequacy of risk management at the FCM. Examiners should review the internal audit reports and workpapers to determine the adequacy of their scope and thoroughness in complying with FCM policies and procedures. If an examiner finds that an internal audit adequately documents the FCM's compliance with a policy or procedure pertaining to the management of the various risk assessments required by the current inspection, that fact should be documented in the workpapers, and inspection procedures should be completed in any area not adequately addressed by the internal audit report. Examiners should periodically spot check areas covered by internal audits to ensure the ongoing integrity of the audit process. Finally, examiners should ensure that internal auditors have adequate training to evaluate

14. If the FCM engages in proprietary trading for its own account, particularly for purposes other than hedging (market making or position taking), or if the FCM acts as an intermediary in any over-the-counter futures or other derivative activities, the examiner should advise the examiner in charge of the inspection so that the firm's proprietary trading can be evaluated in connection with similar activities of the consolidated financial organization.

15. The inspection procedures for reviewing front- and back-office operations may be found in sections 2050.3 and 2060.3, respectively, of the *Trading and Capital-Markets Activities Manual.*

the FCM's compliance with its policies and procedures and with applicable laws and regulations (both inside and, if applicable, outside the United States).

If an examiner has determined that it is not necessary to perform a routine back-office review, he or she should confirm that the FCM has addressed operations risks in its policies and procedures. Examiners also should review the internal controls of an FCM to ensure that the firm is operated safely and soundly according to industry standards and that it complies with any Board regulations or conditions placed on the FCM's activities. Examiners should be alert to any "red flags" that might indicate inadequate internal controls. An FCM must be organized so that its sales, operations, and compliance functions are separate and managed independently. If an FCM engages in proprietary trading, examiners should confirm that the firm has procedures that protect against conflicts of interest in the handling of customer orders (examples of these conflicts of interest include front-running or ex-pit transactions). To make an overall assessment of the FCM's future business, the results of any review should be consolidated with the results of reviews by other FCMs inspected during this cycle.

3250.0.9 INSPECTION OBJECTIVES

1. To identify the potential and extent of various risks associated with the FCM's activities, including credit, market, liquidity, and reputation risks.
2. To evaluate the adequacy of the audit function and review significant findings, the method of follow-up, and management's response to correct any deficiencies.
3. To assess the adequacy of the risk-management function at the FCM.
4. To assess the adequacy of and compliance with the FCM's policies and procedures and the adequacy of the internal control function.
5. To evaluate and determine the FCM's level of compliance with relevant statutes, Board regulations, interpretations, orders, and policies.
6. To assess the adequacy of risk management of affiliated FCMs on a consolidated basis.

3250.0.10 INSPECTION PROCEDURES

3250.0.10.1 Structural Organization and Activity Analysis

3250.0.10.1.1 General

1. Identify all bank holding company subsidiaries that engage in FCM- or CTA-type activities in the United States or abroad or identify U.S. FCM/CTA subsidiaries of FBOs. Determine which firms should be inspected to provide a global view of the adequacy of management of these activities on a consolidated basis, based on the scope of activities and the degree of supervision by other regulators. Complete applicable procedures below for firms selected for inspection.
2. Review first-day-letter documents, notices filed under Regulation Y, Board orders and letters authorizing activities, previous inspection reports and workpapers, previous audit reports by futures regulators (CFTC, DSRO, National Futures Association, foreign futures regulator) and correspondence exchanged with those regulatory entities, and reports by internal or external auditors or consultants.
3. Note the scope of the FCM's activities, including—
   a. execution and clearing;
   b. execution only for affiliates and third parties;
   c. clearing-only for affiliates, third parties, professional floor traders (locals);
   d. pit brokerage;
   e. advisory;
   f. discretionary portfolio management;
   g. commodities or commodity pool operator (in FCM or in affiliate);
   h. margin financing;
   i proprietary trading;
   j. exchange market maker or specialist;
   k. types of instruments (for example, financial, agricultural, precious metals, petroleum);
   l. contract markets where business is directed;
   m. other derivatives products (should be identified, for example, interest-rate swaps and related derivative contracts, foreign-exchange derivative contracts, foreign government securities, other);
   n. other futures-related activities, including off-exchange transactions;
   o. riskless-principal transactions; and
   p. registered broker-dealers.
4. Note exchange and clearinghouse memberships here and abroad, noting any financial commitments and any guarantees by the FCM

or its parent[16] to the exchange or clearinghouse with respect to proprietary, affiliate, or customer transactions.

5. Note any new lines of business or activities occurring at the FCM or any changes to exchange and clearing memberships since the last inspection.
6. Note the percentage of business conducted for—
   a. affiliate banks,
   b. nonbank affiliates,
   c. customers (note the breakdown between institutional and retail customers and if there is any guarantee or letter of comfort to customers in which the parent company provides that it will reimburse customers for loss as a result of the FCM's failure or other default),
   d. proprietary accounts (hedging, position-taking), and
   e. professional floor traders (locals, market makers).

3250.0.10.1.2 Audit Program

Determine the quality of the internal audit program. Assess the scope, frequency, and quality of the audit program for the FCM and related activities. Consider spot checking areas covered by internal audits.

1. Review the most recent audit report, noting any exceptions and their resolution.
2. Determine whether internal auditors have adequate training to evaluate the FCM's compliance with its policies and procedures and with applicable laws and regulations.
3. Verify that audit findings have been communicated to senior management and material findings have been reported to the FCM's board of directors and parent company.
4. Identify any areas covered by these procedures that are not adequately addressed by the internal audit report.
5. Identify areas of the internal audit report that should be verified as part of the current inspection.

3250.0.10.1.3 Operational Activities

Determine the scope of review that is appropriate to activities and allocate examiner resources, considering the adequacy of internal audit workpapers.

1. Complete the appropriate front- and/or back-office inspection procedures when—
   a. front- and back-office operations have not been examined by the DSRO within the last two years,
   b. material deficiencies in front- or back-office operations were found by the DSRO during the most recent audit, or
   c. the primary regulator for the FCM is not a U.S. entity.
2. Advise the examiner in charge of the inspection of the parent company if the FCM engages in proprietary trading or over-the-counter futures or derivatives business as principal or agent.

3250.0.10.2 Board and Senior Management Oversight

1. Review the background and experience of the FCM's board of directors and senior management, noting prior banking and futures brokerage experience.
2. Determine if the board of directors of the FCM has approved written policies summarizing the firm's activities listed below, and addressing oversight by the board or a board-designated committee:
   a. the risk appropriate for the FCM, including credit, market, liquidity, operation, reputation, and legal risk (see SR-95-51)
   b. the monitoring of compliance with risk parameters
   c. the exchange and clearinghouse memberships
   d. the internal audit function
3. Determine if senior management of the FCM has adopted procedures implementing the board's policies for—
   a. approval of new-product lines and other activities;
   b. transactions with affiliates;
   c. transactions by employees;
   d. compliance with applicable regulations and policies and procedures;
   e. management information reports;
   f. the separation of sales, operations, back-office, and compliance functions; and
   g. reports to the FCM boards of directors on material findings of the complaint or audit

16. The parent bank holding company cannot provide a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by the FCM subsidiary for its own account or for the account of any affiliate. See Regulation Y, section 225.28(b)(7)(iv)(B).

functions and on material deficiencies identified during the course of regulatory audits or inspections.

4. Determine that policies and procedures are periodically reviewed by the board of directors or senior management, as appropriate, and ensure that they comply with existing regulatory and supervisory standards and address all of the FCM's activities.
5. Review management information reporting systems and determine whether the board of directors of the parent company (or a designated committee of the parent's board) is apprised of—
   a. material developments at the FCM,
   b. the financial position of the firm including significant credit exposures,
   c. the adequacy of risk management,
   d. material findings of the audit or compliance functions, and
   e. material deficiencies identified during the course of regulatory reviews or inspections.
6. Review the FCM's strategic plan.
   a. Assess whether there are material inconsistencies between the stated plans and the FCM's stated risk tolerances.
   b. Verify that the strategic plan is reviewed and periodically updated.

3250.0.10.3 Risk Management

3250.0.10.3.1 Credit Risk

1. Review credit-risk policies and procedures.
   a. Verify the independence of credit-review approval from the limit-exceptions approval.
   b. Verify that the procedures designate a senior officer with the responsibility to monitor and approve limit-exception approvals.
2. Determine whether the FCM has authority to open customer accounts without parent company approval.
3. Review the customer base (affiliates, third parties) for credit quality in terms of affiliation and business activity (affiliates, corporate, retail, managed funds, floor traders, etc.).
4. Evaluate the process for customer-credit review and approval. Determine whether the customer-credit review identifies credit risks associated with the volume of transactions executed or cleared for the customer.
5. Evaluate the adequacy of credit-risk-management policies. Determine if they—
   a. establish and require adequately documented credit limits for each customer that reflect their respective financial strengths, liquidity, trading objectives, and potential market risk associated with the products traded;
   b. require periodic updates of such credit limits in light of changes in the financial condition of each customer and market conditions; and
   c. do not permit the FCM to waive important broker safeguards, such as the right to liquidate customer positions upon default or late payment of margin.
6. Consider verifying the above information by sampling customer-credit files.
7. Verify that up-to-date customer-credit files are maintained on site or are available for review during the inspection. If the customer-credit approval was performed by the parent company or an affiliate bank, verify that the FCM's files contain information indicating the scope of the credit review, the approval, and credit limits.
8. Review notifications and approval of limit exceptions for compliance with FCM procedures.
9. Determine whether the FCM has adopted procedures identifying when the FCM should take steps to limit its customer-credit exposure (for example, when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions).
10. Evaluate the adequacy of risk management of customer-financing activities.
11. Determine that the credit-review process is independent from the marketing, sales, and financing function.
    a. Verify that the FCM has policies that identify customer-credit standards and that it establishes overall lending limits for each customer.
    b. Assess the adequacy of the credit-review process and documentation, even when credit review is performed by an affiliate.
12. Review the instances when the FCM has lent margin to customers on an unsecured basis. If the FCM does not engage in margin financing as a business line, verify that extensions are short-term and within the operational threshold set for the customer.

3250.0.10.3.2 Clearing-Only Risk

1. Determine whether each clearing arrangement is in writing and that it—
   a. identifies the customer and executing brokers, and defines and adequately documents the respective rights and obligations of each party;
   b. establishes overall limits and trading parameters for the customer that are based on the customer's creditworthiness and trading objectives; and
   c. permits transaction limits to be adjusted to accommodate market conditions or changes in the customer's financial condition.
2. When the FCM has entered into a clearing-only agreement with a customer, verify that it has reviewed the creditworthiness of each executing broker or its qualifying clearing firm identified in the agreement.
3. If the FCM acts as the primary clearing firm for locals or other customers, confirm that the firm has adopted procedures for monitoring and controlling exposure. Note whether the firm monitors customer positions throughout the trading day and how this monitoring is accomplished.

3250.0.10.3.3 Carrying Brokers, Executing Brokers, and Pit Brokers

1. If the FCM uses other brokers to execute and/or clear transactions, either on an omnibus or a fully disclosed basis, determine that it has adequately reviewed the creditworthiness and approved the use of the other brokers. If the FCM uses nonaffiliated executing brokers, confirm that it also has considered the reputation of the broker's primary clearing firm. If the other broker is likely to use another broker, determine whether the broker has given the FCM an indemnification against any loss that results from the performance or failure of the other broker.
2. If the FCM uses other brokers to execute or clear transactions in non-U.S. markets, determine whether senior management understands the legal risks pertinent to doing business in those markets and has adopted policies for managing those risks.
3. When the FCM uses third-party "pit brokers" to execute transactions, verify that the FCM has reviewed and approved each broker after considering the reputation of the pit broker's primary clearing firm.

3250.0.10.3.4 Exchange and Clearinghouse Membership

1. Verify that the FCM completes a due-diligence study of each exchange and clearinghouse before applying for membership in the organization.
   a. Determine whether board minutes approving membership demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme.
   b. Determine whether, in approving membership in a non-U.S. exchange or clearinghouse, the board's minutes indicate a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in the particular jurisdiction. The minutes should also reflect discussion of any material differences from U.S. precedent in how foreign accounts are viewed, for example, whether customer funds held in an omnibus account are considered separate (segregated) from those of the FCM or whether the relationship between the FCM and its customers is viewed as an agency or principal relationship in the host country.
2. Verify that the FCM has apprised its parent company of the results of its study of the exchange or clearinghouse and that it has written authorization by senior management of its parent company to apply for membership.
3. Verify that the FCM monitors the financial condition of each exchange and clearing organization for which it is a member.
4. Review all guarantees, letters of comfort, or other forms of potential contingent liability. Verify that the parent company has not provided a guarantee to the clearinghouse for the performance of the FCM's customer obligations.[17] Note any guarantees against the parent losses incurred from the failure of an FCM and advise the examiner in charge of the parent company's inspection, who can confirm that guarantees are included in the

17. The parent bank holding company cannot provide a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by the FCM subsidiary for its own account or for the account of any affiliate. See Regulation Y, section 225.28(b)(7)(iv)(B).

bank holding company's calculation of consolidated risk-based capital.

3250.0.10.3.5 Market Risk

1. If an FCM engages in proprietary trading, determine whether policies and procedures are in place to control potential conflicts of interest between its brokerage business and trading activities.
2. When an FCM plans to enter (or has entered into) a foreign market, determine if the FCM performed due-diligence reviews of relevant legal and regulatory issues, as well as on local business practices.

3250.0.10.3.6 Liquidity Risk

1. Verify that the FCM has established and monitors daily settlement limits for each customer to ensure that liquidity is sufficient to meet clearinghouse obligations.
2. Determine whether the FCM has established back-up liquidity facilities to meet unexpected shortfalls.
3. Verify that the FCM monitors by product the amount of open interest (concentrations) that it holds at each exchange, either directly or indirectly through other brokers. If positions are held on foreign exchanges and concentrations are not monitored, verify that the FCM is able to monitor its positions and manage its potential liquidity risks arising from that market.
4. Review liquidity contingency plans for dealing with dramatic market changes.

3250.0.10.3.7 Reputation Risk

1. Review management information reporting systems and determine whether—
   a. the FCM is able to assess the extent of any material exposure to legal or reputation risk arising from its activities, and
   b. the parent company receives sufficient information from the FCM to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities.
2. If the FCM provides investment advice to customers or commodity pools, determine whether it has procedures designed to minimize the risks associated with advisory activities. Such procedures might address the delivery of risk disclosures to customers, the types of transactions and trading strategies that could be recommended or effected for retail customers, compliance with the "know your customer" recordkeeping and other sales practice rules of the SROs, and conformance to any trading objectives established by the customer or fund.
3. If the FCM acts as a CPO, verify that it has obtained prior Board approval and is in compliance with any conditions in the Board order.

3250.0.10.4 Operations, Internal Controls, and Compliance

1. Determine the extent to which operating risk is evaluated and controlled through the use of internal audits, contingency planning, and other managerial and analytical techniques.
2. Review the most recent summary of management points or similar document and also respective correspondence issued by the FCM's DSRO or other primary futures regulator. Discuss any criticism with FCM management and confirm that corrective action has been taken.
3. Consider reviewing a small sample of accounts and transactions to confirm that appropriate controls are used and that the FCM has incorporated operations risks into its policies and procedures.
4. Review the organizational structure and reporting lines within the FCM and verify separation of sales, trading, operations, compliance, and audit functions.
5. Determine that the FCM's policies and procedures address the booking of transactions by affiliates and employees and other potential conflicts of interest.
6. If the FCM is authorized to act as a CPO, review the most recent NFA or other primary futures regulator's audit, including any informal findings by examiners. Discuss any criticism with the FCM management and confirm that corrective action has been taken.
7. If the FCM executes and clears nonfinancial futures, verify that the FCM has procedures to avoid taking physical possession of the nonfinancial product when effecting "exchange for physical transactions" for customers.

8. When the FCM takes physical delivery of commodities due to failure or unwillingness of a customer to make or take delivery of its contracts, determine whether the FCM has and follows procedures to close out its position. Note if the FCM frequently takes delivery of physical commodities.
9. Assess the adequacy of customer-complaint review by reviewing the complaint file and how complaints are resolved. Note if the FCM receives repeat or multiple complaints involving one or more of its activities or employees.
10. Determine whether the FCM has developed contingency plans that describe actions to be taken in times of market disruptions and whether such plans address management responsibilities, including communications with its parent bank holding company, liquidity, the effect on customer-credit quality, and communications with customers.

3250.0.10.5 Conclusions

1. Prepare inspection findings and draw conclusions as to the adequacy of the FCM's risk-management, compliance, operations, internal controls, and audit functions.
2. Present findings to FCM management and submit inspection findings to the examiner in charge of the parent company inspection.

3250.0.11 FCM Supplemental Checklist Questionnaire

	Yes	*No*
3250.0.11.1 General Questions		
1. Is the FCM a separately incorporated subsidiary of the bank holding company as required by Regulation Y, 12 C.F.R. 225.28(b)(6)(iv)?	______	______
2. Has the parent bank holding company provided a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by a subsidiary for its own account or for the account of any affiliate (prohibited by Regulation Y (see 12 C.F.R. 225.28(b)(6)(iv))?	______	______

3. How long has the FCM been in operation?______yrs.
4. Approximately how many customers does the FCM have?______
5. What degree of market participation does the FCM have (mark (x) for the highest level of involvement)?
   a. __________ FCM, nonmember of futures exchange. Must execute trades through exchange members and is subject to NFA rules.
   b. __________ Exchange member. Holds membership on one or more futures exchanges entitling FCM to execute trades on the exchange(s) and subjecting FCM to the rules of exchange(s).
   c. __________ Clearinghouse member. Holds membership in an exchange's clearinghouse as well as exchange membership, thus enabling FCM to execute and clear its own transactions. Such FCM is subject to exchange and clearinghouse rules.
6. If FCM is an exchange member, on which exchange(s) (domestic and foreign) does the FCM have membership(s)?

   ____

   ____

   ____

	Yes	No
7. If FCM is a clearing member, list below the clearinghouse(s) of which it is a member. ____ ____ ____		
8. Does the FCM periodically make an adjusted net capital computation to verify that it maintains capitalization fully adequate to meet its own commitments and those of its customers, including affiliates?	_____	_____
(NOTE: Under the CFTC's net capital computations, there have been no capital requirements for "hedge" transactions by FCM affiliate banks. It may be necessary to request that an adjusted net capital computation be made to determine the amount of adjusted net capital required when affiliate trades are treated as third-party transactions.)		
9. Does a review of the FCM's correspondence from its designated self-regulatory organization reveal that the FCM meets CFTC requirements with respect to capital rules, segregation of customer assets, and risk disclosure?	_____	_____
10. If an FCM will receive services from an affiliate (e.g., the lead bank assesses FCM customer-credit risk or monitors customer positions and margin accounts), have the FCM and affiliate entered into a formal service agreement on an explicit fee basis?	_____	_____

3250.0.11.2 Management

	Yes	No
1. Does the FCM's management have expertise and previous experience as a broker, dealer, or participant in cash, futures, or forward markets related to those in which the FCM executes transactions?	_____	_____
2. Does the FCM's management have prior banking experience?	_____	_____
3. Does it appear that management has the expertise necessary to evaluate the viability of various hedging strategies?	_____	_____
4. Does it appear that FCM management has the ability to recognize imprudent or unsafe customer activity that could endanger the FCM?	_____	_____
5. Does the board of directors have written policies that summarize the firm's activities and its oversight function (certain functions may be designated to a board audit or other committee) with respect to—		
a. risk appropriate for the FCM?	_____	_____
b. compliance monitoring and risk parameters?	_____	_____

3250.0.11.3 Controls of Risk Exposure with Customers

	Yes	No
1. Does the FCM have a system for assessing and periodically re-evaluating customer-credit risk?	_____	_____

	Yes	No
2. Does the FCM take customer-credit risk into consideration and establish for each customer—	______	______
a. position limits for each contract the customer wishes to trade?	______	______
b. an aggregate position limit for outstanding contracts held by each customer?	______	______
3. Does the FCM have a system for monitoring customer positions to ensure positions are within the limits imposed by the FCM?	______	______
4. Does the FCM have an adequate system in place to monitor its overall risk exposure, primarily customer-default risk, on a daily basis?	______	______
5. Do customer agreements and internal procedures enable the FCM to—		
a. limit the types of trades a customer engages in?	______	______
b. refuse, when appropriate, to execute any trades except those resulting in liquidation of existing positions?	______	______

3250.0.11.4 Margin Requirements

	Yes	No
1. Does the FCM have a system for daily monitoring of margin accounts to ensure that margin calls are promptly issued and satisfied?	______	______
2. Does the customer agreement permit and has the FCM adopted procedures for liquidating a customer's position if margin calls are not promptly satisfied?	______	______
3. Do customer-account agreements authorize the FCM to require higher initial and variation margin levels than those set by the exchanges?	______	______
4. Does the FCM have a system in place for obtaining higher customer margins in instances when the FCM determines—	______	______
a. a customer's futures position or deteriorating financial condition necessitates a greater amount of margin to protect the FCM?	______	______
b. volatile market conditions justify higher levels of margin than those required by an exchange?	______	______

3250.0.11.5 Credit Risk

	Yes	No
1. Is the credit-review approval independent from the limit-exceptions approval?	______	______
2. Does a senior officer monitor and approve limit-exception approvals?	______	______
3. Does the customer-credit review identify credit risks associated with the volume of transactions executed or cleared for the customer?	______	______
4. Is adequate documentation required and maintained of credit limits for each customer that reflect customers' respective financial strengths and liquidity, trading objectives, and the potential market risk associated with the products traded?	______	______
5. Has the FCM adopted procedures identifying when the FCM should take steps to limit its customer-credit exposure (e.g., when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions)?	______	______
6. Is the credit-review process independent from the marketing/sales function and the financing function?	______	______

	Yes	*No*

3250.0.11.6 Clearing-Only Risk

1. Is each arrangement in writing and does it—
   a. identify the customer, executing brokers, and define and adequately document the respective rights and obligations of each party? _____ _____
   b. establish overall limits and trading parameters for the customer that are based on the customer's creditworthiness and trading objectives? _____ _____
   c. permit transaction limits to be adjusted to accommodate market conditions or changes in the customer's financial condition? _____ _____
2. Has the FCM or its qualifying clearing firm verified that it has reviewed the creditworthiness of each executing broker? _____ _____
3. If the FCM acts as the primary clearing firm for locals or other customers, has the firm adopted procedures for monitoring and controlling exposure throughout the trading day? _____ _____

3250.0.11.7 Carrying Brokers, Executing Brokers, and Pit Brokers

1. If the FCM uses other brokers to execute and/or clear transactions, either on an omnibus or fully disclosed basis, has it adequately reviewed the creditworthiness and approved the use of the other brokers? _____ _____
2. Has the FCM been given an indemnification against any loss that results from the performance or failure of the other broker? _____ _____
3. If the FCM uses nonaffiliated executing brokers, has it considered the reputation of the broker's primary clearing firm? _____ _____

3250.0.11.8 Exchange and Clearinghouse Membership

1. Does the FCM complete a due-diligence study of each exchange and clearinghouse before applying for membership in such organization? _____ _____
2. Do the board minutes approving such memberships demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme? _____ _____
3. In approving membership in a non-U.S. exchange or clearinghouse, do the board minutes evidence a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in a particular jurisdiction? _____ _____
4. Does the FCM monitor the financial condition of each exchange and clearing organization for which it is a member? _____ _____

3250.0.11.9 Market Risk

1. If an FCM engages in proprietary trading, are policies and procedures in place to control potential conflicts of interest between its brokerage business and trading activities? _____ _____
2. If an FCM has entered or plans to enter a foreign market, has the FCM performed due-diligence reviews of relevant legal and regulatory issues, as well as on local business practices? _____ _____

	Yes	No

3250.0.11.10 Liquidity Risk

1. Has the FCM established and does it monitor daily settlement limits for each customer to ensure liquidity sufficient to meet clearinghouse obligations? ______ ______
2. Has the FCM established back-up liquidity facilities to meet unexpected shortfalls? ______ ______
3. Does the FCM monitor the amount of open interest (concentrations) by product that it holds, directly or indirectly, at each exchange? ______ ______

3250.0.11.11 Reputation Risk

1. Is the FCM able to assess the extent of any material exposure to legal or reputation risk arising from its activities? ______ ______
2. Does the parent company receive sufficient information from the FCM's information systems to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities? ______ ______
3. If the FCM provides investment advice to customers or commodity pools, does it have procedures designed to minimize the risks associated with advisory activities? ______ ______
4. If the FCM acts as a CPO, has it obtained prior Board approval and is it in compliance with any conditions in the Board order? ______ ______

3250.0.11.12 Internal Controls

1. Does the FCM have written procedures pertaining to the following:
   a. the types of futures and options on futures contracts which the FCM will execute? ______ ______
   b. individuals authorized to effect transactions and sign contracts and confirmations? ______ ______
   c. the firms or individuals with whom FCM employees may conduct business? ______ ______
2. Does the FCM obtain written authorization from customers specifying the individuals who are authorized to execute trades on behalf of the customers? ______ ______
3. Does the FCM have written procedures governing—
   a. the solicitation and acceptance of customers? ______ ______
   b. the execution of purchases and sales? ______ ______
   c. processing transactions? ______ ______
   d. accounting for transactions? ______ ______
   e. clearing of transactions? ______ ______
   f. safekeeping of customer margin deposits or securities deposited as margin? ______ ______
4. Does the FCM have written contracts with all firms or individuals who may conduct business on behalf of the FCM? ______ ______
5. Does the FCM have proper segregation of duties to ensure that individuals involved in executing transactions are not able to make accounting entries? ______ ______
6. Does the FCM have a numbered and controlled system of order tickets and confirmations to prevent unauthorized trading and to verify the accuracy of records and enable reconciliation throughout the system? ______ ______

	Yes	No
7. Does the FCM have procedures to time stamp receipt of all orders at least to the nearest minute and execute all orders strictly in chronological sequence (to the extent consistent with the customers' specifications)?	_____	_____
8. Does the FCM have a system for routing incoming confirmations to an operating unit separate from the unit that executes transactions?	_____	_____
9. Does the FCM have a system for comparing internal and external confirmations to ensure that the FCM will not accept or deliver securities and/or margin payments without proper authorization and documentation?	_____	_____
10. Does the FCM have procedures to ensure that someone outside the trading unit is responsible for resolution of trades in which incoming and outgoing confirmations do not match?	_____	_____
11. With respect to transactions cleared by others, are procedures in place for verifying and agreeing clearing FCM open position and margin deposit reports?	_____	_____
12. Does the FCM review daily outstanding contracts, customer positions, and margin balances?	_____	_____
13. Does FCM management regularly review all adjustments affecting futures positions or income recognition to verify that such adjustments were proper and approved?	_____	_____
14. Are subsidiary ledgers regularly reconciled to the general ledger?	_____	_____
15. Has the FCM adopted written supervisory procedures for supervising brokers and others to ensure that they follow written policies and procedures?	_____	_____
16. Are there written procedures containing criteria for selecting and training competent personnel?	_____	_____
17. Does the FCM have a comprehensive reporting system for providing management with all the information necessary to effectively manage the FCM's operations?	_____	_____
18. Are procedures in place to ensure that any futures advisory services (investment advice) furnished—		
a. reflect the views of persons authorized to supervise advisory activities?	_____	_____
b. are authorized under Regulation Y or by Board order?	_____	_____
19. Is there a formal and comprehensive internal audit program pertaining to FCM activities?	_____	_____

3250.0.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Brokerage of gold and silver bullion and coins (provided subsequent basis for FCM execution and clearance of futures contracts)				38 *Federal Register* 27,552 (1973)
FCMs for the execution of futures contracts for gold, silver, platinum bullion, and coins				1990 FRB 552 1985 FRB 467 1977 FRB 951
FCMs for the execution and clearance of futures contracts				1982 FRB 651 1982 FRB 514
Engage in FCM activities: U.S. government securities, negotiable money market instruments, foreign exchange				1983 FRB 729 1983 FRB 216
FCM engaged in the execution and clearance of options				1983 FRB 733
Inclusion into Regulation Y permissible nonbanking activities (1984 and 1987)		225.28(b)(7)(iv)		1984 FRB 53 1984 FRB 591
Execution and clearing of futures contracts on a municipal bond index and to provide futures advisory services				1986 FRB 144 1985 FRB 803 1985 FRB 651 1985 FRB 111
Execute, purchase, and sale of gold and silver bullion and coins for the account of customers				1985 FRB 467 1985 FRB 251 1985 FRB 111
Advisory services for futures contracts on stock indexes and options thereon				1987 FRB 220
Advice on certain futures and options on futures				1988 FRB 820
Execution and clearance of futures contracts on stock indexes, options thereon, and futures contracts on a municipal bond index				1985 FRB 970
Execution and clearing futures contracts on stock indexes				1985 FRB 801
Providing investment advice on financial futures and options on futures		225.28(b)(6)(iv) (Regulation Y)		1997 FRB 275 1986 FRB 833

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing investment advice on trading futures contracts and options on futures contracts in nonfinancial commodities				1991 FRB 126
Executing-only and clearing-only trades				1993 FRB 728 1993 FRB 723
Discretionary portfolio management services on futures and options on futures on financial commodities				1995 FRB 386
Discretionary portfolio management services on futures and options on futures on nonfinancial commodities				1995 FRB 803
FCM executing and clearing, and clearing without execution, futures and options on futures on nonfinancial commodities				1993 FRB 1049
Trading for one's own account in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments				1995 FRB 190
Commodity and index swap transactions—originator, principal, agent, broker, or adviser				1995 FRB 191 1995 FRB 190
Trading in futures options on futures contracts based on commodities or on stock, bond, or commodity indexes for one's own account				1995 FRB 185
Discretionary portfolio management services on futures and options on futures on financial commodities				1995 FRB 386 1994 FRB 151
FCM execution, clearance, and advisory services for contracts on financial and nonfinancial commodities for noninstitutional customers				1995 FRB 880
Serving as a commodity pool operator				1996 FRB 569

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Primary clearing firm for a limited number of floor traders and brokerage services for forward contracts on financial and nonfinancial commodities				1997 FRB 138

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

This section serves as a prelude to the futures commission merchant activities (FCM) that are provided as examples of previous Board FCM decisions. Sections 3251.0.1 through 3251.0.13 provide brief historical summaries of Board decisions that may have led to the authorizations that have been incorporated into the April 1997 revision of Regulation Y for this activity. The summaries provide the reader with some historical perspective as to how and why the current provisions of Regulation Y evolved for FCMs. Certain conditions and commitments within these orders may no longer apply to the current provisions of Regulation Y. Therefore, reference must be made to the current Regulation Y, section 225.28(b)(7)(iv).

3251.0.1 FCM BROKERAGE OF FUTURES CONTRACTS ON A MUNICIPAL BOND INDEX

A bank holding company applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to engage de novo, through a wholly owned subsidiary located in the state of New York, to execute and clear futures contracts on a municipal bond index. The applicant also proposed to offer futures advisory services for a separate fee or as an integrated package of services to futures commission merchant customers through the subsidiary.

The Board had previously approved by regulation the activity of executing and clearing futures contracts on bullion, foreign exchange, U.S. government securities, and money market instruments, primarily on the basis that banks may hold and deal in the underlying cash items. The proposed futures contract on a municipal bond index was based on an index of general obligation bonds selected by the *The Bond Buyer*. The Bond Buyer Municipal Index is composed of 50 tax-exempt municipal revenue and general obligation bonds chosen on the basis of criteria that favor recently issued and actively traded bonds. The index is intended to be an accurate indicator of trends and changes in the municipal bond market. The offering of futures contracts based on the bond index (broad spectrum of municipal securities) could provide FCM customers with a more effective tool for hedging against the price risk associated with a portfolio of municipal bonds than any of the existing interest-rate futures contracts.

Banks are permitted to hold and deal in general obligation bonds, and they are active participants in the cash markets for those bonds. Based on these facts, the Board determined that the applicant's proposal was substantially similar to proposals to broker other financial futures previously approved by the Board, and was thus closely related to banking.

With regard to the proposed advisory activities, the Board had previously approved by order the provision of advisory services relating to approved FCM activities (1984 FRB 780). The applicant proposed to provide advisory services either for a separate fee or as an integral package of services to FCM customers. The services would include written or oral presentations on the historical relationship between the cash and futures markets, a demonstration of examples of financial futures uses for hedging, and assistance in structuring a hedging strategy. The applicant would provide these services only to major corporations and other financial institutions.

Based on all the facts provided, the Board concluded that—

1. the proposed activities by the applicant could reasonably be expected to produce benefits to the public;
2. the proposed FCM activities would entail risks or conflicts of interests different than those considered and addressed by the Board in its approvals of other FCM activities; and
3. the balance of the public-interest factors was favorable.

The Board noted, however, that trading of the futures contract involved in the application had not been approved by the Commodity Futures Trading Commission (CFTC). It therefore conditioned its December 21, 1984, approval of the application on the CFTC's approval of the contract (1985 FRB 111).

3251.0.2 FCM BROKERAGE OF CERTAIN FUTURES CONTRACTS ON STOCK INDEXES INCLUDING OPTIONS

A bank holding company applied, under section 4(c)(8) of the BHC Act and section 225.21(a) of Regulation Y, to engage, de novo through its wholly owned futures corporation, in executing and clearing, on major commodity exchanges, futures contracts on stock indexes and options on such futures contracts. The subsidiary would execute and clear—

1. the Standard & Poor's 100 Stock Price Index futures contract;
2. the Standard & Poor's 500 Stock Price Index futures contract (S&P 500);
3. options on the S&P 500, all of which are traded on the Index and Option Division of the Chicago Mercantile Exchange;
4. the Major Market Index futures contract, currently traded on the Chicago Board of Trade; and
5. the FT-SE 100 Equity Index futures contract, currently traded on the London International Financed Futures Exchange.

The execution and clearance of stock index futures and options traded on major commodity exchanges appeared to be functionally and operationally similar to securities brokerage, permitted for bank holding companies under section 225.28(b)(6)(i) of Regulation Y. Like municipal bond index futures (an activity proposed by an applicant which was previously approved by Board order), these futures contracts are settled in cash and are designed to allow customers to hedge the market risk associated with holding financial assets, in this instance, corporate equity securities. The equities represented by the listed indexes were chosen on the basis of criteria that favor a combination of securities that would accurately reflect fluctuations in the stock market.

The Board approved the application on February 4, 1985, based on the above analysis and on the fact that national banks have been permitted to execute and clear stock index futures, and options thereon, for the account of customers, through their FCM operations subsidiaries (1985 FRB 251). It also took into consideration the fact that trust departments of banks have begun to use stock index futures contracts and options on such contracts to hedge the market risk facing diversified stock portfolios.

3251.0.3 LIMITED FCM CLEARING-ONLY AND EXECUTING-ONLY TRADES

A bank holding company (the applicant) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to engage de novo in various FCM activities. The activities were to be conducted through its wholly owned FCM subsidiary (the company). The FCM activities consisted of—

1. executing and clearing, executing without clearing, and clearing without executing, as agent for institutional customers, the futures contracts and options on futures contracts listed in appendix A of the order;
2. executing and clearing as agent for institutional customers, through omnibus trading accounts with unaffiliated FCMs, the futures contracts and options on futures contracts listed in appendix B of the order; and
3. providing related investment advisory services.

The applicant proposed to conduct the activities throughout the United States.

The applicant requested authority to conduct, through the company, both execution and clearing activities on the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT). The company also planned to conduct FCM activities through omnibus customer trading accounts established in its own name with clearing members of the exchanges on which the company would not be a member.[1]

The applicant also sought authority for the company to clear trades on the CME and the CBOT that had been executed by unaffiliated brokers pursuant to "give-up agreements." Under the applicant's proposal, the company would not be the primary clearing member for any nonclearing member on the CBOT and would not qualify any nonclearing member on the CME. The company also planned to execute trades that would be given up for clearance, at the customer's request, to an unaffiliated FCM.

The Board had previously determined, by regulation and order, that acting as an FCM in executing and clearing all of the proposed financial futures contracts and options on futures contracts, and providing investment advisory services with respect to such contracts, are activities closely related to banking under sec-

1. An omnibus account is an arrangement between a member clearing firm of an exchange and a nonmember FCM that seeks to conduct business on that exchange. Using this arrangement, the member clearing firm executes and clears transactions for the nonmember FCM and its customers. The omnibus account reflects all positions of the FCM's customers but is divided into separate segments for each customer for the purposes of calculating margin requirements, reporting current holdings, and other matters.

tion 4(c)(8) of the BHC Act with two exceptions.[2] See section 225.28(b)(7)(iv) and (b)(6)(iv) of Regulation Y and the Board orders found at 1992 FRB 953, 1991 FRB 64, 1990 FRB 881, and 1990 FRB 554.

On January 9, 1991, the Board denied a bank holding company's application to engage, through a nonbanking subsidiary, in clearing-only activities related to securities options and other financial instruments. The applicant in that case had proposed that its subsidiary primarily clear, but not execute, trades for professional floor traders (primarily market makers and specialists) trading for their own accounts on major securities and commodities exchanges. (See section 3700.12 and 1991 FRB 189.)

In the 1991 case, the Board was concerned that, by not engaging in both the execution and clearance of a trade, the nonbanking subsidiary could not decline transactions that posed unacceptable risk. It would have been obligated to settle each trade entered into by one of its customers, even if the customer did not have the financial resources to honor the obligation. No mechanism existed by which the nonbanking subsidiary could contemporaneously monitor the intra-day trading activities of the floor traders, its primary customers. The Board decided that the proposed nonbanking activity exposed the parent bank holding company to substantial credit risk. This decision was based on (1) the subsidiary's inability to monitor and control the risks to be undertaken and (2) the fact that clearing agents had to guarantee the financial performance of their customers to the clearinghouses of the exchanges on which they operate. The public-benefit considerations therefore precluded approval of that application under section 4(c)(8) of the BHC Act.

The applicant's proposal differed from the 1991 case in several respects. Under the proposal, the company would not serve as the primary or qualifying clearing firm for any unaffiliated customers. Also, the company would clear only those trades that it executed, or that other executing brokers executed and the company accepted for clearance pursuant to a customer's give-up agreement. The executing brokers would be independent from the customers and would have the opportunity to evaluate the trade before it was executed.

All of the company's clearing-only activities would be conducted pursuant to give-up agreements. Under these give-up agreements and other customer agreements, the company would have the right to refuse to accept for clearance any customer trade that it deemed unsuitable. The refusal could stem, for example, from consideration of market conditions or the customer's financial situation or objectives. Also, the applicant represented that it would be able to restrict the number and types of positions to be held by a customer as it deemed reasonable. The company could then refuse to accept trades that posed unacceptable risks.

The company established a framework for limiting risk from the clearing-only activities. It would review the creditworthiness of each potential customer and, based on the review, approve or reject the customer and establish appropriate limits concerning trading, margin, credit, and exposure limits. The company had controls in place to monitor the intra-day trading activities and risk exposure of its customers.

The Board determined that the credit and other risk considerations associated with the proposed clearing-only activities on the CME and CBOT were consistent with previous approvals. The decision was based on (1) the framework for limiting risk from clearing-only activities, (2) the commitments made by the applicant, and (3) the other facts of record. After reviewing other required considerations, the Board approved the application on May 6, 1993 (1993 FRB 723). Approval was subject to the commitments made by the applicant and the terms and conditions set forth in the order as well as in other Board orders related to the proposed activities.

3251.0.4 FCM CLEARING TRANSACTIONS BY PREAPPROVED EXECUTION GROUPS

A foreign banking organization (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a) of Regulation Y to engage de novo in clearing trades of sophisticated institutional investors relating to contracts on futures and options on futures. Trades would be cleared through the applicant's majority-owned clearing subsidiary (the com-

2. The two exceptions are the Deutsche Aktienindex 30 Stock Index futures and the German Government Bond Index futures contracts traded on the Deutsche Terminborse GmbH. These two contracts had been approved as FCM activities pursuant to Regulation K. The Board also noted that these contracts served the same functions as the futures contracts for which FCM activities had previously been approved under section 4(c)(8) of the BHC Act.

pany) on the Chicago Mercantile Exchange (CME) and the Board of Trade of the City of Chicago (CBOT) and executed by nonaffiliated floor brokers.

In particular, the applicant proposed to accept for clearance customer orders that are executed by preapproved execution groups pursuant to "give-up agreements." [3] The applicant expected that the company would initially provide only limited execution services. The company would not be the primary clearing firm for any non-clearing member of the CBOT, and would not qualify any nonclearing member of the CME.

The applicant also sought approval to engage in other FCM and data processing and transmission activities. The applicant committed that the company would conduct these activities according to the provisions and subject to the limitations of Regulation Y (section 225.28(b)(7)(iv) and (b)(14)).[4] The company also planned to engage in certain other activities that the applicant maintained were incidental to its FCM services. These activities included the management of institutional-customer funds under its control. The incidental activities would also include providing to institutional customers, on request, general advice about (1) sources of information, (2) the selection and arrangement of an appropriate execution group, (3) the availability of computer software relating to futures and options on futures, (4) order-placement alternatives, and (5) cost-reduction methods in the use of futures and options on futures for hedging purposes. The company committed that it would not provide investment advice relating to futures and options on futures or on any other matter not authorized by the order.

The Board previously denied a proposal in which a nonbanking subsidiary of a BHC would have cleared, but not executed, trades for professional floor traders (primarily market makers and specialists) trading for their own account on major securities and commodity exchanges. (See 1991 FRB 189 and section 3700.12.) In that order, the Board was concerned that, by not engaging in both the execution and clearance of a trade, the FCM nonbanking subsidiary could not decline transactions that posed unacceptable risk. It would have been obligated to settle each trade entered into by one of its customers, even if the customer did not have the financial resources to honor the obligation. No mechanism existed by which the FCM nonbanking subsidiary could contemporaneously monitor the intra-day trading activities of the floor traders, its primary customers. The Board decided that the proposed nonbanking activity exposed the parent bank holding company to substantial credit risk. This decision was based on (1) the FCM's inability to monitor and control the risks to be undertaken and (2) the fact that the clearing agents had to guarantee the financial performance of their customers to the clearinghouses of the exchanges on which they operate. The public-benefit considerations therefore precluded approval of that application under section 4(c)(8) of the BHC Act.

The applicant's proposal differed from the above-mentioned denied application in various respects. In the applicant's case, the company would not serve as the primary or qualifying clearing firm for any broker that executes its clearing-only trades or for any nonaffiliated customer. The company would clear only trades that it executes, or that other executing brokers execute and the company accepts for clearance pursuant to the customer's give-up agreement.

The applicant represented that, under the give-up agreements, the company would have the contractual right to refuse a customer's trade that exceeded established trading limits that were documented in the give-up agreement for that particular customer. The company would have a period of time within which it could determine if the executed trade was properly authorized according to established limits, and could decide to reject the trade.

The company's customer base would consist of sophisticated institutional investors. The company would review the creditworthiness and other characteristics of each potential customer. Based on that review, it would approve or reject the customer and establish appropriate trading, credit, margin, and exposure limits for the customer. It would accept for clearance only trades that had been executed by preapproved execution groups trading on the CBOT and CME. Company would approve an execution group only if the floor brokers, and their primary or qualifying clearing firms, satisfied the com-

3. Under a give-up agreement, the executing floor broker (or give-in broker), pursuant to a customer's instructions, gives up an executed order for clearance to a clearing member other than the executing broker's primary clearing member (or qualifying member). Such agreements are used primarily to allow institutional customers to select a broker who has superior expertise and execution skills with respect to specific contracts or types of orders, while maintaining their accounts and positions with a clearing firm in which they have financial confidence.

4. Company would not trade for its own account except (1) to hedge a cash position in the related financial instrument or (2) to offset or liquidate a clearing error arising in the normal course of business.

pany's financial, managerial, and operational standards.

The Board decided that the credit and the other risk considerations associated with the proposed nonbanking activities were consistent with requirements for approval. The decision was based on (1) the framework described in the order; (2) the fact that the company would not be the primary or qualifying clearing firm for any broker that executed the company's clearing-only trades, or for any nonaffiliated customer; (3) the other contractual and operational distinctions noted between this proposal and the previous denied application (1991 FRB 189); and (4) the other facts of record.

The Board noted that it had recently approved applications by two bank-affiliated FCMs to engage in clearing-only activities, also on the CBOT and the CME (1993 FRB 723 and 1993 FRB 728). For a brief summary of the initial order, see section 3251.0.3.

The Board approved the application on August 2, 1993 (1993 FRB 961). The approval was subject to the facts of record, all the commitments made by the applicant, and the limitations and conditions stated in the order.

3251.0.5 FCM—EXECUTING AND CLEARING, AND CLEARING WITHOUT EXECUTING, FUTURES AND OPTIONS ON FUTURES ON NONFINANCIAL COMMODITIES

A bank holding company (the applicant, a BHC within the meaning of the BHC Act) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.3 of the Board's Regulation Y to act, through a wholly owned subsidiary (the company), as a futures commission merchant (FCM) for unaffiliated customers in executing and clearing, and clearing without executing, futures and options on futures on *nonfinancial commodities*. Initially, the applicant proposed to conduct these activities in futures and options on futures on heating oil, crude oil, corn, wheat, soybeans, cattle, and hogs. The applicant must give at least 20 days' written notice to the Federal Reserve before it engages in FCM activities with respect to additional contracts linked to other physical commodities, unless other contracts are approved for any other bank holding company under the BHC Act.

The company is engaged in executing and clearing on major commodities exchanges futures and options on futures on financial commodities and certain broad-based and widely traded stock and bond indices.[5] The company proposed to engage in its proposed activities on the CBOT, CME, and New York Mercantile Exchange (NYMEX).

The company *will not* trade in the proposed derivative instruments for its own account. However, when a customer defaults on a contract after the termination of futures trading and the company is required to make or take delivery of the underlying commodity, or when it exercises its right to liquidate a customer's account, the company is permitted to take the necessary actions to mitigate its damages. These actions include acting for its own account in retendering or redelivering the commodity, entering into an exchange-for-physical transaction, or entering into an offsetting transaction in the cash market, provided these and other appropriate actions are taken as soon as practicable.

The company will limit its proposed services only to institutional customers and will not provide such services to retain brokerage customers, locals, or market makers. Approximately 10 percent of its business will be conducted on behalf of managed commodity funds (regulated by the Commodity Futures Trading Commission (CFTC) and the National Futures Commission). None of the managed funds would be owned, sponsored, advised by, or otherwise affiliated with the applicant. The company will not act as a commodity trading advisor,[6] or otherwise provide investment advice on the proposed instruments.

The Board had not previously approved the execution and clearance by bank holding companies of futures and options on futures on nonfinancial commodities. The Board's approval had been limited to acting as an FCM in the execution and clearance on major commodities exchanges of futures and options on futures on a variety of financial commodities, such as gold

5. See 1985 FRB 970. The company already engages in FCM activities on the Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), Commodity Exchange, London International Financial Futures and Options Exchange, Marche a Terme International de France, and Singapore International Monetary Exchange.

6. As defined in the Commodities Exchange Act, a commodity trading advisor includes, with certain exceptions, "any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of the regular business, issues or promulgates analyses or reports concerning commodities." (7 U.S.C. 2)

and silver bullion and coins, foreign exchange, government securities, certificates of deposit and money market instruments that banks may buy and sell for their own accounts, and stock and bond indices.[7]

3251.0.5.1 BHC's Execution and Clearance of Futures and Options on Futures on Nonfinancial Commodities

National banks engage in a broad range of FCM activities involving all types of exchange-traded futures and option contracts consisting of financial and nonfinancial commodities for the accounts of customers, and for their own accounts, for hedging purposes. The Office of the Comptroller of the Currency (OCC) reasoned that the clearing process for any futures contract or option on a futures contract involves essentially an extension of credit because, upon receiving an executed order from a customer, the clearing broker supplies its own credit in an order on behalf of the customer and then sends the order to the exchange clearing organization for settlement. The OCC also determined that the execution, clearance, and advisory services provided by an FCM to its customers are essentially the same whether or not the underlying commodities are financial or nonfinancial.

Some national banks act as an FCM in the execution and clearance of futures and options on futures on a broad array of financial and nonfinancial commodities. The state of New York Banking Department has also permitted several New York–chartered banks to engage, to a limited extent, in FCM activities involving derivative instruments on nonfinancial commodities.

The Board has previously authorized bank holding companies to conduct FCM activities involving numerous instruments based on financial commodities. The Board determined that acting as an FCM in connection with contracts involving nonfinancial commodities is operationally and functionally similar to conducting FCM activities with respect to derivative contracts involving financial commodities. In both instances, the FCM monitors customer credit risk and trading exposure; assesses and collects initial and maintenance margins from customers; and brokers, executes, and clears trades.

Acting as an FCM for derivative instruments involves functions, skills, risks, and expertise that are substantially similar to those associated with the execution and clearance of financial futures and option contracts that the Board previously approved. The mechanics of executing and clearing trades are operationally the same whether the commodity underlying the exchange-traded derivative instrument is financial or nonfinancial. The rules and regulations of the CFTC, as well as the rules, procedures, practices, capital requirements, and safeguards of the various commodities exchanges, govern both the execution and clearance of nonfinancial futures and options and the execution and clearance of financial futures and options.

In 1991, the Board permitted bank holding companies to provide investment advice on trading futures contracts and options on futures contracts in nonfinancial commodities, such as agricultural and energy commodities. (See 1991 FRB 126.) It concluded that (1) providing investment advice on investing in futures and options on nonfinancial commodities appeared to be the functional equivalent of providing advice on futures and options on futures on financial commodities and (2) exchange-traded futures and options on futures involving nonfinancial commodities were essentially financial instruments.

The Board concluded, based on an analysis of the range of FCM activities currently existing in banking (as summarized above and cited in the order), that the activity of acting as an FCM in the execution and clearance of futures and options on futures on nonfinancial commodities, as proposed by the applicant, is an activity that is closely related to banking for the purposes of the BHC Act.

3251.0.5.2 FCM's Execution and Clearance of Futures and Options on Futures on Nonfinancial Commodities

The Board noted that both the company and the commodities exchanges on which the proposed FCM activities would be conducted are subject to regulatory oversight by the CFTC. The company's trading and clearance activities would also be subject to regulation and review by the CFTC and the commodities exchanges. The

7. See section 225.28(b)(7)(iv) of Regulation Y (12 C.F.R. 225). See also 1985 FRB 251, 1985 FRB 111, 1977 FRB 951, and 38 *Federal Register* 27,552 (1973). The applicant's proposed clearing without execution activities were approved in 1993 (FRB 723–728). The company proposed to conduct its clearing-only activities subject to the same conditions and limitations set forth in these Board orders, including the use of the "give-up agreement" by and among the company, its customers, and the nonaffiliated executing FCM that allows the company to refuse to clear trades that exceed specified risk parameters.

applicant committed to conduct the proposed activities subject to the same rules and procedures the Board imposed on FCM activities in derivatives of financial commodities, including prohibitions on extending credit to customers for the purpose of meeting margin requirements. The applicant committed to take several further steps in the event that one of the company's customers has an open position in a contract after futures trading is ceased, and the customer is not willing or is unable to make or take delivery. Based on the commitments made by the applicant for conducting the proposed activities, the limitations on the activities cited in the order, and all the facts on record, the Board approved the application on September 28, 1993, subject to all the terms and conditions set forth in the order and the noted Board regulations and orders that relate to the proposed activities. (See 1993 FRB 1049.)

3251.0.6 FCM AND RELATED ADVISORY SERVICES FOR OPTIONS ON EUROTOP 100 INDEX FUTURES AND THE ONE-MONTH CANADIAN BANKER'S ACCEPTANCE FUTURES

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to act as an FCM for and provide advisory services to nonaffiliated persons, in connection with the purchase and sale of futures and options on futures contracts that are based on bonds or other debt instruments; certain commodities; or stock, bond, or commodity indices. The applicant proposed contracts that were not previously considered by the Federal Reserve System: options on Eurotop 100 Index futures, to be traded on the Commodity Exchange, Inc. (Eurotop contracts), and the one-month Canadian Banker's Acceptance Futures, to be traded on the Montreal Exchange (banker's acceptance futures). These contracts are based on a financial instrument or a broad-based financial index and are comparable to contracts previously considered by the Federal Reserve System. They have essentially the same terms and serve the same functions as futures and options contracts for which FCM and related advisory services have been approved by the Board under section 4(c)(8) of the BHC Act. The Board concluded that the skills necessary to engage in providing FCM and futures advisory services are the same as those used to provide such services with regard to previously approved contracts. The Board thus approved the applicant's provision of these FCM and related advisory services for these contracts by the company, concluding that the activity is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. (See 1995 FRB 188–189.)

3251.0.7 FCM TRADING FOR ITS OWN ACCOUNT IN FUTURES, OPTIONS, AND OPTIONS ON FUTURES CONTRACTS BASED ON CERTIFICATES OF DEPOSIT OR OTHER MONEY MARKET INSTRUMENTS

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to trade as an FCM in all futures, options, and options on futures contracts based on certificates of deposit or other money market instruments that are permissible investments for national banks. The Board had previously authorized company to trade for its own account, for purposes other than hedging, in futures, options, and options on futures contracts based on U.S. government securities that are permissible investments for national banks and in similar contracts based on certain money market instruments. (See 1991 FRB 759.) In that order, the Board noted that trading in these contracts would require a market judgment on interest rates. It was noted that banks, through their core lending and funding activities, had developed expertise in judging interest-rate and price movements. For those reasons, and because that proposal would not authorize company to trade in derivative contracts based on securities or instruments that a state member bank could not purchase for its own account, the Board determined the trading activity to be closely related to banking under section 4(c)(8) of the BHC Act.

The Board concluded that its reasoning in the 1991 order could be applied currently to this expanded 1994 proposal. The Board noted that the Office of the Comptroller of the Currency had determined that trading in futures and options contracts based on bank-eligible securities or instruments is an activity that is within the legally authorized powers of national banks (OCC Interpretive Letter No. 494 (December 20, 1989)). The Board thus concluded that the proposed trading activity is conducted by banks and is so operationally and functionally similar to activities conducted by banks that banks are particularly well-equipped to engage in the activity. It therefore concluded that trading for one's own account, for purposes other than hedging, in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments that are permissible investments for national banks is an activity that is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. (See 1995 FRB 190.)

3251.0.8 FCM ENGAGING IN COMMODITY AND INDEX SWAP TRANSACTIONS AS AN ORIGINATOR, PRINCIPAL, AGENT, BROKER, OR ADVISOR

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to engage in FCM activities and in acting as an originator, principal, agent, broker, or advisor with respect to swaps and swap-derivative products and over-the-counter option transactions based on certain commodities; stock, bond, or commodity indices; or a hybrid of interest rates and these commodities or indices (commodity and index swap transactions).[8] Except for certain advisory services, the Board had not determined whether these proposed activities are closely related to banking under section 4(c)(8) of the BHC Act. The Board had determined, by order or regulation, that acting as an originator, principal, broker, agent, or advisor with respect to interest-rate and currency swaps and swap-derivative products relating thereto (financial swap transactions) are activities closely related to banking and are thus permissible for bank holding companies. (See Regulation Y, section 225.28(b)(6) and 1993 FRB 345.)

8. The proposed activities are subject to the same commitments relating to interest-rate and currency swap transactions and related swap-derivative products. (See 1993 FRB 345.)

The applicant anticipates that the section 20 subsidiary's swap transactions will be based on a variety of stock and bond indices, similar to those previously approved in connection with proposed FCM activities (or to a specially tailored basket of securities selected by the parties) (index transactions), or they could be based on precious metals and energy products or related commodity indices (commodity transactions). They also could include hybrid transactions that are based on a combination of interest rates and such indices or commodities.

Commodity and index swap transactions are operationally, structurally, and functionally similar to financial swap transactions. Both types of swaps involve privately negotiated financial transactions. The parties involved in the transaction agree to exchange specified payment streams over a specific period of time, based on a predetermined formula. For an interest-rate swap, the basic structure is an exchange between two counterparties of the payment streams that arise out of different interest payment obligations, calculated on the basis of an agreed-upon notional principal amount. With the commodity or index swap transaction, the parties exchange payment streams based on a notional principal amount and the prices of certain commodities or the value of or returns on certain securities or indices of securities, or on a combination of these and other measures such as interest rates. For both types of swap transactions, the parties enter into these contracts to meet various common investment objectives, including taking positions in the market for the underlying assets for investment purposes, limiting one's exposure to market uncertainties and future price fluctuations, and preserving principal while participating in the potential returns of a particular financial market or economic sector. Since a swap transaction is negotiated between parties, the economic terms of the transaction (including the duration of the contract; notional principal amount; method of calculating and frequency of payments; and underlying assets, rates, or indices upon which the payments are to be determined) can be individually tailored to meet specific financial goals and risk sensitivities of the counterparty.

National banks have been authorized by the OCC to engage in activities that involve matched and unmatched commodity and index swap transactions (including related swap-derivative products and over-the-counter options). The New York State Banking Department also approved these activities for state-chartered banks under its jurisdiction. In addition, the Board permits state member banks to enter into perfectly matched commodity and index swap transactions, provided the transactions are consistent with their state charters. Further, the Federal Reserve Bank of New York, acting under delegated authority, has approved proposals by state member banks to engage in such activities on an unmatched basis. (See 12 C.F.R. 208.128.)

For the foregoing reasons and based on the facts of record, the Board determined that engaging in commodity and index swap transactions is an activity conducted by banks. The Board also considered the similarities between these transactions and the financial swap transactions noted above, as well as the fact that banks and other intermediaries play a similar role in financial swap transactions and commodity and index swap transactions. It was noted that all of these contracts represent forms of financial intermediation that banks have historically engaged in. Based on all the facts on record, the Board concluded that these proposed activities are closely related to banking under section 4(c)(8) of the BHC Act.

As noted previously, the company also proposes to provide advisory, agency, and brokerage services with respect to commodity and index swap transactions. The Board believes that the authority of banks to conduct these activities could be implicit in or incidental to their authority to engage in the transactions as principal. In its analysis, the Board noted that banks can develop a familiarity and expertise as to the structure and economic effects of these transactions, which should well equip them to provide the intended advisory, agency, and brokerage services. National banks have been expressly authorized to provide advisory, execution, and other services with respect to exchange-traded futures and options on futures contracts based on financial and nonfinancial commodities. (See OCC Interpretive Letter No. 494.) The exchange-traded transactions are used for purposes similar to the over-the-counter transactions for which the applicant proposes that the company render advisory, agency, and brokerage services. The pricing bases for, economic effects of, and risk presented by the two types of transactions are also similar in important respects.

Based on the facts on record, the Board determined that the proposed advisory, agency, and brokerage services are activities conducted by banks or are operationally and functionally similar to such activities. Thus, they are closely related to banking under section 4(c)(8) of the BHC Act. (See 1995 FRB 190–191.)

3251.0.9 FCM TRADING IN FUTURES, OPTIONS, AND OPTIONS ON FUTURES CONTRACTS BASED ON COMMODITIES OR ON STOCK, BOND, OR COMMODITY INDICES FOR ITS OWN ACCOUNT

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to engage in *trading for its own account* for purposes other than hedging in futures, options, and options on futures contracts based on certain commodities or on stock, bond, or commodity indices—transactions that have not been expressly authorized for banks. The instruments to be traded are generally the same as those previously approved by the Board in considering FCM and futures advisory activities of bank holding company subsidiaries, such as crude oil futures, Standard & Poor's 500 Stock Price Index futures, and municipal bond index futures. (See 1993 FRB 1,049 and 1994 FRB 151 and also SR-93-27 (refer to Appendix A).) The applicant proposes to engage in FCM activities and go beyond furnishing those FCM and related advisory services and seeks the Board's permission for the company to trade these instruments for its own account. Such activities include arbitrage operations, market making for customer-accommodation purposes, and proprietary trading (taking positions for investment purposes), as well as hedging transactions.

The proposed activities could consist of exchange-traded instruments that could be based on commodities such as crude oil, providing for delivery of the underlying commodity upon expiration of the contract. The applicant confirmed that it does not intend to take delivery of such commodities but plans to take several actions to avoid delivery of commodities other than precious metals. These actions include closing positions in expiring contracts during trading periods and engaging in exchange-for-physical transactions after trading closes. The Board stipulated, as a condition of approval, that the applicant could not take delivery of the commodities, except in unusual circumstances. Whenever delivery is taken, the applicant is required to notify the Federal Reserve System and divest itself of the commodity promptly. The Board views the contracts as financial instruments, despite the possibility that trading in such contracts can result in the delivery and ownership of commodities that banking organizations are generally not permitted to hold. The Board also noted, with respect to the proposed exchange-traded transactions that are based on an index of securities or commodities, that (1) the transactions would be settled in cash and (2) they would not provide for the delivery of the underlying securities or commodities.

The Board had not previously approved this trading activity, with respect to the instruments proposed, for bank holding companies or their subsidiaries under section 4(c)(8) of the BHC Act. The Board has, however, authorized acting as an FCM and providing advisory services with respect to the instruments to be traded. The Board also approved similar trading with respect to instruments based on U.S. government securities and money market instruments. (See 1991 FRB 759.) With respect to section 20 nonbank subsidiaries, the Board has recognized the utility of trading in these instruments to hedge market exposure resulting from other trading activities, indicating that these bank holding company subsidiaries may engage in such risk-management transactions as a necessary incident to their underwriting and dealing activities. (See 1994 FRB 449.) No federal bank regulatory authority had expressly permitted banks to trade in the proposed instruments for their own accounts for purposes other than hedging.

The Board believes that the proposed trading activities are closely related to banking. It noted that banks engage in activities with respect to the instruments in question that are similar to or related to the proposed trading activities and that they engage in trading activities for the same purposes with respect to similar instruments, including exchange-traded contracts based on bank-eligible securities and instruments and over-the-counter transactions based on commodities and various indices.

The Board further noted that banking organizations have substantial experience with exchange-traded derivative transactions based on commodities or on commodity or securities indices. It also noted important similarities between the proposed instruments and transactions that have been authorized for banks for nonhedging purposes. Moreover, the Board believes that the risks inherent in the proposed trading activities are similar to those that are experienced by banks that engage in swaps and other permissible transactions; hence, the proposed transactions require analytical skills; risk-management policies, procedures, and techniques; and computer and operations systems similar to those used by banks for engaging in those permissible transactions. Based on this reasoning, the Board determined the proposed activity to be closely related to banking under section 4(c)(8) of the BHC Act. The Board's December 23, 1994, approval is subject to all the facts of record, all the commitments made in connection with the application, and the conditions cited in the order. (See 1995 FRB 185.) These include adhering to future supervisory or examination policies and guidance issued by the Board for a banking organization's derivatives business, including policies or guidance with respect to customer transactions, trading and marketing practices and policies, and related systems and controls.

3251.0.10 APPENDIX A—PREVIOUS PRIOR-APPROVAL REQUIREMENTS FOR BANK HOLDING COMPANIES PROPOSING TO ENGAGE IN FCM ACTIVITIES

In May 1993, the Board reduced the prior-approval requirements for bank holding companies proposing to engage in certain futures commission merchant (FCM) activities. (See SR-93- 27.) First, the Board delegated to Reserve Banks its authority to approve proposals by bank holding companies to act as an FCM in executing and clearing any futures contract on a financial commodity or stock or bond index that the Board has previously approved, on any Board-approved exchange. The Board also delegated to Reserve Banks its authority to approve proposals by bank holding companies to act as an FCM or commodity trading advisor in providing investment advisory services for previously approved financial instruments.

In addition, the Board modified and, in certain cases, eliminated the prior-approval requirement for bank holding companies seeking to act as an FCM for additional financial instruments or to act as an FCM on additional exchanges in which the bank holding company already has Federal Reserve System approval to engage generally in FCM activities. Any bank holding company that had previously received approval to act as an FCM under either Board order or the former sections 225.25(b)(18) and (b)(19) of Regulation Y could act as an FCM subject to certain limitations and conditions. These requirements were replaced by the April 1997 Regulation Y revision at section 225.28(b)(7)(iv).

3251.0.11 PROVIDING DISCRETIONARY PORTFOLIO MANAGEMENT SERVICES ON FUTURES AND OPTIONS ON FUTURES ON FINANCIAL COMMODITIES

A foreign bank (the applicant), a bank holding company within the meaning of the BHC Act, applied under section 4(c)(8) of the act to engage through company in providing discretionary portfolio management services with respect to exchange-traded futures and options on futures on financial commodities.[9] The provision of discretionary portfolio management services, with respect to futures and options on futures on financial commodities, had not been previously considered by the Board as to whether it is closely related to banking under section 4(c)(8) of the act.

In providing discretionary management services, company would manage customers' accounts and purchase and sell in its sole discretion exchange-traded futures and options on futures on financial commodities for such accounts. Company would provide discretionary management services in combination with providing futures commission merchant (FCM) transactional services and would only provide such services to institutional customers.[10] Company would not act as a counterparty on customer transactions or trade these instruments for its own account. In addition, company would not purchase or sell over-the-counter contracts for accounts over which it exercises discretion.

The Board has permitted bank holding company FCMs and commodity trading advisors to provide investment advice with respect to futures and options on futures on financial and nonfinancial commodities. (See Regulation Y, section 225.28(b)(6) and 1994 FRB 151.) The bank holding company argued that discretionary management is a normal manner of providing investment advice to institutional customers. Indeed, the Board permits bank holding companies to act as discretionary portfolio managers as part of providing investment advisory and full-service brokerage services with respect to securities. (See Regulation Y, section 225.28(b)(6) and (b)(7)(i).) In addition, the Office of the Comptroller of the Currency permits national banks to engage in discretionary funds management with respect to futures and options on futures.[11]

The applicant also indicated that company would provide the proposed futures-related discretionary portfolio management services in accordance with the limitations and conditions that would be imposed if company were providing portfolio management services in the securities context. In this regard, the applicant committed that company would only provide the proposed discretionary portfolio management services to institutional customers and only at the request of such customers.

The applicant also indicated that it would have a fiduciary relationship with all customers to whom it provides the proposed discretionary management services and has committed that company would comply with applicable law, including fiduciary principles. As one method of meeting its fiduciary obligations, the bank holding company committed that company would obtain the consent of customers before engaging, as principal or agent, in a transaction in which any affiliate of company acts as principal in futures or options on futures transactions on the customer's behalf. Company and its affiliates also agreed not to share any confidential information concerning their respective customers without the consent of the customer. In addition, the applicant stated that company would exercise its discretionary management authority only in purchasing and selling exchange-traded instruments. Therefore, concerns surrounding over-the-counter instruments, such as the potential for abuses due to the lack of price transparency, were not presented by the proposal.

For these reasons, the Board concluded that providing discretionary portfolio management services with respect to futures and options on futures on financial commodities is closely related to banking and a proper incident to banking for purposes of section 4(c)(8). The application was approved by the Board on February 9, 1995. (See 1995 FRB 386.)

9. The bank holding company also proposed to engage in a variety of data processing, securities, futures, and foreign exchange–related activities through company and another subsidiary. The Board previously has determined by order or regulation that these activities are closely related to banking. The bank holding company committed to conduct these activities in accordance with the conditions established by the Board in Regulation Y and prior orders.

10. Company would provide these services to commodity pools but would not become a commodity pool operator.

11. See OCC Interpretive Letter No. 494 (December 20, 1989).

3251.0.12 FCM EXECUTION, CLEARANCE, AND ADVISORY SERVICES FOR CONTRACTS ON FINANCIAL AND NONFINANCIAL COMMODITIES FOR NONINSTITUTIONAL CUSTOMERS

A foreign banking organization (the notificant) subject to the provisions of the Bank Holding Company Act (BHC Act) provided notice under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its proposal that its indirect U.S. subsidiary (the indirect subsidiary)[12] acquire certain assets and assume certain liabilities of a company.[13] The notificant would engage indirectly in FCM execution, clearance, and advisory activities with respect to futures and options on futures on financial and nonfinancial commodities[14] and in buying and selling foreign exchange in the spot, forward, and over-the-counter options markets on the order of investors as riskless principal.[15] The Board had previously determined by order and regulation that the above proposed activities are closely related to banking within the meaning of section 4 of the BHC Act.[16]

12. The indirect subsidiary is wholly owned by the notificant. The indirect subsidiary engages in various futures commission merchant, foreign-exchange, and securities-related activities. See 1994 FRB 646 and 649.

13. The acquired firm was a clearing member of certain financial and nonfinancial commodities exchanges. The FBO stated that the indirect subsidiary would become a clearing member of those exchanges. In addition, that subsidiary would provide FCM services with respect to two exchange-traded contracts that had not previously been approved by the Board (heating oil crack-spread options and gasoline crack-spread options) and would purchase and sell through the use of omnibus account arrangements certain futures and options on futures on nonfinancial commodities traded on two other exchanges.

14. These activities include providing execution-only and clearing-only services to customers. See 1993 FRB 723 and 1994 FRB 151.

15. The indirect subsidiary would provide the proposed riskless-principal services only to institutional customers, except that it would provide such services to certain noninstitutional customers when they direct it to convert funds from one currency to another to trade futures and options on futures contracts. Foreign exchange–related advisory services would not be provided to these noninstitutional customers.

16. See 12 C.F.R. 225.28(b)(7)(iv) and 225.28(b)(6) and 1990 FRB 649 (1990).

3251.0.12.1 Providing FCM Services to Certain Sophisticated Noninstitutional Customers

First, the notificant proposed that the indirect subsidiary would provide FCM execution, clearance, and advisory services with respect to contracts on both financial and nonfinancial commodities to persons that do not qualify as institutional customers but who trade futures and options on futures solely to hedge risks arising from their business activities (noninstitutional commercial hedger customers), such as farmers. The Board has limited bank holding companies to providing nonfinancial commodities–related FCM services only to institutional customers. Similarly, with respect to contracts on financial commodities, the Board has not permitted bank holding companies to provide execution-only or clearing-only services to noninstitutional customers and only permits bank holding companies to provide advisory services to financially sophisticated customers that have significant dealings in the underlying commodities.[17]

The indirect subsidiary's noninstitutional commercial hedger customers would be engaged or would be affiliated with a commercial enterprise that is engaged in producing, manufacturing, processing, or merchandising products or in providing services that are related to the commodities underlying the futures and options on futures contracts in which the customers would trade. The noninstitutional commercial hedger-customers would not be engaged in executing their own trades on the floor of any commodities exchanges. The notificant stated that the indirect subsidiary would require noninstitutional commercial hedger customers to state in writing that they would only engage in "bona fide hedging transactions," as defined by the Commodity Futures Trading Commission (CFTC).[18] In addition, an initial credit-review process will be established to determine whether a noninstitutional commercial hedger customer's proposed hedging activities are appropriate in light of the customer's net worth and business activities. The indirect subsidiary will not permit noninstitutional commercial hedger customers to trade in any commodities other than those that the customer would trade to hedge risks from its commercial activities, and it would establish a system to detect any unauthorized trading activities.

By limiting transactional services and advice to areas in which the customer has special expertise, the proposed limitations address the concern that the customer would rely unduly on the bank holding company's advice or that the customer would be unable to detect conflicts of interest or advice that is motivated by the bank holding company's self-interest. Moreover, the notificant will abide by all the other limitations designed to more specifically address the potential risks that may result from providing clearing-only and execution-only services to these customers.

3251.0.12.2 Foreign-Exchange Activities

Second, in connection with the proposal that the indirect subsidiary will buy and sell foreign exchange on the order of customers as riskless principal, the notificant proposed that the indirect subsidiary be permitted to purchase and sell foreign exchange for its own account for limited purposes while also providing foreign-exchange-related execution and advisory services.[19] In several limited circumstances, the Board has permitted a bank holding company to provide foreign-exchange-related transactional and advisory services in a subsidiary that purchases and sells foreign exchange for its own account.[20] For example, the Board has permitted bank holding companies to provide foreign-exchange-related advice and transactional services through a subsidiary engaged in purchasing and selling foreign exchange for its own account to hedge positions in permissible interest-rate or currency-swap transactions or to hedge risks arising from the permissible securities underwriting and dealing activities of the subsidiary.[21]

The indirect subsidiary will take positions in foreign exchange only as a means to hedge financial-statement translations of income for its foreign parent and as necessary for the payment of invoices denominated in foreign currencies. It would not enter into a foreign-exchange transaction for its own account with a customer if the customer is receiving foreign-exchange services relating to such transaction from this subsidiary. The notificant committed that the indirect subsidiary will observe the standards of care and conduct applicable to fiduciaries with respect to its foreign-exchange-related advisory activities and will provide foreign-exchange-related execution and advisory services only to institu-

17. See 1993 FRB 1049 and 12 C.F.R. 225.25(b)(19) (contracts on financial commodities). These limitations address concerns that, in futures transactions, unsophisticated customers may place undue reliance on investment advice received from a banking organization and may not be able to detect investment advice that is motivated by the advisor's self-interest. Similarly, in cases involving clearing-only transactions, the limitation helps address the added risk to the bank holding company that results from its more limited ability to review and reject trades that have been executed through another FCM.

18. See 17 C.F.R. 1.3(z).

19. The indirect subsidiary currently provides foreign-exchange-related execution and advisory services to its customers. In permitting bank holding companies to provide foreign-exchange execution and advisory services on a combined basis, the Board has relied on the representation that the subsidiary providing the foreign-exchange-related services would not purchase or sell foreign exchange for its own account.

20. The Board also previously has noted that in conducting foreign-exchange operations, commercial banks combine the functions of giving advice, executing transactions, and taking positions in foreign exchange.

21. See 1994 FRB 157 and 1993 FRB 892.

tional customers. The notificant also committed that the indirect subsidiary's personnel engaged in purchasing and selling foreign exchange for its own account will not have access to information about the foreign-exchange trading activities of customers and that customer representatives will not have access to information about the foreign-exchange activities of personnel engaged in purchasing and selling foreign exchange for the indirect subsidiary's own account.[22]

3251.0.12.3 Board's Decision on the Proposed FCM Activities

Based on the foregoing and all the facts of record, the Board approved the notification subject to all the terms and conditions set forth in the order and in the above-noted Board regulations and orders that relate to these activities. The Board's determination is subject to all the terms and conditions set forth in the Board's Regulation Y, including those in sections 225.7 and 225.23(b). The Board's decision is specifically conditioned on compliance with all the commitments made. The notice was approved on July 14, 1995 (see 1995 FRB 880).

3251.0.13 FCM SERVING AS A PRIMARY CLEARING FIRM FOR A LIMITED NUMBER OF FLOOR TRADERS AND BROKERAGE SERVICES FOR FORWARD CONTRACTS ON FINANCIAL AND NONFINANCIAL COMMODITIES

A foreign banking organization and its parent holding companies (the notificants), bank holding companies within the meaning of the Bank Holding Company Act, requested the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire all the voting securities of a company (the company) and thereby engage in a wide range of nonbanking activities, including securities- and derivatives-related activities. The company and its principal subsidiary (the subcompany) engage worldwide in a wide range of investment advisory, securities underwriting, and futures-related activities. The notificants proposed to merge the subcompany and the company into the notificants' existing nonbank section 20 company (the section 20 company). The section 20 company would continue as a registered broker-dealer with the Securities and Exchange Commission under the Securities Exchange Act of 1934 and as a member of the National Association of Securities Dealers. The section 20 company would also become registered as a futures commission merchant (FCM) and a commodity trading advisor (CTA).[23]

The notificants proposed to engage in a variety of FCM-related activities the Board previously had determined, by regulation or order, were so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act. The proposed activities included engaging in execution-only, clearing-only, and omnibus account activities with respect to futures and options on futures based on financial and nonfinancial commodities, and providing discretionary portfolio management services with respect to futures and options on futures on financial and nonfinancial commodities.[24] (See 1997 FRB 138–142.) The section 20 company committed to providing these futures-related execution-only, clearing-only, and discretionary portfolio management services only to institutional customers and certain sophisticated noninstitutional commercial hedger customers.[25]

3251.0.13.1 Primary Clearing Firm for a Limited Number of Professional Floor Traders

The notificants also proposed that the section 20

22. To address potential conflicts of interest in connection with providing the proposed foreign-exchange riskless-principal services, the notificant committed that the indirect subsidiary will disclose to each customer that receives advice relating to over-the-counter transactions in the foreign-exchange market that it may have an interest as a counterparty principal in the course of action ultimately chosen by the customer. Also, in any case in which the indirect subsidiary has an interest in a specific over-the-counter foreign-exchange transaction as counterparty principal, it will advise its customer of that fact before recommending participation in that transaction.

23. The subcompany was already registered as an FCM and CTA.

24. The notificants committed that the section 20 company would provide these services in accordance with the limitations previously established by the Board. See 1993 FRB 723, 1993 FRB 1049, and 1994 FRB 151.

25. The notificants stated that all noninstitutional commercial hedger customers would meet the requirements previously reviewed by the Board. See 1995 FRB 880.

company provide clearing-only services to, and serve as the primary clearing firm for, certain professional floor traders on two exchanges with respect to the futures contracts and options on futures contracts traded on such exchanges.[26] The Board previously has determined that providing clearing services with respect to exchange-traded securities, options, futures, and options on futures contracts is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. In 1991, however, the Board denied an application by the notificants to engage de novo in providing the proposed services to an unlimited number of market makers and other professional floor traders dealing for their own accounts.[27]

In the 1991 order, the Board recognized that a company serving as the primary clearing firm for professional floor traders may be exposed to significant financial risks because the company generally would not have the ability to reject an executed trade presented to it for clearance, even when the company believes the trade presents unacceptable risks in light of market conditions or the traders' financial position. The Board also noted that, at the time of the 1991 application, the applicants lacked appropriate operational systems to track and manage the intraday risks arising from the trading activities of the floor traders. This lack of a mechanism to monitor intraday trading activities presented the possibility that a professional floor trader could incur substantial losses through the trading of options or futures contracts, which the applicants would be obligated to clear and guarantee, before the applicants could act to mitigate their credit-risk exposure.

It was noted that since 1991, the Board and bank holding companies have gained substantial experience with the conduct, methods, procedures, and regulation of clearing-only activities. Also, since 1991, the Board had authorized bank holding companies to provide clearing-only services with respect to futures contracts and options on futures contracts for customers other than professional floor traders, subject to certain conditions designed to ensure that the bank holding companies have the ability to manage the attendant financial risks.[28]

The Board concluded that the facts of record indicated that the subcompany had and the section 20 company would have sufficient risk-management policies, procedures, and systems to permit the notificants and the section 20 company to adequately monitor and control the risks, including the intraday risks, associated with the section 20 company's proposal to serve as the primary clearing firm for a limited number of professional floor traders on the two exchanges. Specifically, the section 20 company would use the subcompany's established trading, credit, margin, and exposure limits for each professional floor trader for which the section 20 company serves as the primary clearing firm. Adherence to these limits is monitored on an intraday basis by experienced personnel who are physically present on the floor of the two exchanges. These personnel visually monitor the trading activities of floor traders on the exchanges and review trades submitted by the floor traders for clearance.[29] If an employee of the section 20 company determines that a floor trader is exceeding the limits it has established, or is otherwise engaged in questionable trading activities, the employee would have the ability

26. A primary clearing firm is obligated to accept and clear all trades submitted by a professional floor trader, even if the trade was initially presented to, and rejected by, another clearing firm. Once a primary clearing firm clears a trade for a professional floor trader, the firm becomes obligated to settle the trade in the event of a default by the professional floor trader. The company served as the primary clearing firm for professional floor traders on the two exchanges. The notificants requested authority for the section 20 company to act as the primary clearing firm for up to 20 professional floor traders on one exchange and 40 professional floor traders on the other.

27. See 1991 FRB 189.

28. In particular, the bank holding companies agreed to provide the clearing-only services pursuant to "give-up" agreements, which provide the bank holding companies with the right to refuse to accept for clearance any customer trade that the bank holding company deems unsuitable in light of market conditions or the customer's financial situation or objective. In addition, the bank holding companies agreed to establish procedures to monitor the intraday trading activities and risk exposure of their clearing-only customers.

29. The Board recognizes that trades on the two relevant exchanges are not electronically submitted to the clearing firm or the exchange. Instead, trading cards for each trade are submitted by each professional floor trader to its clearing firm, which enters the trade into the exchange's clearing system. Both exchanges require that the subcompany collect the trading cards from each floor trader at least once during each half-hour period, thereby providing the subcompany personnel with an opportunity to review the intraday trading activities of floor traders. The rules of one exchange also require that the subcompany enter all collected trades into the exchange's on-line clearing system within 45 minutes of the end of the half-hour period during which the trades were collected. That exchange's on-line clearing system also permits the subcompany to monitor the trading activities of floor traders, both individually and in the aggregate, on an intraday basis, and allows the subcompany to identify any potentially unmatched trades. Although the other exchange does not operate an on-line clearing system, the subcompany personnel maintain tally sheets that are updated every 30 minutes and reflect all trades submitted by each professional floor trader throughout the day.

to limit or halt the floor trader's activities, require the floor trader to post additional margin, partially or entirely liquidate the floor trader's positions, or immediately revoke the floor traders membership on the exchange.[30] The notificants' operations managers on the two exchanges also would personally guarantee the section 20 company against any losses that it may incur from serving as the primary clearing firm for floor traders on the exchanges, thereby providing such personnel with an incentive to closely monitor the trading activities of the floor traders. The notificants also stated that the section 20 company would install an on-line risk-management system that would provide its personnel with intraday data on the trading activities of the professional floor traders, and the ability to analyze its exposure to such trading activities on an intraday basis.

The Board noted that the type of risk-management systems necessary to appropriately manage the risks arising from a particular activity necessarily depends on the scope and nature of the proposed activity. In this regard, the Board noted that the section 20 company proposed to serve as the primary clearing firm for only a limited number of professional floor traders on two exchanges. These exchanges have relatively small trading areas and volumes, which permit personnel on the floors of the exchanges to monitor trading activity. The Board noted that the Federal Reserve Bank had conducted an on-site operational and managerial infrastructure review used by the subcompany to monitor and control the financial risks associated with its primary clearing activities on the two exchanges. Based on that review and other facts of record, the Board concluded that the subcompany had the managerial and operational resources and systems to adequately monitor and control the financial risks arising from its role as primary clearing firm on the two exchanges.

The Board also noted that approval of the proposal could reasonably be expected to produce public benefits. Specifically, the Board noted that the subcompany served as the primary clearing firm for a significant percentage of the professional floor traders on the two exchanges and that the notificants' proposal would permit the section 20 company to continue providing primary clearing services to such professional floor traders.

In light of all the facts of record, including the limited nature of the section 20 company's proposed clearing-only activities for professional floor traders, the commitments provided by the notificants, and the operational and managerial systems that the section 20 company will have in place to monitor and control the risks arising from the proposed activities, the Board concluded that the credit and other risk considerations associated with the proposed clearing-only activities for professional floor traders on the two exchanges are consistent with approval of this notice and that, therefore, the proposed activity is a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act.

3251.0.13.2 Brokerage Services with Respect to Forward Contracts Based on Certain Financial and Nonfinancial Commodities

The notificants also proposed that the section 20 company act as broker with respect to forward contracts based on certain financial and nonfinancial commodities. In this capacity, the company would assist customers in arranging forward contracts with third parties pursuant to which the customers would make (or receive) delivery of financial and nonfinancial commodities on a future date.[31] The section 20 company would act as a broker only with respect to forward contracts that are based on those financial and nonfinancial commodities that also serve as the basis for an exchange-traded futures contract.[32] The Board recognized that banking regulators had not expressly permitted banks to engage in the proposed activity.

Bank holding companies are permitted to act as a broker in the execution and clearance of futures contracts and options on futures contracts based on financial and nonfinancial commodities.[33] As noted above, the forward contracts that the section 20 company proposed to broker would be based on the same financial and nonfinancial commodities that underlie futures contracts that bank holding companies

30. The subcompany's risk-management personnel also electronically receive trade information from the two exchanges up to four times a day. Reports based on such data are prepared by risk-management personnel and reviewed daily.

31. Because the section 20 company will act only as a broker, the section 20 company will not itself be required to take physical delivery of the nonfinancial commodities underlying the forward contracts that it arranges under any circumstances.

32. Exchange-traded futures contracts may be based on a wide variety of commodities, including precious metals, oil, cocoa, or wool.

33. See 1993 FRB 1049.

are permitted to broker as an FCM. Bank holding companies also are permitted to broker forward contracts on foreign exchanges and arrange swap transactions that are based on nonfinancial commodities or indices of nonfinancial commodities.[34] Accordingly, based on these and other facts of record, the Board concluded that acting as a broker for forward contracts based on those financial and nonfinancial commodities that underlie an exchange-traded futures contract is a permissible activity for bank holding companies under section 4(c)(8) of the BHC Act.

34. See 1995 FRB 185.

3251.0.13.3 Conclusion

Based on all the facts of record, the Board approved the notice subject to all the terms and conditions discussed in the order and in the section 20 orders, as modified by the modification orders. (See 1997 FRB 138.)

With the adoption of the April 1997 revision to Regulation Y, the Board authorized certain types of other transactional services in section 225.28(b)(7)(v). Bank holding companies can provide to customers as *agent* transactional services with respect to swaps and similar transactions—

1. any transaction that is described in section 225.28(b)(8) of the regulation;
2. any transaction that is permissible for a state member bank; and
3. any other transaction involving a forward contract, option, futures, option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange.

Under this provision of the current rule, a bank holding company can provide transactional services for customers involving any derivative or foreign-exchange transaction that the bank holding company is permitted to conduct for its own account (item 1 above). A bank holding company may also act as a broker with respect to forward contracts based on a financial or nonfinancial commodity that also serves as the basis for an exchange-traded futures contract. This permits a bank holding company to act as agent in a forward contract that involves the same commodities and assessment of risk that underlie the permissible FCM activities of bank holding companies. This authority is not extended to forward contracts for the delayed sale of commercial products (such as automobiles, consumer products, etc.) or real estate.

Before the incorporation of the above transactions into the authority of Regulation Y, such activities had been previously approved individually by Board order. This section provides, as historical examples, summaries of such activities that were previously approved by Board order. Such orders led to the incorporation of the nonbanking activity into the April 1997 Regulation Y "laundry list." The reader of these examples should only consider the current provisions for "other transactional services" as found in section 225.28(b)(7)(v) of Regulation Y. There should be no reliance on previous Board order commitments, supervisory policies, and interpretations that relate to this nonbanking activity that were in existence before April 21, 1997, unless such provisions remain. Certain former provisions or commitments may no longer be applicable.

3255.0.1 BROKERING OPTIONS ON SECURITIES ISSUED OR GUARANTEED BY THE U.S. GOVERNMENT AND ITS AGENCIES AND OPTIONS ON U.S. AND FOREIGN MONEY-MARKET INSTRUMENTS

A bank holding company applied for the Board's approval under section 4(c)(8) and section 225.21(a) of the Board's Regulation Y to engage de novo, through a wholly owned indirect subsidiary, in certain futures commission merchant and broker-dealer activities. One of the activities proposed for Board approval consisted of engaging in brokerage activities with respect to options on certain physicals, that is, securities issued or guaranteed by the U.S. government and its agencies and U.S. and foreign money-market instruments. The Board concluded that an option on a physical appears to serve the same function as other instruments in that it offers the investor a means to hedge portfolio risk. The Board had previously approved applications to engage in discount securities brokerage for retail customers with respect to corporate securities, and had added discount securities brokerage to the list of permissible nonbanking activities for bank holding companies generally. As a broker for options on physicals, it was stated that the indirect subsidiary would act solely as agent on behalf of nonaffiliated persons for the purchase and sale of options.[1] The services performed by a broker of options on the proposed securities appeared to be similar to those of other brokers. The Board thus concluded on December 8, 1983, that the proposal was closely related to banking (1984 FRB 238).

3255.0.2 BROKERING OPTIONS IN FOREIGN CURRENCY ON EXCHANGES REGULATED BY THE SEC

A BHC applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to engage

1. A broker of options on U.S. government and agency securities and options on money market instruments is a securities broker under the securities laws.

de novo, through a wholly owned subsidiary, in executing and clearing options in foreign currency. The Board referenced its approval to a previous order regarding the brokering of options on certain financial physicals (see subsection 3255.0.1 above). The Board concluded that its rationale for this prior action was equally applicable to the brokerage of options in foreign exchange. The Board noted that the applicant had been active in the cash and forward markets for foreign currency and had the expertise to provide the proposed services to customers. The Board concluded on March 19, 1984, that, in the manner proposed, the applicant's proposal to broker options in foreign currency was closely related to banking (1984 FRB 368).

In considering the potential for adverse effects, the Board took into account and relied on the regulatory framework established pursuant to law by the SEC for the trading of options. In addition, the Board noted that the applicant would not trade any of the options involved for its own account.

3255.0.3 EXECUTING AND CLEARING CFTC-REGULATED OPTIONS ON BULLION AND FOREIGN EXCHANGE ON AUTHORIZED COMMODITY EXCHANGES

A BHC applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to engage de novo through its wholly owned subsidiary in executing and clearing options. As part of that request, the BHC requested the Board to approve the executing and clearing of CFTC-regulated options on bullion and foreign exchange on authorized commodity exchanges. In making a determination that the activity was closely related to banking, the Board noted—

1. that it previously determined the brokering of futures and options on futures in bullion and foreign exchange to be a permissible nonbanking activity under the former section 225.25(b)(18) of Regulation Y (currently section 225.28(b)(7)(iv));
2. that options on physicals serve essentially the same function as futures and options on futures; and
3. that the brokering of options on certain physicals, that is, U.S. government securities, money market instruments, and options on foreign currency regulated by the SEC, is closely related to banking (1984 FRB 368, see subsection 3255.0.2, above).

The Board determined that the proposed CFTC-regulated options on physicals are functionally and operationally comparable devices for hedging investment-portfolio risk. The Board also determined that the applicant's proposal was substantially similar to proposals to engage in options activities previously approved by the Board. It noted that the applicant had been active in the cash and forward markets for bullion and foreign currency and that it possessed the expertise to provide the proposed services to customers. The Board therefore concluded the activity to be closely related to banking and approved the application on June 5, 1984, in the manner proposed (1984 FRB 591).

Under Regulation Y, a bank holding company may engage in—

1. underwriting and dealing in government obligations and money market instruments (see section 3260.0.1),
2. certain investing and trading activities as principal, and
3. buying and selling bullion and related activities.[1]

A bank holding company may engage or trade as principal in the following:

1. foreign exchange
2. forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security,[2] if—
   a. a state member bank is authorized to invest in the asset underlying the contract;
   b. the contract requires cash settlement;
   c. the contract allows for assignment, termination, or offset prior to delivery or expiration, and the company—
      (1) makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or
      (2) receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset; or
   d. the contract does not allow for assignment, termination, or offset prior to delivery or expiration and is based on an asset for which futures contracts or options on futures contracts have been approved for trading on a U.S. contract market by the Commodity Futures Trading Commission, and the company—
      (1) makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or
      (2) receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset
3. forward contracts, options,[3] futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement

Before the incorporation of these activities involving investment transactions as principal into the authority of Regulation Y, certain of the activities had been approved individually by Board order. Following the Board's adoption of the April 1997 revised Regulation Y, a bank holding company can continue to trade in foreign exchange and bank-eligible securities. Bank holding companies, however, are no longer required to have a separate subsidiary to provide advice to customers when engaging in trading activities as principal.

This section provides, as historical examples, summaries of such activities that were previously approved by Board order. Such orders may have led to the incorporation of the nonbanking activity into the April 1997 Regulation Y "laundry list." The reader of these examples should only consider the current regulatory provisions as currently found in section 225.28(b)(8) of Regulation Y. Only minimum reliance should be placed on previous Board order commitments, supervisory policies, and interpretations that relate to this nonbanking activity that were in existence before April 21, 1997, unless such provisions remain currently. Certain former provisions or commitments may no longer be applicable.

3260.0.1 UNDERWRITING AND DEALING IN GOVERNMENT OBLIGATIONS AND MONEY MARKET INSTRUMENTS

A bank holding company may engage in underwriting and dealing in obligations of the United States, general obligations of states and their

1. A bank holding company is authorized to buy, sell, and store gold, silver, copper, platinum, and palladium bullion, coins, bars, and rounds, and any other metal approved by the Board.
2. See sections 3260.0.4.6 and 3920.0.
3. This does not include acting as a dealer in options based on indexes of bank-ineligible securities when the options are traded on securities exchanges. These options are securities for purposes of the federal securities laws.

political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 U.S.C. 24 and 355. This activity includes banker's acceptances and certificates of deposit, under the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks. See Regulation Y, section 225.28(b)(8)(i) and section 3240.0.

3260.0.2 FOREIGN EXCHANGE

A bank holding company may engage as principal in foreign exchange. See Regulation Y, section 225.28(b)(8)(ii)(A).

3260.0.3 DEALING IN GOLD, SILVER, PLATINUM, AND PALLADIUM BULLION AND COINS

On September 27, 1973, the Board approved a foreign banking organization's request to acquire 30 percent of the voting shares of a domestic company engaged in the trading and arbitrage of gold and silver bullion on various exchanges and in the open market. The subsidiary is enabled to participate in the domestic gold bullion market under 12 U.S.C. 24 (para. 7), which specifically authorized national banks to deal in bullion.

The Board found that buying and selling gold and silver bullion and silver coin, dealing in exchange and silver futures, and arbitraging gold and silver in markets throughout the world are activities closely related to banking or managing or controlling banks. Thus, in approving the application, the Board maintained its basic position that it will benefit the public to allow foreign banks to engage in U.S. activities on a nondiscriminatory basis. (See 1973 FRB 775.)

In another case, a BHC applied for the Board's permission to engage in certain activities related to dealing in gold and silver bullion. The activities consisted of (1) buying and selling gold and silver bullion, bars, rounds, and bullion coins for its own account and the account of others; (2) financing the production, refining, and fabrication of gold and silver, including lending and borrowing gold and silver in connection with such financing; (3) arbitraging gold and silver in markets throughout the world; and (4) providing various incidental services for customers, such as arranging for the safe custody, assaying, and shipment of gold and silver.[4]

The Board determined previously that many of the proposed activities are permissible for BHCs. A BHC may engage in the purchase and sale of gold and silver for its own account and for the account of others.[5] The Board believed the assaying and arranging for transport to be part of this activity.[6] Financing activities for the production and fabrication of gold and silver are permissible activities. (See section 225.28(b)(1) of Regulation Y—Extending credit and servicing loans.) The Board approved the application by order on November 24, 1986 (1987 FRB 61). (See SR-87-7.)

In a subsequent case, a foreign banking organization presented its application to the Board, pursuant to section 4(c)(8) of the BHC Act, requesting permission to engage in the activity, through its wholly owned subsidiary, of purchasing and selling platinum coins issued by the Canadian and Australian governments as legal tender. The subsidiary would acquire the platinum coins issued by the Canadian and Australian governments solely for the purpose of effecting distribution. It would maintain an inventory of the coins. However, it would not purchase the coins for investment or speculation for its own account or offer its customers investment advice regarding their purchase and sale. It would enter into forward contracts with its customers. In considering the BHC's application, the Board noted that the Office of the Comptroller of the Currency had authorized national banks to purchase and sell platinum coins and that the proposed activities were operationally and functionally similar to purchasing and selling gold and silver coins. The Board found the purchasing and selling of platinum coins that function as legal tender to be closely related to banking. The related application was approved on June 25, 1990 (1990 FRB 681).

In a more recent case, a foreign bank subject to the provisions of the BHC Act applied for the

4. The applicant further notified the Board of its intention to purchase and sell for its own account options, futures, and options on futures on gold and silver bullion. The applicant committed to take positions in these investments only as a means of hedging its position in the underlying commodity, that is, gold and silver. The activity was thus permissible under section 4(c)(1)(C) of the BHC Act, which allows BHCs to furnish services to or perform services for such BHCs or its banking subsidiaries.

5. See 1986 FRB 345, 1986 FRB 146, 1985 FRB 467, and 1981 FRB 635.

6. The Board allowed another BHC to provide storage facilities, weighing, coin-counting, and transportation services for bullion and coin. (See 38 *Fed. Reg.* 27,552 (1973).)

Board's permission under section 4(c)(8) of the act and section 225.23 of Regulation Y for its section 20 subsidiary to trade platinum coin and bullion for its own account. The Office of the Comptroller of the Currency has determined that a national bank may engage in this activity. (See OCC Interpretive Letter No. 553, May 2, 1991, relying, in part, on the fact that several countries had recently introduced platinum coins.) The Board had not previously determined that this activity was closely related to banking under section 4(c)(8) of the act. As stated previously, it had determined that the purchase and sale of platinum coins that function as legal tender is an activity that is closely related to banking. (See 1994 FRB 346 and 1990 FRB 681.) The Board had also approved as a nonbanking activity, under Regulation K, trading in platinum by bank holding company subsidiaries located abroad (1994 FRB 177 and 1990 FRB 552). On the basis of these decisions, the Board concluded that the proposed activity is closely related to banking. (See 1995 FRB 190.)

With respect to palladium, a bank holding company applied for the Board's approval under section 4(c)(8) of the act and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through a wholly owned asset-management subsidiary that will be established to serve as the general partner of limited partnerships (the partnerships) for investing in a wide variety of commodities and exchange-traded and over-the-counter instruments, including trading in precious metals. The partnerships would trade and invest in coin and bullion consisting of such precious metals as palladium, platinum, gold, and silver.

The Board has previously determined that it is closely related to banking under the act for bank holding companies to trade in all the instruments and commodities it proposed for the partnerships, except palladium.[7] Banks currently are permitted to engage in palladium trading.[8] Therefore, the Board concluded that trading palladium coin and bullion is closely related to banking within the meaning of section 4(c)(8) of the act.

3260.0.4 ENGAGING AS PRINCIPAL IN DERIVATIVES INVOLVING FINANCIAL ASSETS AND NONFINANCIAL ASSETS OR GROUPS OF ASSETS

A bank holding company may engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset, nonfinancial asset, or group of assets, other than a bank-ineligible security. A financial asset includes gold, silver, platinum, palladium, copper, and any other metal approved by the Board. See Regulation Y, section 225.28(b)(8)(ii)(B).

3260.0.4.1 Trading for a Company's Own Account in Futures, Options, and Options on Futures Based on U.S. Government Securities and Certain Money Market Instruments

A foreign bank, subject to the provisions of the BHC Act, applied to the Board under section 4(c)(8) and section 225.23 of the Board's Regulation Y to engage through a wholly owned subsidiary in trading activities for its own account. The trading included futures, options, and options on futures based on U.S. government securities that are permissible investments for national banks (bank-eligible securities) and certain money market instruments.[9]

The Board had previously determined that BHCs could purchase derivative instruments based on government securities for the purpose of reducing interest-rate exposure. (See 12 C.F.R. 225.142, Statement of Policy Concerning Bank Holding Companies Engaging in Futures, Forward, and Option Contracts on U.S. Government and Agency Securities and Money Market Instruments.) Previously, the Board approved applications to trade in derivative instruments based on foreign exchange for the company's own account for other than hedging purposes. (See 1989 FRB 217.) Section 225.28(b)(7)(iv) and 225.28(b)(6)(iv) of Regulation Y detail a BHC's ability to act as futures commission merchant and to offer advice with regard to futures

7. See 12 C.F.R. 225.28(b)(6)(iv), 1987 FRB 61 (trading gold and silver bullion and coin), and 1995 FRB 190 (trading platinum coin and bullion for a BHC's own account).

8. See OCC Interpretive Letters Nos. 683 (1995) and 553 (1991).

9. See 1991 FRB 759 for a listing of the derivative instruments to be traded, which are listed in appendix A. The subsidiary would hedge its positions in these instruments with the instruments listed in appendix B of the order.

and options on futures on bank-eligible securities, respectively.

The purchasing and selling of derivative instruments that represent the right to purchase and sell bank-eligible securities is considered by the Board to be closely related to banking.[10] The experience gained by banks in dealing with the securities underlying these instruments would equip the banks to trade in instruments based on these securities. In addition, the derivative instruments based on money market instruments require a market judgment on interest rates. Banks have developed an expertise in such judgments through their lending and funding activities. The Board thus concluded on July 12, 1991, the activity of trading for a company's own account in derivative instruments based on bank-eligible securities and certain money market instruments to be closely related to banking. (See 1991 FRB 759).

3260.0.4.2 Dealing as a Registered Options Trader on Foreign-Exchange Options

A foreign bank subject to the BHC Act applied under section 4(c)(8) of the act to deal, through its wholly owned U.S. subsidiary, as a registered options trader (trader) on foreign-exchange options. As a trader, the subsidiary would act as dealer and market maker in such options to assist in the maintenance of a ''fair and orderly'' market on the designated exchange. A trader deals for its own account in order to maintain a ''fair and orderly'' market in certain options when a lack of price continuity or temporary disparity exists on options for which the trader makes a market. The subsidiary would be obliged to make a market in the proposed foreign-currency options, or bid and offer, for all traders who approach it on the designated exchange. The subsidiary would not be obliged in any way as to the price and quantity it bids and offers. A trader is permitted to ''leave the floor,'' that is, not trade, if it meets minimum trading levels each quarter.

The Board previously recognized that foreign-exchange activities have traditionally been conducted at banks and are permissible activities under the BHC Act.[11] The Board noted that the Office of the Comptroller of the Currency authorized national banks to deal in foreign-currency options as a trader on a securities exchange. It also noted that through bank participation in the interbank market for foreign-currency options, banks developed experience in dealing, market making, and risk management, which are deemed essential elements of the activities proposed. For these reasons and the facts presented in the BHC's application, the Board approved the nonbanking activity as being closely related to banking. The application was approved by the Board on July 30, 1990 (1990 FRB 776).

3260.0.4.3 Acting as a Specialist in Options on Foreign Exchange

A foreign bank subject to the BHC Act applied for the Board's approval under section 4(c)(8) of the act (12 U.S.C. 1843(c)(8)) and section 225.21(a) of the Board's Regulation Y (12 C.F.R. 225.21(a)) for its wholly owned subsidiary (the company) to act as the sole specialist in deutsche mark options on a specified exchange (the exchange). As a specialist, the subsidiary would act as a dealer and market maker in these options for the purpose of assisting in the maintenance of a fair and orderly market on the exchange.

The Board found the activity of engaging as a specialist in foreign-currency options on the exchange to be closely related to banking for purposes of section 4(c)(8) of the BHC Act. Banks provide services that are operationally similar to the activities proposed. The Board deemed banking organizations to be particularly well equipped to provide the proposed activities. The Board believes that banks possess substantial experience in dealing in foreign exchange and related services that are similar to the functions involved in the BHC's proposed specialist activity. Foreign-exchange activities were noted as having been traditionally conducted by banks that are major participants in all aspects of the foreign-exchange markets. Banks act as market makers in various currencies. Banks trade for their own account as well as for their customers in virtually all foreign-exchange markets and instruments, including trading in foreign-currency options on regulated exchanges, as proposed by this BHC applicant.

The Board believes the financial risk in this case to be sufficiently minimized since (1) the rules of the exchange allow the specialist to set

10. The applicant was not authorized to purchase derivative instruments based on securities or instruments that a state member bank may not purchase for its own account.

11. See 1989 FRB 217, 308, and 580.

the price and quantity that it will buy and sell in order to limit its risk in an adverse or volatile market; (2) the specialist is prohibited from speculating; and (3) the BHC has committed not to write unhedged options, having developed substantial experience with hedging from its existing foreign-currency and options business. The company will be a registered broker-dealer with the Securities and Exchange Commission (SEC) and will thus be subject to the SEC's net capital rule. The Board expects that the company will maintain capital adequate to support its activity and to cover reasonable expenses and losses at all times.

The Board considered its earlier decision (1986 FRB 141) to deny a proposal to act as a specialist in French franc options on the exchange, summarized in section 3700.8. The Board believes that the facts and circumstances in this case were different in several significant respects from the current situation. The current proposal did not raise the issues relating to potential conflicts of interest and risk raised by the earlier decision (1986 FRB 141). The markets for deutsche marks and deutsche mark options are more liquid than they were for French francs at that time. Further, the market for foreign-currency options has broadened significantly on the exchange, and the involvement of commercial banks in that market has become more widespread. The Board approved the BHC's application by order on June 22, 1989. (See 1989 FRB 580.)

3260.0.4.4 Acting as a Dealer, Broker with Respect to Interest-Rate and Currency Swaps and Related Transactions

A bank holding company applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y for its wholly owned subsidiary to engage de novo in—

1. intermediating in the international swap markets by acting as originator and principal in interest-rate swap and currency-swap transactions;
2. acting as an originator and principal with respect to certain risk-management products such as caps, floors, and collars, as well as options on swaps, caps, floors, and collars (swap-derivative products);
3. acting as a broker or agent with respect to the foregoing transactions and instruments; and
4. acting as an adviser to institutional customers regarding financial strategies involving interest-rate and currency swaps and swap-derivative products.

The Board has permitted bank holding companies under section 4(c)(8) of the act to provide advice in connection with interest-rate and currency swaps, interest-rate caps, and similar transactions.[12] (See 1987 FRB 59 and 1989 FRB 308.) However, the Board had not previously approved the remaining activities proposed under section 4(c)(8) of the act. The Board determined that the remaining activities proposed are closely related to banking for the reasons summarized below.

Intermediating in the International Swap Market; Acting as an Originator and Principal with Respect to Certain Risk-Management Products—Caps, Floors, Collars, and Options on Swaps, Caps, Floors, and Collars

1. Banks, in particular, the money center banks, do conduct the proposed intermediation

12. Swap terminology:

Interest-rate swap. An exchange between two counterparties of different payment streams arising out of fixed-rate and floating-rate payment obligations. The exchange is made using the same currency and is calculated by reference to a mutually agreed-upon ''notional'' principal amount.

Currency swap. An exchange between two counterparties of a fixed-rate interest obligation in one currency for a fixed-rate interest obligation in another currency. Currency swaps may involve an initial physical exchange of principal at an agreed-upon current exchange rate or an exchange of interest payments in different currencies on an agreed-upon notional amount with no actual transfer of principal. In either case, there will be periodic exchange of fixed-rate interest payments over the course of the swap. Upon maturity, there would be a re-exchange of the original principal amounts.

Cap. An agreement under which one party purchases from the other a promise to pay, at predetermined future times, the excess, if any, of a specified floating interest rate over a fixed per annum rate. Caps may be sold separately or packaged with an interest-rate swap.

Floor. An agreement under which one party purchases a promise by another to pay the amount, if any, by which a specified floating interest rate is lower than a fixed per annum rate at specified times during the life of the agreement. Floors may be sold separately or packaged with an interest-rate swap.

Collar. The simultaneous sale of a cap and purchase of a floor, or purchase of a cap and sale of a floor.

Agent or broker in swap market. An agent or broker in the swap market locates, for a fee, a suitable counterparty for a party seeking to enter into a swap agreement.

Intermediary in swap market. A party that is willing to step between the two parties of a swap agreement and act as a principal counterparty with each of the other participants, thus taking on the credit risk of each of the participants. Upon entering into a swap with one counterparty, the intermediary enters into an equivalent and offsetting swap with another counterparty.

activities within the international swap market.

2. Banks have participated in the swap markets for several years as end-users, entering into swaps and purchasing swap-derivative products in order to hedge other business risks or to match assets and liabilities.

Acting as a Broker or Agent with Respect to These Transactions and Instruments

1. Banks provide services that are operationally similar to the proposed activities.
2. The Board had previously determined that acting as a broker with respect to foreign-exchange forward transactions is closely related to banking since banks have historically engaged in the provision of assistance with respect to foreign exchange. (See 1983 FRB 221.) Currency swaps are very similar to foreign-exchange forward transactions. The primary difference is the exchange of interest rates in connection with currency swaps. Interest-rate swaps are similar to currency swaps in that they involve agreements to exchange different payment streams that arise out of a prescribed principal amount. Similarly, caps, floors, and collars involve agreements to pay an amount by reference to a prescribed interest rate.

The Board approved the application on June 26, 1989 (see 1989 FRB 582), subject to the commitments included in the order to minimize the potential risk (that is, credit, price, basis, portfolio, and operations risk) and the possible conflicts of interest.

3260.0.4.5 Currency Swaps for Hedging a BHC's Own Position in Foreign Currency

A foreign bank, subject to section 4 of the BHC Act, applied for the Board's permission to acquire, through its wholly owned subsidiary, all the shares of a company located in New York, New York. The acquired company would engage in several nonbanking activities. One of the activities, not previously approved by the Board for BHCs, consisted of entering into currency-swap transactions for hedging the BHC's own position in foreign currency. The Board previously found that banks engage in this activity and thus concluded that the activity is closely related to banking.[13] In conducting this activity, the applicant is to use the same policies, quantitative limitations, and internal controls and audit programs applicable to its trading in futures, options, and options on futures and similar contracts used for hedging, including the guidelines in the Board's policy statement.[14] The application was approved on August 15, 1990 (1990 FRB 860).

3260.0.4.6 Derivative Transactions as Principal (Commodities Underlying Derivative Contracts)

On June 27, 2003, the Board amended section 225.28 of Regulation Y (12 C.F.R. 225.28(b)(8)(ii)(B)), effective August 4, 2003, to permit bank holding companies (BHCs) to enter into commodity derivative contracts (commodity contracts) that are settled by the BHC receiving and transferring title to the underlying commodity instantaneously, by operation of contract, without taking physical possession of the commodity. The Board also modified the existing condition in Regulation Y that generally prevented BHCs from engaging as principal in a physically settled commodity contract unless the contract specifically provides for assignment, termination, or offset before delivery (the contractual offset requirement).

The restrictions in Regulation Y that were effective before August 4, 2003, were designed to reduce the potential that BHCs would become involved in and bear the risks of physical possession, transport, storage, delivery, and sale of bank-ineligible commodities. These restrictions ensured that the commodity derivatives business of a BHC was largely limited to acting as a financial intermediary that facilitates transactions for customers who use or produce commodities or are otherwise exposed to commodity-price risk as part of their regular business.

The former Regulation Y derivatives restrictions, however, impeded the ability of BHCs to participate substantially in certain derivatives markets. Notably, in some over-the-counter (OTC) forward markets (U.S. energy markets, for example), the physically settled derivative contracts traded by market participants do not specifically provide for assignment, termination, or offset prior to delivery and, thus, did not conform to the contractual offset requirement of

13. See 1989 FRB 582.

14. Statement of Policy Concerning Bank Holding Companies Engaging in Futures, Forward and Options Contracts on U.S. Government and Agency Securities and Money Market Instruments. See 12 C.F.R. 225.142 (establishing guidelines for trading in forward, futures, and option contracts on financial instruments).

Regulation Y. Moreover, participants in these markets generally settle contracts by temporarily taking and making delivery of title to the underlying commodities and, thus, did not comply with the requirement in Regulation Y that the BHC make every reasonable effort to avoid taking or making delivery of the asset underlying the contract (the delivery avoidance requirement).

Financial intermediary participants in these markets generally enter into back-to-back derivative contracts with third parties that effectively offset each other. That is, financial intermediaries in these markets that enter into a contract to buy, for example, a certain number of barrels of oil from a certain counterparty in a certain future month generally also will enter into another contract, before the expiration of the original contract, to sell the same number of barrels of oil to another counterparty in the same future month on substantially identical delivery terms. These market practices typically result in the creation of a chain of contractual relationships that begins with a commodity producer, passes through a number of intermediaries who have entered into matched contracts both to buy and sell the same commodity at the same future time, and ends with a purchaser that intends to take physical delivery of the commodity. On the maturity date of the derivative contracts, the producer will be responsible for making physical delivery, and the ultimate buyer will be responsible for accepting physical delivery, while each intermediate participant in the chain will be deemed, by operation of contract, to have instantaneously received and transferred legal title to the commodity.

The Board believes that a BHC that takes title to a commodity on an instantaneous, pass-through basis takes no risk that is greater than or different in kind from the risk that the BHC has as a holder of a commodity derivative contract that met the former requirements of Regulation Y. Instantaneous receipt and transfer of title to (but not physical possession of) commodities does not appear to involve the usual activities relating to, or risks attendant on, commodity ownership. Instead, such transactions involve the routine operations functions of passing notices, documents, and payments—functions that BHCs regularly perform in their role as financial intermediaries in other markets. Moreover, although BHCs that receive and transfer title to commodities on an instantaneous, pass-through basis face default risks, they are not significantly different than the default risks associated with cash-settled derivative contracts or derivative contracts that include the assignment, termination, or offset provisions previously required by Regulation Y. In addition, banking organizations that engage in derivatives activities, including the modified Regulation Y commodity derivatives activities, will remain subject to the general securities, commodities, and energy laws and the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission (CFTC), and the Federal Energy Regulatory Commission.

For the above reasons, the Board modified Regulation Y by changing the delivery avoidance requirement to allow BHCs to take or make delivery of title to commodities underlying commodity derivative transactions on an instantaneous, pass-through basis. A BHC takes and makes delivery of title to a commodity on an instantaneous, pass-through basis for purposes of Regulation Y only if the BHC takes delivery of title to the commodity from a seller and immediately thereafter makes delivery of title to the commodity to a buyer. Accordingly, the revised delivery avoidance requirement does not provide authority for a BHC to take physical delivery of commodities for use or investment or to make physical delivery of commodities out of the inventory of the BHC. In other words, the BHC must not be the original seller of the commodity in the initial position in the delivery chain or the ultimate buyer of the commodity in the last position in the delivery chain.

The Board's modification of Regulation Y also changed the contractual offset requirement to permit BHCs to participate in physically settled derivative markets in which the standard industry documentation does not allow for assignment, termination, or offset. In particular, the modified Regulation Y allows BHCs to enter into commodity contracts that do not require cash settlement or specifically provide for assignment, termination, or offset before delivery so long as the contracts involve commodities for which futures contracts have been approved for trading on a U.S. futures exchange by the CFTC (and the BHC complies with the revised delivery avoidance requirement).[15]

15. The CFTC publishes annually a list of the CFTC-approved commodity contracts. See, for example, Commodity Futures Trading Commission, *FY 2001 Annual Report to Congress* 126. With respect to granularity, the Board intends this requirement to include all types of a listed commodity. For example, any type of coal or coal derivative contract would satisfy this requirement, even though the CFTC list specifically approves only Central Appalachian coal.

The Board's modifications of the derivatives provisions in Regulation Y are effective for all BHCs. (See 2003 FRB 385.)

3260.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Investment transactions as principal		225.25(b)(8)		
Investing and trading activities—engaging as principal	1843(c)(8)—section 4(c)(8) of the BHC Act	225.28(b)(8)(ii)		
BHCs can (1) take and make delivery of title to commodities underlying commodity derivatives contracts on an instantaneous, pass-through basis and (2) enter certain commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset prior to delivery		225.28(b)(8)(ii)(B)		2003 FRB 385

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Effective December 31, 1980, the Board amended section 225.28(b) of Regulation Y (12 C.F.R. 225.28(b)(2)(i)) to include the performance of real estate appraisals in the list of activities permissible for bank holding companies to engage in. The Board concluded that banks perform real estate appraisals either in connection with extensions of credit involving real estate lending or as a discrete activity. In addition, such an appraisal activity calls upon the necessary skills and resources often possessed by banking organizations. The Board thus determined that the activity of performing appraisals of real estate is closely related to banking and that its performance by bank holding companies will yield net benefits to the public.

In addition to authorizing the appraisals of real estate as a nonbanking activity, the Board has previously determined by order that the appraisal of certain types of personal property, both tangible and intangible, is closely related to banking (1985 FRB 118). Providing personal property appraisals was added to the list of permissible nonbanking activities in Regulation Y. It was combined with the already-approved activity of providing real estate appraisals (12 C.F.R. 225.28(b)(2)(i)). The action was approved by the Board on October 31, 1986, effective December 15, 1986, without any conditions. In permitting bank holding companies to engage in the activity of providing valuations of companies, the Board noted that the commercial lending and trust departments of banks commonly make valuations of a broad range of tangible and intangible property, including the securities of closely held companies. Providing valuations of companies necessarily involves the appraisal of various types of intangible personal property, such as securities of closely held corporations, as well as any tangible personal property that a company might possess.

Banks currently engage in the appraisal of personal property through their trust departments. Trust departments value private business interests for their own trust accounts and other types of personal property in a customer's estate for probate and tax purposes. Banks engage in property appraisal activities in connection with secured lending activities and routinely appraise property which they take as collateral on loans, including perishable commodities, durable goods, computer software, crops, livestock, machinery, and equipment.

Banks also engage in appraisal activities in connection with their leasing activities. With regard to leasing, banks determine the residual value of leased property, such as vehicles and equipment, in order to establish the terms of a lease. Some money-center banks have appraised aircraft and locomotives, in connection with their leasing or lending transactions. Finally, banks may become involved in personal property appraising when they appraise real property, since certain types of real property, such as factories or apartment buildings, contain fixtures or other personal property that must be evaluated separately to determine the value of the real property.

3270.0.1 SCOPE OF INSPECTION

As noted within the subsequent inspection procedures, a sampling of real estate and personal property appraisals is to be reviewed to determine whether the appraised value of the property is reasonable and the documentation supports the appraisal.

Regulatory appraisal standards for federally related transactions are discussed below and must be considered in determining the scope of the inspection. The types, components, and procedures that should be used in evaluating real estate appraisals are included in section 2231.0, which contains guidelines for use by bank holding companies and subsidiaries for real estate appraisal and evaluation programs. Personal property appraisal involves estimating or determining the value of property other than real property.

3270.0.2 APPRAISAL STANDARDS FOR FEDERALLY RELATED TRANSACTIONS

The Board approved, on June 27, 1990, Appraisal Standards for Federally Related Transactions[1] that represent amendments to Regulation H (12 C.F.R. 208) and Regulation Y (12 C.F.R. 225) that are designed to protect federal financial and public policy interests in real estate transactions requiring the services of an appraiser. The regulations are intended to supplement the Board's appraisal guidelines currently in effect. Section

1. "Federally related transaction" refers to any real estate–related financial transaction entered into on or after August 9, 1990, that (1) the Board or any regulated institution engages in or contracts for and (2) requires the services of an independent appraiser.

208.50 of Regulation H refers to the appraisal standards for federally related transactions entered into by state member banks. The appraisal standards for federally related transactions are found in subpart G, section 225 of Regulation Y. The amendments were the result of implementing provisions of title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) regarding real estate appraisals. The Regulation Y amendments identify which transactions require an appraiser (section 225.63),[2] set forth minimum standards for performing appraisals (section 225.64), and distinguish those appraisals requiring the services of a state-certified appraiser from those requiring a state-licensed appraiser (section 225.63). The effective dates are August 9, 1990, for the appraisal standards and July 1, 1991, for the appraiser certification and licensing requirements. Other provisions address appraiser independence (section 225.65), professional association membership, and competency.

3270.0.3 APPRAISER'S QUALIFICATIONS

With respect to an institution's selection of appraisers, examiners need to consider the following:

1. The professional certification, license, or other recognition of the competence of the appraiser. For real estate appraisals, the appraiser must have the proper state certification or license required by section 225.63 of Regulation Y. Examiners should also consider the September 1992 Guidelines for Real Estate Appraisal and Evaluation Programs. For personal property appraisals, the appraiser's qualifications might be evidenced by certification from a nationally recognized personal property appraisal organization or they may be supported by license or other recognition of the competence of the appraiser.
2. The reputation and standing of the specialist in the view of his peers and others familiar with the person's capability of performance.
3. The relationship, if any, of the appraiser to the bank holding company in order to determine independence and objectivity.
4. The appraiser's documented accomplishments (for example, the appraiser's personal "qualifications statement" or job history resume).
5. Whether the appraiser's experience and knowledge or expertise relates to the property appraised.
6. Whether the appraiser meets continuing-education requirements for licensing or certification. Membership or the absence of membership in any particular appraisal organization should not be accepted as prima facie evidence of an appraiser's qualifications.

3270.0.4 KEY COMPONENTS OF A PERSONAL PROPERTY APPRAISAL REPORT

When reviewing personal property appraisals, the appraisal should describe the following:

1. the kind of value being determined, such as fair market value, liquidation value, replacement/reproduction value, etc.
2. the property being valued
3. the detailed procedures used to estimate the values, such as—
   a. analysis of comparable sales,
   b. estimation and analysis of income, and
   c. the appraised values as of a specific date
4. the name of the individual who made the appraisal and who is responsible for its validity and objectivity (to the person receiving the appraisal, to third parties, and to the public)
5. the personal qualifications data of the appraiser

3270.0.5 APPRAISAL OF CONSTRUCTION AND CONSTRUCTION-ANALYSIS SERVICES

The activity of providing construction-analysis services, including appraisal of construction projects at various stages of development and disbursement of construction loan funds in accordance with the terms of the loan agreement, is included within the permissible activities of real estate appraising and loan servicing.

2. The Appraisal Standards for Federally Related Transactions that are found in Regulation Y were amended, effective December 28, 1998, to exclude from the Board's appraisal requirements transactions involving the underwriting of or dealing in mortgage-backed securities. The amendment permits bank holding company subsidiaries engaged in the underwriting of and dealing in securities to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board' s appraisal requirements.

3270.0.6 INSPECTION OBJECTIVES

1. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
2. To determine whether the company has formal written policies and procedures. For real estate appraisals, the policies and procedures should be consistent with the Guidelines for Real Estate Appraisal and evaluation programs in section 2231.0.
3. To determine if there is compliance with the appraisal standards for federally related transactions detailed in the Board's Regulations H and Y.
4. To determine whether the appraisals were performed on an independent basis.
5. To determine whether the individuals performing the appraisals are qualified and that the appraisals are reasonable.
6. To determine whether the appraisals are current, complete, and reasonably accurate.
7. To determine if real estate appraisals are performed by state-licensed or state-certified appraisers.

3270.0.7 INSPECTION PROCEDURES

1. Review the company's financial statements and determine if there are any factors or trends that could have an adverse impact on the parent holding company or the bank subsidiaries.
2. Review the company's policies and procedures to determine that the following are present:
   a. Adequate minutes are prepared of the board and board committee meetings.
   b. Professional liability insurance and blanket bond coverage, if appropriate, are in place and the coverage appears sufficient.
   c. Only qualified individuals are authorized to perform appraisals.
3. Review a sampling of the real estate and personal property appraisals to determine how a value is derived and whether this value is adequately substantiated.
4. For the appraisals reviewed in procedure 3, determine the reason for each appraisal. If it is for the purpose of valuing collateral for a loan extended by or to a bank affiliate, does the value appear realistic in relation to the loan amount?
5. Check for compliance with section 106(b) of the 1970 Amendments of the BHC Act (prohibition against tie-in arrangements). (See section 3500.0.)

3270.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Real estate appraisal activity approval		225.28(b)(2)(i)		1980 FRB 962 and 984 1997 FRB 275
Acquisition of a nonbanking subsidiary that performs valuations of companies and of large blocks of stock for a variety of purposes				1985 FRB 118
Personal property appraisal activity approval		225.28(b)(2)(i)		1986 FRB 833 1997 FRB 275
Appraisal standards for federally related transactions		225 subpart G, 225.61–225.67	4–053	1990 FRB 639 1999 FRB 50

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The activities of check-guaranty and check-verification services permit bank holding companies to authorize the acceptance by subscribing merchants of certain personal checks tendered by the merchant's customers in exchange for goods and services, and to purchase validly authorized checks from merchants in the event the checks are subsequently dishonored.

The Board determined, previously, that check-guaranty services were closely related to banking, and had approved applications by bank holding companies on a case-by-case basis to engage in the activity (1979 FRB 263 and 1981 FRB 740). See also 1999 FRB 582, 1996 FRB 348 (fraud-detection services), 1994 FRB 1107, and 1995 FRB 492 (ATM network services).

The Board noted the potential for unfair competition or conflicts of interest with respect to the authorization of checks not drawn on affiliated banks. To minimize this possibility, the Board has maintained a condition in Regulation Y, noted in previous orders, stating that the check guarantor cannot discriminate against checks drawn on unaffiliated banks.

3320.0.1 INSPECTION OBJECTIVES

1. To determine the extent of exposure to guaranteed bad-check losses.
2. To determine whether management is qualified and effective in controlling losses.
3. To determine whether administrative and operating procedures and check-guaranty and check-verification transactions are processed in accordance with established Board or Board committee authorization policies and procedures, including adequate internal control procedures.
4. To determine whether recordkeeping and data processing are adequate and current to avoid losses resulting from outdated or inaccurate information.
5. To determine whether any significant contingent liabilities exist.
6. To determine whether the financial condition of the nonbanking subsidiary will have an adverse influence on the financial condition of the consolidated corporation.

3320.0.2 INSPECTION PROCEDURES

1. Review financial statements to determine the financial condition of the company and past and current operating trends. Test the accuracy of those records against the financial statements for each material asset, liability, and equity account.
2. Review the minutes of the board of directors and executive committees and correspondence exchanged with the company's legal counsel.
3. Review authorization records for check-guaranty and check-verification services for adequacy to determine whether check clearance is verified and whether the company has an accurate record of its contingent liability for guaranteed checks.
4. Review collection records to determine whether follow-up procedures on purchased guaranteed bad checks are adequate and whether they evidence timely collection contacts and successful recoveries.
5. Determine whether collection-problem checks are turned over to attorneys or collection agencies for appropriate collective or legal action on a timely basis.
6. Review the company's history of bad-check losses and the current status of uncollected bad checks, and determine whether adequate reserves have been set aside for those losses.
7. Determine whether fee calculations and billing procedures ensure accuracy and propriety.

3320.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Engage de novo through a new nonbank subsidiary in the activity of check verification				1979 FRB 263
Retail check-authorization and check-guaranty activities				1981 FRB 740 1999 FRB 582
Fraud-detection services				1996 FRB 348 (see footnote 15)
Amendment of Regulation Y adding check verification as a permissible activity		225.28(b)(2)(iii)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Board authorized the addition of operating a collection agency to the list of approved activities. A collection-agency subsidiary seeks to collect payment on the overdue bills of debtors, charging the party submitting the claim a flat dollar amount or a specified percentage commission contingent on the amount collected. The Board determined that operating a collection agency is closely related to banking as banks engage in debt-collection activities for loans they originate and service, including overdue credit-card accounts.

The Board recognized the potential for unfair competition and conflicts of interest through the operation of a collection agency. Accordingly, the Board established the following conditions on operating a collection agency:

1. The collection agency shall not obtain the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies
2. The collection agency shall not provide preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

3330.0.1 INSPECTION OBJECTIVES

1. To determine whether the collection agency is obtaining the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies.
2. To determine whether the collection agency provides preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.
3. To determine what effect the activity has on the parent company, its subsidiaries, and the overall consolidated organization, and whether the company or activity evidences a going concern.
4. To determine whether the company has formal written policies and operating and internal control procedures to successfully administer the activity.
5. To determine the extent of management expertise, experience, and involvement with the administration of the activity.
6. To determine the extent of compliance with laws, regulations, and interpretations associated with the activity, including the Fair Credit Reporting Act, Fair Debt Collection Practices Act, and Right to Financial Privacy Act.
7. To determine whether the company administers formal training programs which include proper operating and compliance methods.
8. To determine whether any significant contingent liabilities exist and whether those liabilities resulted from the failure of the bank holding company or its nonbanking subsidiary to fulfill its responsibilities as an agent for its customers.

3330.0.2 INSPECTION PROCEDURES

1. Review financial statements to determine the financial condition of the company and past and current operating trends. Test the accuracy of the financial statements against the company’s financial records and other supportive corroborating evidence.
2. Review the minutes of the board of directors and executive committees, and correspondence exchanged with the company’s legal counsel with regard to possible contingency losses.
3. Review collection records for adequacy, and determine whether the amount of payments received is independently verified.
4. Review collection records—tickler files—to determine whether follow-up procedures on acquired accounts are adequate and whether they evidence timely collection contacts and successful recovery rates.
5. Determine whether appropriate legal action is used and authorized by customers on a timely basis.
6. Determine whether fee calculations and billing procedures ensure accuracy and propriety.
7. Review parent company and subsidiary administrative and operating policies, and determine whether the collection agency is prohibited from obtaining the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies.
8. Review customer lists and billings and any prioritized collection schedules, and determine whether the collection agency is providing any preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

3330.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Amendment of Regulation Y adding collection-agency services as a permissible activity		225.28(b)(2)(iv)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

A bank holding company that engages in the activity of operating a credit bureau gathers, stores, and disseminates factual information relating to the identity and paying habits of consumers. Credit bureaus then provide this information for a fee to credit grantors, such as retailers, banks, and finance companies, to enable the institutions to arrive at prudent credit-granting decisions. The Board concluded that the activity is closely related to banking as banks maintain credit files and analyze credit information as part of their consumer-lending function.

The Board recognized that possible adverse effects could result from a potential conflict of interest when a bank holding company performs credit bureau activities. For example, under the Fair Credit Reporting Act, a credit bureau is required to investigate the accuracy of any item of information disputed by a consumer (15 U.S.C. 1681(i)). A bank holding company credit bureau may not conduct an impartial investigation if the disputed information originates with an affiliate. The Board thus imposed the condition that a credit bureau could not provide preferential treatment to a customer of an affiliated financial institution.

Regulation Y allows bank holding companies to engage only in consumer-credit-reporting activities rather than credit-reporting activities concerning large commercial institutions.

3340.0.1 Inspection Objectives

1. To determine whether the activity is limited to only consumer-credit-reporting activities.
2. To determine whether the bank holding company gives preferential treatment to a customer of an affiliated financial institution.
3. To determine the adequacy of internal policies and operating and internal control procedures.
4. To determine whether any significant contingent liabilities exist which arose from the failure of the holding company and its nonbanking subsidiary to fulfill their responsibilities as an agent for their customers.
5. To determine whether appropriate steps have been taken to ensure compliance with the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Right to Financial Privacy Act.
6. To determine whether adequate controls exist to prevent unauthorized access into any computerized credit bureau credit files to preserve the confidentiality of the information stored for customers' use.

3340.0.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent company or its banking or nonbanking subsidiaries.
2. Review recordkeeping practices, and determine whether such management information systems are adequate to service customers and limit the risk of loss resulting from weak recordkeeping activities.
3. Review customer logs or client lists, and determine whether the activity is limited to only consumer-credit-reporting activities.
4. Review the activity and billings for a customer of an affiliated financial institution, and compare those findings to the activities and billings of other customers. Determine whether the bank holding company is giving preferential treatment to a customer(s) of an affiliated financial institution.
5. Review the company's policies and operating and internal control procedures for the activity, and determine whether they have been documented and whether they are being tested for compliance as part of the company's internal/external audits.
6. Review correspondence with legal counsel, and determine whether any significant contingent liabilities exist due to the failure of the holding company and its nonbanking subsidiary to fulfill their responsibilities as an agent for their customers.
7. Determine whether internal control procedures and compliance audits test for compliance with the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Right to Financial Privacy Act.
8. Determine what steps have been taken to prevent unauthorized access to any computerized credit bureau credit files to preserve the confidentiality of the information stored for customers' use.

3340.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Denial of a BHC's proposal to engage in providing credit ratings for large businesses				1985 FRB 118
Activity is closely related to banking and a permissible nonbanking activity for consumer-credit reporting only		225.28(b)(2)(v)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

3500.0.1 INTRODUCTION

Among other things, section 106 of the Bank Holding Company Act amendments of 1970 (section 106) prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank.[1] The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services.[2] Tying arrangements that are prohibited by section 106 may be addressed by the bank's appropriate federal banking agency through an enforcement action, by the Department of Justice through a request for an injunction, or by a customer or other person injured by the tying arrangement through a request for an injunction or a legal action against the bank for damages.[3]

Although section 106 prohibits banks from imposing certain types of tying arrangements on their customers, the statute also expressly permits banks to engage in other forms of tying and authorizes the Board to grant additional exceptions to the statute's prohibitions by regulation or order.

3500.0.2 PROHIBITIONS UNDER SECTION 106

Section 106 prohibits a bank from extending credit, leasing or selling property, furnishing any service, or fixing or varying the consideration for any of the foregoing on the condition or requirement that a customer

- obtain some additional credit, property, or service from the bank or its affiliates other than a loan, discount, deposit, or trust service;
- provide some additional credit, property, or service to the bank or its affiliates, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service; or
- not obtain some additional credit, property, or service from a competitor of the bank or of an affiliate of the bank unless the condition is reasonably imposed in a credit transaction to assure the soundness of the credit.[4]

The most common types of tying arrangements are those where a bank product or consideration for a bank product to a customer is conditioned upon the customer obtaining another product from the bank or an affiliate. There are two elements necessary to establish a tying arrangement under these circumstances: (1) the arrangement must involve two or more separate products, and (2) the customer is, in fact, required to buy a tied product in order to get a tying product.

3500.0.3 APPLICABILITY OF SECTION 106

Section 106 applies only to tying arrangements that are imposed by a bank, whether or not they are subsidiaries of holding companies. The statute does not apply to tying arrangements imposed by affiliates of the bank. However, an examination of the facts and circumstances of a tying arrangement imposed by a bank affiliate that involves a bank product could reveal that the arrangement essentially is a tying arrangement set forth by the bank, but structured to appear as though it is required by the bank affiliate. These arrangements may constitute prohibited tying arrangements.

Section 106 specifically allows a bank to engage in a tying arrangement if the tied product is a "loan, discount, deposit, or trust service" (a "traditional bank product") provided to a customer.[5] The Board has not clarified the scope of this exception.

A parallel provision, codified in section 5(q) of the Home Owners' Loan Act of 1933, applies to savings associations and is also administered by the Board.[6]

1. 12 U.S.C. 1972. Although part of the Bank Holding Company Act amendments of 1970, section 106 applies to a bank whether or not the bank is owned or controlled by a bank holding company.

2. Banks and their affiliates, including nonbank affiliates, are also subject to the tying restrictions contained in the federal antitrust laws (the Sherman and Clayton Acts). 15 U.S.C. 1 et seq.; 15 U.S.C. 12 et seq.

3. 12 U.S.C. 1972, 1973, 1975, and 1976.

4. 12 U.S.C. 1972(1).

5. 12 U.S.C. 1972(1)(A). Products or services in the form of a "loan, discount, deposit, or trust service" are considered to be traditional bank products.

6. 12 U.S.C. 1464(q).

3500.0.4 EXCEPTIONS TO SECTION 106

Section 106 expressly permits a bank to condition the availability or price of a product on a requirement that the customer also obtain a loan, discount, deposit or trust service from the bank. The statute also expressly permits a bank to condition the availability or price of a product on a requirement that the customer provide the bank with some additional product that is related to and usually provided in connection with a loan, discount, deposit, or trust service. Mixed-product arrangements—or arrangements whereby bank customers can receive a discount if they choose several products among a larger menu of products—may or may not violate section 106 depending on the facts and circumstances.

In addition to the statutory exceptions set forth in section 106, additional regulatory exceptions can be found in the Board's Regulation Y (12 CFR 225.7). These exceptions include (1) situations where the tied product is a traditional bank product offered by an affiliate of the bank, (2) combined-balance discount packages, and (3) bank transactions with foreign persons.

The Board is also authorized, in consultation with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, to grant additional exceptions to the statute's prohibitions by regulation or order.

3500.0.5 INTERNAL CONTROLS TO PROMOTE COMPLIANCE WITH PROHIBITIONS OF SECTION 106

Banks should have policies, procedures, and systems in place that are reasonably designed to promote bank compliance with the tying prohibitions of section 106. The types of policies, procedures, and systems appropriate for a particular bank depend on the bank's size and the nature, scope, and complexity of its activities. Banks should review and update their policies, procedures, and systems periodically to ensure that they reflect any changes in the nature, scope, or complexity of their activities or applicable statutes, regulations, or supervisory guidance.

Banks should also ensure that appropriate bank personnel receive education and training concerning the provisions of section 106. A bank's internal audit function should periodically review and test its tying policies, procedures, and systems in order to confirm that they are working effectively and in the manner intended.

3500.0.6 SUPERVISORY CONSIDERATIONS

Depending on the facts and circumstances, it may be appropriate to assess compliance with section 106 at the holding company or the state member bank. Examiners should focus on the holding company's responsibility to oversee and safeguard against prohibited tying arrangements by its bank subsidiaries and affiliates. In addition, examiners may conduct more targeted examinations of the marketing programs, training materials, internal reports and internal tying investigations of a bank. Examiners should be aware that the principal objective of section 106 is to eliminate any potential for "arm twisting" customers into buying some other product to get the product they desire. In assessing tying arrangements, examiners should focus their review on the bank's policies, procedures, and internal controls as well as training and audit programs covering compliance with section 106. As part of this supervisory review, examiners should consider the inspection objectives and procedures in subsections 3500.0.7 and 3500.0.8.

Examiners should assess the adequacy of the bank's audit and compliance programs related to tying arrangements. If the audit program focused on tying arrangements is infrequent or inadequate, examiners may consider reviewing a sample of pertinent extensions of credit (for example, loans, lines of credit, and letters of credit) that may be susceptible to improper tying arrangements.

The determination of whether a violation of section 106 has occurred often requires a careful review of the specific facts and circumstances associated with the relevant transaction between the bank and the customer. If there is an apparent violation of law at the bank, examiners generally should communicate the findings in the report of examination or supervisory letter, which includes the name of the applicable law (section 106 of the Bank Holding Company Act amendments of 1970 (12 U.S.C. 1972)) or regulation (Regulation Y, 12 CFR 225.7), a brief description of the scope of the relevant law, the requirements of the regulation or statute, and a discussion of how or why the violation occurred. The discussion in the report of examination should also describe any plans or recommendations for corrective action.

3500.0.7 INSPECTION OBJECTIVES

1. To assess the adequacy of the institution's policies and procedures related to tying arrangements.
2. To determine whether the institution has established internal controls and procedures for complying with section 106.
3. To determine whether the institution appropriately monitors internal loan reviews of pertinent bank extensions of credit to borrowers whose credit facilities or services may be susceptible to improper tying arrangements in violation of section 106 or the Board's regulations.
4. To determine whether training is provided to management and employees who are responsible for compliance with tying prohibitions.

3500.0.8 INSPECTION PROCEDURES

Preliminary Review

1. Determine whether the institution engages in any activities that present an increased opportunity to inappropriately tie its services or credit facilities to other services or facilities.

Policies

2. Determine whether there is a holding-company-wide policy or if the holding company's banking subsidiaries have their own policies related to tying arrangements.
3. Ascertain whether the institution's policy incorporates safeguards to prevent violations of relevant statutes and regulations. Consider whether the policy
   a. indicates that certain tying arrangements are prohibited by statute and regulations;
   b. provides specific examples of impermissible practices relevant to the product lines; and
   c. contains procedures for employees to follow if questions arise concerning the application of the prohibitions against tying arrangements.
4. Assess whether the policy requires periodic review of servicing contracts between the bank and its affiliates, as well as expectations for reviewing the substance of transactions, to determine—
   a. the capacity in which the bank and its tied affiliate are acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?);
   b. the nature of all services provided; and
   c. billing arrangements for service fees, the frequency of billing, the method of computation, and the basis for such fees.
5. Determine whether the policy related to tying arrangements provides expectations for employee training, and whether management and its internal auditors have periodically confirmed that there is compliance with such an internal policy.
6. Determine whether the policy is periodically reviewed by appropriate risk-management staff and updated to accurately reflect the products and services offered by the holding company and its subsidiaries.

Monitoring and Internal Controls

7. Assess the holding company's program to monitor the internal loan reviews of subsidiary banks and their affiliates. Such reviews should include
   a. the inspection of credit files for loan agreements and other documentation that place conditions or restrictions on borrowers that indicate a possible tying arrangement.
   b. internal loan reviews of files for insurance applications, particularly if an insurance subsidiary maintains a consistently high penetration rate on credits granted by bank affiliates, which could indicate the presence of improper tying arrangements.
8. While reviewing credit and collateral files (especially loan agreements) as well as the accounts receivable area, consider whether any extension of credit—or terms for an extension of credit—are conditioned upon the customer—
   a. obtaining additional credit, property, or services from the bank, other than a loan, discount, deposit, or trust service;
   b. obtaining additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
   c. providing an additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
   d. providing additional credit, property, or service to the bank's parent holding com-

pany or any of the parent's other subsidiaries; or

e. not obtaining other credit, property, or service from a competitor of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

9. Review the holding company's internal controls that are intended to prevent prohibited tying arrangements by its bank subsidiaries and affiliates.
10. Review incentives that may encourage tying arrangements by bank employees, such as commission structures and fee-splitting arrangements between departments.

Audit

11. Determine whether the audit function assesses the institution's compliance with the prohibitions on tying arrangements.
12. Identify whether the institution's legal counsel or other competent experts review transactions in the appropriate areas of the holding company, its bank subsidiaries, and affiliates to ensure compliance with the prohibitions against tying arrangements. If yes, determine whether they identified any compliance weaknesses or are aware of customer allegations of prohibited tying arrangements.

Training

13. Assess the appropriateness of training programs aimed to instruct employees on tying arrangements. Consider whether
    a. employees are aware of the prohibitions against tying arrangements;
    b. participation in a training program is required for new employees; and
    c. training programs concerning the tying requirements are updated to reflect new activities at the institution.

A foreign bank that operates in the United States through a branch, agency, or commercial lending company subsidiary, or that owns or controls a U.S. bank or Edge corporation, must conform to the nonbanking restrictions of the BHC Act.

The BHC Act also provides exemptions that permit a foreign bank with U.S. banking operations to engage in certain nonbanking activities. As with domestic bank holding companies, pursuant to section 4(c)(8), a foreign bank may own shares of any company that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. As described below, a foreign bank may also qualify for additional exemptions pursuant to sections 4(c)(9) and 2(h). These latter exemptions apply only to foreign banking institutions and seek to limit the extraterritorial application of federal banking law while preserving national treatment of these institutions' domestic counterparts.

3510.0.1 REGULATION K

Regulation K implements the nonbanking restrictions of section 4 of the BHC Act by applying the limits to any foreign banking organization (FBO). An FBO is (1) any foreign bank that either operates a branch, agency, or commercial lending company subsidiary in the United States, or that controls a U.S. bank, and (2) any company that owns or controls a foreign bank described in (1). (See 12 C.F.R. 211.21(o) to apply these limits.) Regulation K requires any FBO that engages in activities in the United States to conform those activities to the nonbanking restrictions by either limiting the activities or obtaining an exemption. (See 12 C.F.R. 211.23(n).)

Regulation K implements statutory exemptions from the BHC Act for certain activities of foreign banks. Sections 4(c)(9) and 2(h) of the BHC Act provide exemptions that are available to "qualifying foreign banking organizations" (QFBOs).

Section 2(h) allows a foreign company that is principally engaged in banking business outside the United States to own foreign affiliates that engage in impermissible nonfinancial activities in the United States, subject to certain requirements. These include requirements that the foreign affiliate must derive most of its business from outside the United States and that it may engage in the United States in only the same lines of business it conducts outside the United States.

Section 4(c)(9) allows the Board to exempt foreign companies from the nonbank activity restrictions of the BHC Act when the exemption would not be substantially at variance with the BHC Act and would be in the public interest. Under this authority, the Board has exempted, among other things, all foreign activities of QFBOs from the nonbanking prohibitions of the BHC Act.

To qualify as a QFBO (and, hence, to be eligible for the 4(c)(9) and 2(h) exemptions), an FBO must chiefly engage in banking activities worldwide; that is, it must demonstrate that more than half of its business is banking and that more than half of its banking business is outside the United States. Regulation K sets forth a multistep test for determining when an FBO primarily engages in banking activities worldwide. This so-called QFBO test is met if "disregarding [the FBO's] U.S. banking business, more than half of [the FBO's] worldwide business is banking; and more than half of its banking business is outside the United States." (See 12 C.F.R. 211.23(a).)

Under the QFBO test, an FBO must satisfy at least two of the following criteria:

1. the banking assets held outside the United States must exceed total worldwide nonbanking assets;
2. revenues derived from the business of banking outside the United States must exceed total revenues derived from its worldwide nonbanking business; or
3. net income derived from the business of banking outside the United States must exceed total net income derived from its worldwide nonbanking business.

In addition, the FBO must meet at least two of the following criteria:

1. the banking assets held outside the United States must exceed the banking assets held in the United States;
2. revenues derived from the business of banking outside the United States must exceed the revenues derived from the business of banking in the United States; or
3. net income derived from the business of banking outside the United States must exceed

net income from the business of banking in the United States.

Regulation K provides rules on how to calculate the assets, revenues, and net income of the FBO and its foreign subsidiaries.[1] In calculating assets, revenues, or net income held or derived from the business of banking "outside the United States," the FBO may not include assets, revenues, or net income, whether held or derived directly or indirectly, of a subsidiary bank, a branch, an agency, a commercial lending company, or another company engaged in the business of banking in the United States, including any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands.

Regulation K provides a broader definition of "banking" for use in the QFBO test. A QFBO may include assets, revenues, and income from any activity that a U.S. bank holding company may perform abroad pursuant to section 211.10 of Regulation K, if the activity is conducted by the foreign bank itself or by a subsidiary. Thus, for example, an FBO may treat certain insurance and securities activities as banking activities for determining QFBO status. (See 12 C.F.R. 211.23(b)(2) and 211.10.) However, this broader definition of banking applies to the QFBO test only. It does not define the types of permissible banking activities that a QFBO may perform in the United States.

An FBO may be unable to satisfy the QFBO test because a substantial part of its financial activities is conducted outside of the foreign bank itself. This might occur, for example, when an FBO conducts substantial life insurance activities through a parent or sister company of the foreign bank. Such an FBO may nevertheless be eligible for some more limited exemptive relief if it meets a modified test. Under this modified test, when calculating assets, revenues, or net income for the prong of the QFBO test that measures whether more than half of an FBO's business is banking, the FBO may count banking activities conducted outside the foreign banking chain. For the other prong of the test, which determines whether more than half of an FBO's banking business is outside the United States, the banking-chain requirement would still apply. An FBO that meets this modified test will be eligible for all of the exemptions other than the exemption for limited commercial and industrial activities provided under section 2(h) (as implemented by 12 C.F.R. 211.23(f)(5)).[2] However, any foreign banks within the FBO that independently meet the QFBO test would be eligible for all of the exemptions available to QFBOs. The modified test is intended to limit the extraterritorial effect of the BHC Act on foreign firms and to avoid penalizing a consolidated group that engages mostly in activities permissible for a U.S. banking organization.

An FBO that does not qualify, or that ceased to qualify for two consecutive years (as reported in the Annual Report of Foreign Banking Organizations, Form FR Y-7, that the FBO filed with the Board), is not eligible for the exemptions afforded by sections 2(h) and 4(c)(9). An FBO that does not qualify for these exemptions may only engage in activities in the United States that are permissible for a domestic bank holding company. An FBO that no longer qualifies under the QFBO test may seek a determination of continued eligibility from the Board. Otherwise, the FBO may only continue to engage in activities begun, or retain investments acquired, before the end of the first fiscal year in which it failed to qualify. Other activities or investments must cease or be divested within three months of the filing of the second FR Y-7, which demonstrates that the foreign bank no longer qualifies for the exemptions. The Board also has the authority to grant exemptive relief under Regulation K to foreign organizations that do not include foreign banks. (See 12 C.F.R. 211.23(e).)

3510.0.2 NONBANKING EXEMPTIONS FROM THE BHC ACT FOR QFBOs UNDER SECTIONS 4(C)(9) AND 2(H)

Sections 2(h) and 4(c)(9) of the BHC Act are exemptive provisions that seek to limit the extraterritorial impact of federal banking law. While there is considerable overlap in these two sections (for example, only a QFBO is eligible for both kinds of exemptions), they also have significant differences (for example, section 2(h) only exempts certain types of activities, whereas

1. A subsidiary is any company that either (1) has 25 percent or more of its voting shares directly or indirectly owned, controlled, or held with the power to vote by a company, including a foreign bank or a foreign banking organization, or (2) is otherwise controlled or capable of being controlled by a foreign bank or foreign banking organization. See 12 C.F.R. 211.21(z).

2. Any FBO that qualifies as a financial holding company (FHC) would be able to make merchant banking investments and investments in connection with its insurance business in the United States to the extent permitted for an FHC. The lack of eligibility for the exemption in section 211.23(f)(5) would not negate or otherwise affect such authority.

section 4(c)(9) may also exempt specific activities or investments upon Board order).

3510.0.2.1 Section 4(c)(9) of the BHC Act

Section 4(c)(9) of the BHC Act authorizes the Board to exempt the U.S. activities of a QFBO, through order or regulation, if the exemption "would not be substantially at variance with the purposes of [the BHC Act] and would be in the public interest." The Board has implemented this provision in Regulation K to permit a QFBO to engage directly or indirectly in any activity outside of the United States; hold the shares of any company that engages in activities in the United States that are "incidental" to foreign business; hold a *noncontrolling* interest in any chiefly foreign company that engages in any activity in the United States, if the foreign company derives more than half its assets and revenues from outside the United States; or own or control voting shares of any company acquired in good faith in a fiduciary capacity as permitted by section 4(c)(4) of the BHC Act. An FBO is *not* permitted to own more than 10 percent of the shares of a foreign company that directly or indirectly engages in underwriting, selling, or distributing securities to an extent not permitted for bank holding companies.[3] (See 12 C.F.R. 211.23(f)(1), (2), (3), (4), and 5(i) and (ii).)

The provision that permits a QFBO to own shares of a foreign company that engages in incidental, international activities in the United States has been defined by interpretation. That is, an activity is "incidental" to a foreign company's activities outside of the United States only if it is an activity that an Edge or agreement corporation may perform in the United States. Section 211.6 of Regulation K defines the permissible activities of an Edge or agreement corporation.[4] An application to the Federal Reserve is not required before a QFBO engages in an activity that is incidental to international business under this exemption.

A QFBO may also request a specific exemption from the BHC Act under section 4(c)(9) to perform otherwise impermissible activities in the United States. The Board considers these requests on a case-by-case basis.

3510.0.2.2 Section 2(h) of the BHC Act

Section 2(h) of the BHC Act permits a QFBO to own or control the voting shares of a foreign company that is principally engaged in business outside of the United States and that engages directly or indirectly in activities in the United States that are the same as or related to the company's lines of business abroad.

Section 2(h) is designed to allow a QFBO that has foreign commercial or industrial affiliates to continue to hold those affiliates, even if the affiliate engages in activities in the United States that would ordinarily be prohibited by section 4 of the BHC Act. The U.S. activities must be the same kind of activity the affiliate conducts outside the United States and the foreign affiliate must be chiefly foreign, that is, it must derive more than half of its assets and revenues from outside the United States. The U.S. branches and agencies of a QFBO may not lend to an affiliate held under section 2(h) except on an arm's-length basis.

A QFBO may *not* engage in financial activities in the United States on the basis of section 2(h). Regulation K provides a list of activities that are considered "financial." These activities should be referenced to Division H (Finance, Insurance, and Real Estate) of the Standard Industrial Classifications (SIC), as well as to selected activities in other divisions of the SIC that are considered financial in nature.[5]

3. Specifically, Regulation K permits a QFBO to (1) engage in activities of any kind outside the United States; (2) engage directly in activities in the United States that are incidental to its activities outside the United States; (3) own or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States other than those that are incidental to the international or foreign business of such company; and (4) own or control voting shares of any company in a fiduciary capacity under circumstances that would entitle such shareholding to an exemption under section 4(c)(4) of the BHC Act if the shares were held or acquired by a bank.

4. Generally, these activities must have an international nexus and may consist of receiving deposits from foreign governments and persons; receiving deposits from other persons under certain conditions; holding or investing liquid funds in certain forms or instruments; engaging in certain credit activities or borrowing funds; receiving or collecting payments under certain conditions; performing foreign-exchange activities; acting as a fiduciary, an investment adviser, or a broker or performing other activities related to investing under certain conditions; providing banking services for employees; and engaging in other activities with prior Board approval. See 12 C.F.R. 211.6(a).

5. The North American Industry Classification System (NAIS) replaces the use of SIC codes. The NAICS codes differ from the SIC codes. To evaluate compliance with section 2(h) of the BHC Act, examiners should consult Regulation K directly when determining whether particular activities are permissible. Regulation K refers to NAICS codes.

Section 2(h) is implemented in Regulation K as follows: A QFBO may own or control voting shares of a foreign company that is engaged directly or indirectly in business in the United States other than that which is incidental to its international or foreign business, subject to the following limitations:

1. More than 50 percent of the foreign company's consolidated assets shall be located, and consolidated revenues derived from, outside the United States.[6] (See 12 C.F.R. 211.23(f)(5)(i).)
2. The foreign company shall not directly underwrite, sell, or distribute, nor directly own or control more than 10 percent of the voting shares of a company that underwrites, sells, or distributes, securities in the United States except to the extent permitted bank holding companies. (See 12 C.F.R. 211.23(f)(5)(ii), 12 C.F.R. 225.124, and section 3510.0.2.3.)

Regulation K places additional restrictions on the 2(h) exemption when a QFBO owns a foreign company that is a subsidiary. Specifically, the foreign company must be, or must control, an operating company. Its direct or indirect activities in the United States are subject to the following limitations:

1. The foreign company's activities in the United States shall be the same kind of activities or related to the activities engaged in directly or indirectly by the foreign company abroad, as measured by the "establishment" categories of the SIC. An activity in the United States shall be considered related to an activity outside the United States if it consists of supply, distribution, or sales in furtherance of the activity. (See 12 C.F.R. 211.23(f)(5)(iii)(A).)
2. The foreign company may engage in activities in the United States that consist of banking securities, insurance or other financial operations, or types of activities permitted by regulation or order under section 4(c)(8) of the BHC Act only under regulations of the Board or with the prior approval of the Board, subject to the following:
   a. Activities within Division H (Finance, Insurance, and Real Estate) of the SIC shall be considered banking or financial operations for this purpose, with the exception of acting as operators of nonresidential buildings (SIC 6512), operators of apartment buildings (SIC 6513), operators of dwellings other than apartment buildings (SIC 6514), operators of residential mobile home sites (SIC 6515), and operating title abstract offices (SIC 6541).
   b. The following activities shall be considered financial activities and may be engaged in only with the approval of the Board under section 211.23(g) of Regulation K:[7] credit reporting services (SIC 7323); computer and data processing services (SIC 7371 to 7379); armored car services (SIC 7381); management consulting (SIC 8732, 8741, 8742, and 8748); certain rental and leasing activities (SIC 4741, 7352, 7353, 7359, 7513, 7514, 7515, and 7519); accounting, auditing, and bookkeeping services (SIC 8721); courier services (SIC 4215 and 4513); and arrangement of passenger transportation (SIC 4724, 4725, and 4729).

The restriction in paragraph 2b. above reflects the fact that section 2(h) is not the source of authority for a QFBO to engage in banking, securities, or other financial activities in the United States through a subsidiary.

The section 2(h) exemption only applies to the nonfinancial, nonbanking activities of an FBO. To preserve competitive equity, the exemption does not permit an FBO to control a foreign nonbanking company that engages in, or that holds more than 5 percent of the voting shares of another company that engages in, banking, securities, insurance, real estate, or other financial activities in the United States. These activities may be performed only with Federal Reserve approval under section 4(c)(8) or 4(c)(9) of the BHC Act.

3510.0.2.3 Foreign Banks' Underwriting of Securities

A number of foreign banks, which are subject to

6. If the foreign company fails to meet the requirements of paragraph (f)(5)(i) (12 C.F.R. 211.23) for two consecutive years (as reflected in annual reports (FR Y-7) the FBO filed with the Board), the foreign company must be divested or its activities must be terminated within one year of the filing of the second consecutive annual report that reflects nonconformance with the requirements of paragraph (f)(5)(i), unless the Board grants consent to retain the investment under 12 C.F.R. 211.23(g).

7. Section 211.23(g) of Regulation K permits a foreign banking organization to request a case-by-case exemption from the nonbanking restrictions to engage in otherwise impermissible activities pursuant to section 4(c)(9) of the BHC Act.

the BHC Act, had participated as co-managers in the underwriting of securities that were distributed in the United States. These banks did not have the authority to engage in securities underwriting activity in the United States. The U.S. offices of affiliates of the foreign banks were used to engage in activities conducted in support of the underwriting transactions, for which these U.S. offices were compensated by the foreign bank. The foreign bank became a member of the underwriting syndicate but it did not distribute any of the securities in the United States or elsewhere. The foreign banks took the position that they were not engaged in underwriting in the United States because any underwriting obligation was booked outside the United States.

A foreign bank that is subject to the BHC Act may engage in underwriting activities in the United States only if it has been authorized under section 4 of that act. Section 225.124 of the Board's Regulation Y states that a foreign bank will not be considered to be engaged in the activity of underwriting in the United States if the shares to be underwritten are distributed outside the United States. In the transactions in question, all of the securities were distributed in the United States.

In 1985, the Board amended Regulation K in section 211.23(f)(5)(ii) to provide clarification that a foreign banking organization shall not "directly underwrite, sell, or distribute, nor own or control more than 10 percent of the voting shares of a company that underwrites, sells, or distributes securities in the United States, except to the extent permitted bank holding companies." When proposing this provision, the Board stated "...that no part of the prohibited underwriting process may take place in the United States and that the prohibition on the activity does not depend on the activity being conducted through an office or subsidiary in the United States."

Regulation K defines "engaged in business" and "engaged in activities" to mean conducting an activity through an office or subsidiary in the United States. The Regulation K definition of "engaged in business," adopted in 1979, however, does not authorize foreign banking organizations to evade regulatory restrictions on securities activities in the United States by using U.S. offices and affiliates to facilitate the prohibited activity. Also, the framework of the Gramm-Leach-Bliley Act (the GLB Act) requires that banking organizations meet certain financial and managerial requirements of the GLB Act and the Board's Regulation K to engage in these activities in the United States.

The Board therefore issued an interpretation on February 7, 2003 (effective February 19, 2003), clarifying that the underwriting by foreign banks of securities to be distributed in the United States is an activity conducted in the United States, regardless of the location at which the underwriting risk is assumed and the underwriting fees are booked. Consequently, any banking organization that wishes to engage in such activity must either be a financial holding company under the GLB Act or have authority to engage in underwriting activity under section 4(c)(8) of the BHC Act (so-called section 20 authority). Revenue generated by underwriting bank-ineligible securities in such transactions should be attributed to the section 20 company for those foreign banks that operate under section 20 authority. (See 12 C.F.R. 211.605.)

3510.0.3 GRANDFATHER RIGHTS

Section 8 of the International Banking Act (IBA) provides grandfather rights to foreign banks that operated a branch, agency, or subsidiary commercial lending company at the time of enactment of the IBA.

Section 8(c) of the IBA permanently grandfathers activities engaged in directly or through an affiliate on or before July 26, 1978, or for which an application to engage in such activities had been filed on or before that date.[8] Grandfathered nonbanking activities may not be expanded through the acquisition of any interest in or the assets of a going concern engaged in the same activities. The Board may, subject to opportunity for hearing, terminate these grandfather rights where it is necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices in the United States. A foreign bank that is required to terminate its indirect grandfathered activity may retain ownership of the shares of the grandfathered company for a period of two years from the date of the Board's action.

Grandfather rights conferred under section 8(c) of the IBA shall terminate immediately upon the filing of an FHC declaration by the foreign bank or foreign company. With respect to a foreign bank or foreign company that did

8. The term "affiliate" means any company that controls, is controlled by, or is under common control with the foreign bank or the parent of the foreign bank.

not file an FHC declaration by November 12, 2001, the Board has the authority, giving due regard to the principle of national treatment and equality of competitive opportunity, to impose such restrictions and requirements on the conduct of any grandfathered activities as are comparable to those imposed on a U.S. FHC, including a requirement to conduct such activities in compliance with any prudential safeguards established under 12 U.S.C. 1828a.

3510.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Foreign banking organizations	1841(h) 1843(c)(9) 3106	211.23(f)(5)		
Underwriting of securities in the United States is an activity conducted in the United States		211.605	3–693	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Section 4(c)(10) of the BHC Act (Exemption from Section 4 for BHCs That Are Banks) Section 3520.0

This manual section explains the "grandfather" or legacy exemption from the general prohibitions of section 4(c)(10) of the Bank Holding Company (BHC) Act for a small group of BHCs that were themselves banks. For such BHCs and their wholly owned subsidiaries, the exemption provided for continued ownership of nonbank shares that were lawfully acquired and owned directly or indirectly prior to enactment of the BHC Act (May 9, 1956). At the time of its enactment, the exemption accommodated only three BHCs. While these BHCs no longer exist, this manual section provides historical background about this exemption from the BHC Act.

Section 4(c)(10) limited its exemption to "wholly owned subsidiaries." To have been eligible for the exemption in section 4(c)(10), the holding company must have continuously held the shares of the wholly owned subsidiary since May 9, 1956. This interpretation aligned with the Federal Reserve Board's interpretations of other sections of the BHC Act.

Section 4(c)(11) (Authorization for BHCs to Reorganize Share Ownership Held on the Basis of Any Section 4 Exemption) Section 3530.0

Section 4(c)(11) was adopted to authorize bank holding companies to reorganize share ownership held on the basis of any section 4 exemption. Reorganization is permitted with respect to section 4(a)(2) grandfathered activities engaged in prior to June 30, 1968, retaining indefinite grandfather authority. Shares held pursuant to Board approval under section 4(c)(8) or any other section 4 exemption also come within section 4(c)(11)'s reorganization authority.

Under section 4(c)(11), a bank holding company is authorized to reorganize its share ownerships, shift its activities among its various entities and form new subsidiaries without Board approval as long as there is no change in the activities of the bank holding company system. Congress also felt it entirely appropriate for these companies to expand their activities so long as such expansion did not produce anticompetitive or other adverse effects. Accordingly, internal expansion of the grandfathered activities was permitted but the provision was added that this section does not authorize the grandfathered companies to acquire, either directly or indirectly, any interest in or the assets of any going concern outside the holding company system (unless the acquisition is pursuant to a contract entered into before June 30, 1968). Congress reasoned that purchasing a going concern engaged in the grandfathered activities of a holding company would tend to have an anticompetitive effect in that it would reduce the number of firms competing against each other in a given activity.

This section provided an exemption from the general prohibitions of section 4 for shares held or activities which became subject to the Act by the 1970 amendments.

Section 4(c)(12) provided not only for continued ownership of shares or performance of activities so held or performed as of December 31, 1970, but also for others permitted afterward by the Board. As stated in subparagraphs (A) and (B) of section 4(c)(12), the 10-year exemption applied if such bank holding companies: (A)(i) ceased to be bank holding companies by December 31, 1980; or (A)(ii) ceased to retain direct or indirect ownership of the nonbank shares or engage in the nonbank activities by December 31, 1980; or (B) complied with such other condition as the Board may prescribe.

A company was required to file an irrevocable declaration that it would cease to be a bank holding company by January 1, 1981, unless the Board granted it hardship exemption under section 4(d) of the Act. Such a company could then expand its nonbanking activities *de novo* without notification to the Board and could acquire a going concern nonbank company 45 days after informing the appropriate Reserve Bank of the proposed acquisition unless notified otherwise within that time. If an irrevocable declaration was not filed, then no acquisition could have been made or activities commenced under section 4(c)(12) except with prior Board approval. These limitations did not apply to acquisitions made pursuant to a binding commitment entered into before March 23, 1971.

Few bank holding companies have claimed an exemption under section 4(c)(12). It is unlikely that many situations involving section 4(c)(12) will be encountered by inspection personnel. However, if a 4(c)(12) company has committed to cease the nonbanking activities examiners must ensure that the divestiture has occurred.

3540.0.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Divestitures		225.138		
Successor rights				1977 FRB 946

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 4(c)(13) of the BHC Act governs the international activities of bank holding companies. In general, the act authorizes the Board to permit domestic bank holding companies to invest in companies that do no business in the United States except what is incidental to international or foreign business. Bank holding companies may invest in the same companies as Edge corporations.

3550.0.1 INVESTMENTS AND ACTIVITIES ABROAD

The investment provisions of Regulation K (sections 211.8, 211.9, and 211.10) implement section 4(c)(13) of the BHC Act. In general, an ''investor'' under Regulation K may invest, directly or indirectly, in a subsidiary or joint venture or may make portfolio investments, subject to the limits in section 211.8 and the general provisions in section 211.9(a). (See SR-02-03 and SR-02-02.)

Bank holding companies may invest in the same types of entities as Edge and agreement corporations. However, member banks may invest directly in only foreign banks; domestic or foreign organizations formed for the sole purpose of holding shares of a foreign bank; foreign organizations formed for the sole purpose of performing nominee, fiduciary, or other banking services incidental to the activities of a foreign branch or foreign bank affiliate of the member bank; and subsidiaries established pursuant to section 211.4(a)(8) of Regulation K (that is, a company that engages solely in activities in which the member bank is permitted to engage or that are incidental to the activities of the member bank's foreign branch). (See all sections of Regulation K for any other activity or investment authorizations, limitations, requirements, or prohibitions not discussed in this section.)

In general, the Board has limited the types of activities that a bank holding company may engage in through the ownership of foreign companies to banking or financially related activities, and to those that are necessary to carry on such activities. These include all of the activities permitted under section 211.10 of Regulation K and section 4(c)(8) of the BHC Act, including equity securities underwriting and management consulting. Many of the activities permitted abroad are not subject to the same limits as those imposed domestically under section 4(c)(8) (for example, brokerage of all types of insurance is permitted abroad).

Activities abroad, whether conducted directly or indirectly, are to be confined to activities of a banking or financial nature and to those that are necessary to carry on such activities. At all times, investors[1] must act in accordance with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital. The Board follows the policy of allowing activities abroad to be organized and operated as best meets corporate policies. The following provides a limited discussion of general investment activities under Regulation K. The regulation should be referred to for more specific requirements and limitations.

In general, an investor may make (1) an investment in a subsidiary, (2) an investment in a joint venture, or (3) a portfolio investment in an organization. With regard to an investment in a subsidiary, the subsidiary must engage in activities authorized under section 211.10 of Regulation K, or in other activities that the Board has determined to be permissible (for a particular case). In the acquisition of a going concern, existing activities that are not otherwise permissible for a subsidiary may account for not more than 5 percent of either the acquired organization's consolidated assets or consolidated revenues. For an investment in a joint venture, no more than 10 percent of the joint venture's consolidated assets or consolidated revenues can be attributable to activities that are not listed in section 211.10.

For portfolio investments in an organization, the investor and its affiliates' total direct and indirect portfolio investments in an organization that is engaged in activities not permissible for joint ventures, when combined with all other shares in the organization (held under any other authority), cannot exceed—

1. 40 percent of the total equity of the organization, or
2. 19.9 percent of the organization's voting shares.

In addition to the individual investment limits, these portfolio investments are subject to an

1. For purposes of sections 211.8, 211.9, and 211.10 of Regulation K, a direct subsidiary of a member bank is deemed to be an investor.

aggregate equity limit. (See section 211.10(a)(15) of Regulation K.) For investments in organizations engaged in activities that are not permissible for joint ventures, when combined with shares held directly and indirectly by the investor and its affiliates under the equity dealing provisions of Regulation K, the investments cannot exceed—

1. 25 percent of the bank holding company's tier 1 capital, where the investor is a bank holding company;
2. 20 percent of the investor's tier 1 capital, where the investor is a member bank;[2] and
3. the lesser of 20 percent of any parent insured bank's tier 1 capital or 100 percent of the investor's tier 1 capital, for any other investor.

3550.0.2 INVESTMENT PROCEDURES

Except as the Board may otherwise determine, direct and indirect investments must be made in accordance with the general-consent, limited-general-consent, prior-notice, or specific-consent procedures of section 211.9 of Regulation K. The investment procedures of section 211.9(a) include the following requirements:

1. *Minimum capital adequacy standards.* The investor, the bank holding company, and the member bank must be in compliance with applicable minimum standards for capital adequacy set out in the capital adequacy guidelines. If the investor is an Edge or agreement corporation, the minimum capital required is total and tier 1 capital ratios of 8 percent and 4 percent, respectively.
2. *Composite rating.* For an investor to make investments under the general-consent or limited-general-consent procedures of sections 211.9(b) and (c), the investor and any parent insured bank must have received a composite rating of at least 2 at the most recent examination.
3. *Modification or suspension of procedures.* The Board may, at any time upon notice, modify or suspend the investment procedures for any investor or for the acquisition of shares of organizations engaged in particular kinds of activities.
4. *Long-range investment plan.* Any investor may submit a long-range investment plan to the Board for its specific consent. If approved by the Board, the plan shall be subject to the other procedures of section 211.9 only to the extent the Board determines is necessary to ensure the safety and soundness of the operations of the investor and its affiliates.
5. *Prior specific consent for initial investment.* For its initial investment in its first subsidiary or joint venture under subpart A of Regulation K, an investor must apply for and receive the prior specific consent of the Board, unless an affiliate previously has received approval to make such an investment.
6. *Expiration of investment authority.* Authority to make investments that was granted under prior-notice or specific-consent procedures shall expire one year from the earliest date on which the authority could have been exercised, unless the Board determines a longer period shall apply.
7. *Conditional approval; access to information.* The Board may impose such conditions on investment authority granted under section 211.9 as it deems necessary. The Board may also require termination of any activities conducted under subpart A of Regulation K, if an investor is unable to provide information on its activities or those of its affiliates that the Board deems necessary to determine and enforce compliance with U.S. banking laws.

3550.0.3 GENERAL CONSENT FOR WELL-CAPITALIZED AND WELL-MANAGED INVESTORS

The Board has granted its limited general consent to make investments by well-capitalized and well-managed investors. For these general-consent provisions to apply, the investor, any parent-insured bank, and any parent bank holding company must be well capitalized and well managed both before and immediately after the proposed investment. The investments are subject to the limitations discussed below.

3550.0.3.1 Individual Limit for Investment in a Subsidiary

The Board grants its general consent for investments by well-capitalized and well-managed investors, subject to certain investment limitations. For an investment in a subsidiary, the total amount that may be invested directly or indirectly (in one transaction or a series of transac-

2. For this purpose, a direct subsidiary of a member bank is deemed to be an investor.

tions) may not exceed 10 percent of the investor's tier 1 capital, where the investor is a bank holding company; 2 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 2 percent of the tier 1 capital of any parent-insured bank or 10 percent of the investor's tier 1 capital, for any other investor.

3550.0.3.2 Individual Limit for Investments in a Joint Venture

For individual investments in a joint venture, the total amount invested directly or indirectly (in one transaction or a series of transactions) may not exceed 5 percent of the investor's tier 1 capital, where the investor is a bank holding company; 1 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 1 percent of the tier 1 capital of any parent-insured bank or 5 percent of investor's tier 1 capital, for any other investor.

3550.0.3.3 Individual Limit for Portfolio Investment

For a portfolio investment, the total amount invested directly or indirectly (in one transaction or a series of transactions) in such company, general partnership, or unlimited-liability company cannot exceed the lesser of $25 million or—

1. 5 percent of the investor's tier 1 capital, in the case of a bank holding company or its subsidiary or an Edge corporation engaged in banking; or
2. 25 percent of the investor's tier 1 capital, in the case of an Edge corporation not engaged in banking.

3550.0.3.4 Aggregate Investment Limits

The amount of all investments made, directly or indirectly, during the previous 12-month period under section 211.9, when aggregated with the proposed investment, shall not exceed 20 percent of the investor's tier 1 capital, where the investor is a bank holding company; 10 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 10 percent of the tier 1 capital of any parent-insured bank or 50 percent of the tier 1 capital of the investor, for any other investor.

3550.0.4 LIMITED GENERAL CONSENT FOR AN INVESTOR THAT IS NOT WELL CAPITALIZED OR WELL MANAGED

3550.0.4.1 Individual Limit

For investors that are not well capitalized and well managed, the Board has granted limited general consent for an investor to make an investment in a subsidiary or joint venture, or to make a portfolio investment. The total amount invested, directly or indirectly (in one transaction or a series of transactions), cannot exceed the lesser of $25 million or 5 percent of the investor's tier 1 capital, where the investor is a bank holding company; 1 percent of the investor's tier 1 capital, where the investor is a member bank; or the lesser of 1 percent of any parent insured bank's tier 1 capital or 5 percent of the investor's tier 1 capital, for any other investor.

3550.0.4.2 Aggregate Limit

The amount of limited-general-consent investments made by such an investor directly or indirectly during the previous 12-month period, when aggregated with the proposed investment, cannot exceed 10 percent of the investor's tier 1 capital, where the investor is a bank holding company; 5 percent of the investor's tier 1 capital, where the investor is a member bank; and the lesser of 5 percent of any parent insured bank's tier 1 capital or 25 percent of the investor's tier 1 capital, for any other investor.

3550.0.5 CALCULATING COMPLIANCE WITH THE INDIVIDUAL AND AGGREGATE GENERAL-CONSENT LIMITS

When determining compliance with the individual and aggregate general-consent limits, an investment by an investor in a subsidiary can only be counted once, notwithstanding that the subsidiary may, within 12 months of making the investment, downstream all or any part of the investment to another subsidiary. Also, when determining compliance with these limits, an investor is not required to combine the value of all shares of an organization held in trading or dealing accounts under section 211.10(a)(15) of

Regulation K with investments in the same organization.

3550.0.6 OTHER ELIGIBLE INVESTMENTS UNDER GENERAL CONSENT

In addition to the general-consent authority already discussed, the Board has granted its general consent for any investor to make the following investments: any investment in an organization in an amount equal to cash dividends received from that organization during the preceding 12 calendar months, and any investment that is acquired from an affiliate at net asset value or though a contribution of shares.

3550.0.7 INVESTMENT INELIGIBLE FOR GENERAL CONSENT

An investment in a foreign bank is ineligible for general consent if (1) after the investment, the foreign bank would be an affiliate of a member bank, and (2) the foreign bank is located in a country in which the member bank and its affiliates have no existing banking presence.

3550.0.8 INVESTMENTS MADE WITH PRIOR NOTICE TO OR THE SPECIFIC CONSENT OF THE BOARD

An investment that does not qualify for general consent under section 211.9(b), (c), or (d) of Regulation K may be made after the investor has provided the Board with 30 days' prior written notice. The notice period commences at the time the notice is received. However—

1. the Board may waive the 30-day period if it finds the full period is not required for consideration of the proposed investment, or that the circumstances presented require immediate action, and
2. the Board may suspend the 30-day period or act on the investment under its specific-consent procedures.

Any investment that does not qualify for either the general-consent or the prior-notice procedure cannot be consummated without the specific consent (that is, express approval) of the Board.

3550.0.9 EXAMINATION OF FOREIGN SUBSIDIARIES OF BHCs

The procedures involved in examining foreign subsidiaries of domestic bank holding companies are generally the same as those used in examining domestic subsidiaries engaged in similar activities. The on-site examination of foreign subsidiaries is, however, necessarily limited. In most cases, examiners should try to implement asset-appraisal procedures by using records at the location of the U.S. parent or bank. Overseas examinations are intended primarily to appraise the firm's internal-control systems and the sufficiency of the firm's reporting to its parent company. For examination objectives and procedures for foreign subsidiaries, see the instructions for similar section 4(c)(8) investments in other sections of this manual.

3550.0.10 INVESTMENTS BY BANK HOLDING COMPANIES, EDGE CORPORATIONS, AND MEMBER BANKS IN FOREIGN COMPANIES

Subject to the limitations within subpart A of Regulation K, the Board allows, with its specific consent, banking organizations to acquire and hold investments in foreign companies that do business in the United States subject to the following conditions:

1. The activities abroad, whether conducted directly or indirectly, must be confined to activities of a banking or financial nature and those that are necessary to carry out such activities. When engaging in these activities, the investors are to act in accordance with high standards of banking and financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital.
2. The activities are either those that the Board has determined to be usual in connection with the transaction of banking or other financial operations abroad as listed in section 211.10 of Regulation K, including those activities authorized with the Board's specific approval, and those that have been determined to be usual in connection with the transaction of the business of banking or other financial operations abroad, consistent with the Federal Reserve Act or the BHC Act.

3550.0.11 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Investment and activities abroad		211.8		
Investment procedures		211.9		
Use of foreign subsidiaries to sell long-term debt obligations in foreign markets			3–706	
Investment by U.S. banking organizations in foreign companies that transact business in the United States		211.602	3–715	
Investment by U.S. banking organizations in futures commission merchant activities overseas				1982 FRB 671
Investment by U.S. banking organization in general life insurance underwriting overseas				1984 FRB 168 1985 FRB 269
Investment by U.S. banking organization in property and casualty insurance underwriting overseas				1985 FRB 267 1985 FRB 808
Investment by U.S. banking organization in physical commodities brokered overseas				1981 FRB 369
Investment in Edge Act corporation	611–632			
Investment in foreign banking corporation	601–604/ 611–618			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

In 1982 the Bank Holding Company Act of 1956 was amended by the Bank Export Services Act (BESA). The Bank Export Services Act provided an exemption to the prohibitions of Section 4 of the BHC Act for a bank holding company's investment in the shares of any company that is an export trading company. The (BESA) was designed to increase U.S. exports by encouraging investments and participation in export trading companies by bank holding companies and the specified investors.

An export trading company is a company that is exclusively engaged in activities related to international trade and, by engaging in one or more export trade services:

1. derives at least one-third of its revenues in each consecutive four-year period (excluding a two-year start up period) from the export of goods and services produced in the United States by persons other than the export trading company or its subsidiaries; and
2. derives revenues from the export, or facilitating the export, of goods or services produced in the United States and those revenues exceed revenues from the import, or facilitating the import into the United States, of goods or services produced outside the United States.

A bank holding company's direct and indirect investment in export trading companies may not exceed 5 percent of the bank holding company's consolidated capital and surplus. The total amount of extensions of credit by a bank holding company and its subsidiaries to its affiliated export trading company may not exceed 10 percent of the bank holding company's consolidated capital and surplus.

A bank holding company may not invest in an export trading company, unless the Board has been given sixty days prior written notice of the proposed investment. The Board may disapprove any proposed investment only if:

1. Such disapproval is necessary to prevent unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest; or
2. It finds that such investment would affect the financial or managerial resources of a bank holding company to an extent that is likely to have a materially adverse effect on the safety and soundness of any subsidiary bank of such bank holding company; or
3. The bank holding company fails to furnish the information required by the Board.

An Edge Act or agreement corporation that is a subsidiary of a bank holding company may invest directly or indirectly in the aggregate up to 5 percent (25 percent in the case of a corporation not engaged in banking) of the voting stock or other evidences of ownership in one or more export trading companies.

Sections 23A and 23B of the Federal Reserve Act applies to transactions between an export trading company and its affiliated banks. Regulation K, however, grants relief from section 23A's collateral requirements where a bank issues a letter of credit or advances funds to an affiliated export trading company solely to finance the purchase of goods for which: (1) the export trading company has a bona fide contract for the subsequent sale of the goods; and (2) the bank has a security interest in the goods or in the proceeds from their sale at least equal in value to the letter of credit or the advance. All other "covered transactions" between a bank and an affiliated export trading company should conform to sections 23A and 23B of the Federal Reserve Act.

3560.0.1 INSPECTION PROCEDURES

Export Trading Companies are generally subsidiaries of bank holding companies. Regulations applicable to them are contained in Section 211.31–4 of Regulation K. Inspections of Export Trading Companies will usually be conducted by international examiners or examiners having specialized training. Examiners conducting inspections of Export Trading Companies should be familiar with these sections as well as Section 4(c)(14) of the BHC Act.

There is no standardized inspection report form for inspections of Export Trading Companies. However, as a minimum, the report is to include the following items:

Page	Description
—	Cover Name of organization Location Name of parent Location of parent Date inspection commenced Date of financial statements
i	Table of Contents Same information as cover
1	Examiner's comments Scope of inspection Summary of condition Violations Operating results Adequacy of accounting records, internal controls, and audit
2	Comparative balance sheets
3	Comparative income statements
4	Classified Assets
	CONFIDENTIAL
A	Officers[1]
B	Directors[1]
C	Confidential comments Assessment of management

1. Same information in tabular form as in Edge report.

Inspection procedures should follow the Export Trading Company Questionnaire, illustrated herein. The questionnaire will be part of a special inspection report, prepared separately, or in conjunction with, a holding company inspection.

A copy of the Export Trading Company report as well as a copy of the Export Trading Company Questionnaire will be retained and included in the workpapers for the BHC inspection. Significant findings will be incorporated into the "Examiner's Comments" page, or the Analysis of Financial Factors page, when appropriate.

3560.0.1.1 Export Trading Company Questionnaire

	Yes	No	NA	Comments
1. Is the Bank Holding Company (BHC) or banking Edge Corporation investment in the Export Trading Company (ETC) limited to 5% of its consolidated capital and surplus? Reference: BESA, Section 203; BHC Act, Section 4(c); Regulation K, Section 211.33(a)		( )		
2. Is the investment in the ETC by an Edge Corporation not engaged in banking limited to 25% of its consolidated capital and surplus? Reference: Same as question 1.		( )		
3. Did the BHC or Edge Corporation furnish the Federal Reserve Board through the local FRB written notice of its proposed investment in the ETC at least 60 days prior to its investment in the ETC? Reference: BESA, Section 203; BHC Act, Section 4(c); Regulation K, Section 211.34		( )		
4. Do the direct and indirect outstanding credit extensions to the ETC by the investor and its subsidiaries exceed 10% of the investor's consolidated capital and surplus? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(B); Regulation K, Section 211.33(b)	( )			
5. If the BHC or its subsidiary has extended credit to an affiliated ETC or to any of the ETC's customers:				
a. are the terms of the credit any more favorable than those afforded to similar borrowers in similar circumstances;	( )			
b. does the credit involve more than normal risk of repayment; and	( )			
c. does the credit present any unfavorable features? Reference: Regulation K, Section 211.33(b)(2)	( )			
6. If the BHC or its subsidiary has extended credit to another investor with at least 10% interest in the ETC, or to an affiliate of the investor:				
a. are the terms of the credit any more favorable than those afforded to similar borrowers in similar circumstances;	( )			

	Yes	No	NA	Comments
b. does the credit involve more than normal risk of repayment; and,	( )			
c. does the credit present any unfavorable features?	( )			
Reference: Same as question 5.				
7. Do covered transactions (under Sections 23A and 23B of the Federal Reserve Act) between a bank and an affiliated ETC meet the collateral requirements of Section 23A unless exempted because the bank has extended a letter of credit or advance to the affiliated ETC solely for the purchase of goods for which:		( )		
a. the ETC has a bona fide sales contract; and				
b. the bank has a security interest in the goods, or in the proceeds from their sale at least equal in value to the letter of credit or advance?				
Reference: Regulation K, Section 211.33(b)(3)				
8. Has the ETC received an export trade Certificate of Review which exempts it from antitrust laws?		( )		
Reference: BESA, Section 301				
9. Has the ETC Certificate holder submitted an annual report to the Secretary of Commerce as required?		( )		
Reference: BESA, Section 308				
10. Is the ETC exclusively engaged in activities related to international trade?		( )		
Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(F) Regulation K, Section 211.32(a)				
11. Is the ETC operated principally for the purposes of exporting goods or services produced in the U.S., or for purposes of facilitating the exportation of goods or services produced in the U.S. by unaffiliated persons by providing one or more export trade services?		( )		

	Yes	No	NA	Comments
The term "export trade services" includes, but is not limited to, consulting, international market research, advertising, marketing, insurance other than acting as principal, agent or broker in the sale of insurance on risks resident or located, or activities performed, in the United States, except for insurance covering transportation of cargo from any point of origin in the U.S. to point of origin in the U.S. to a point of final destination outside the U.S., product research and design, legal assistance, transportation, including trade documentation and freight forwarding, communication and processing of foreign orders to and for exporters and foreign purchasers, warehousing, foreign exchange, financing, and taking title to goods in order to facilitate U.S. exports. An ETC may engage in importing, barter, and third-party trades only if these activities further U.S. exports and only if the preponderance of ETC activities do not involve importing and the revenues from export activities exceed revenues from import activities. Reference: Same as question 10.				
12. If the ETC has expanded its activities significantly beyond those in the original notice to the Board, such as to taking title to goods, product research and design, product modification, or activities not specifically covered in the BHC Act, has the investor given a 60 day notice in advance to the Board? Reference: Regulation K, Section 211.34		( )		
13. If the ETC has been in operation more than six years, is more than one-third of the ETC's revenue in the last consecutive four-year period derived from exports or facilitating exports of U.S. goods and services produced in the U.S. by persons other than the ETC or its subsidiaries? Revenue includes net sales revenue from the trading of goods by the ETC for its own account and gross revenue from all other activities of the ETC. Reference: Regulation K, Section 211.32(a)		( )		

	Yes	No	NA	Comments
14. Does the ETC engage in agricultural production, manufacturing or product modification of goods, e.g., repackaging, reassembly, or extracting by-products other than incidental product modification as necessary to conform to the requirements of foreign countries for sale of the goods in the foreign countries? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(c) Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(c)	( )			
15. Does the ETC take title to goods for which it has received no firm purchase order or commitment? Reference: BESA, Section 103(a)(3)	( )			
16. What period of time do the goods on which the ETC has taken title remain in the inventory of the ETC?				
Does this activity appear unduly speculative? Reference: Same as question 15.	( )			
17. Do the nature and terms of sale of goods retained by the ETC appear to be in line with proper ETC business operations, i.e., not unduly speculative and related to authorized activities? Reference: Same as question 15.		( )		
18. If the ETC acts as a principal, agent, or broker in the sale of insurance, does such activity exclude the sale of insurance on risks or activities located or performed in the U.S. Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(F)		( )		
19. If the ETC engages in, or holds shares of a company engaged in underwriting, selling or distributing securities in the U.S., are such activities limited to the same extent as for BHC's under applicable Federal and State banking laws and regulations? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(C), 12 USC, Section 1843(c)(14)(C)(i)		( )		

	Yes	*No*	*NA*	*Comments*
20. Does the ETC take positions in commodities, commodity contracts, securities or foreign exchange other than as may be necessary in the course of the ETC's authorized business transactions? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(D)	( )			
21. Are activities of the ETC Certificate holder in compliance with the Certificate of Review? (If not, the ETC could be subject to antitrust laws.) Reference: BESA, Section 306		( )		
22. Does the ETC capital base appear to adequately support the strength of the ETC and its ability to withstand unexpected adverse developments so as not to affect the financial resources of the parent or the safety and soundness of affiliated banks? Reference: 43 *Federal Register,* 26,448(1983).		( )		
23. Is there any evidence of adverse effect of the investment in the ETC on the investment in the ETC on the financial or managerial resources of the BHC or Edge Corporation investor, or on the safety and soundness of any subsidiary bank of a BHC investor? Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(A)(iv)(11)	( )			
24. Has the ETC's capital to asset ratio remained at all times at or above the minimum established in the original notice to the Board?		( )		
25. Is the ETC in compliance with operational policies, including maximum financial leverage per transaction, as established in the original notice to the Board?		( )		

( ) = Exception

____
Export Trading Company

____
Bank Holding Company Investor

____
Examination Date

Prepared by: ____________________

Date: ____________________

As a general rule, a bank holding company must provide 60 days' prior written notice to its Reserve Bank to engage in any nonbanking activity, or to acquire or retain the shares of a company engaged in an activity based on section 4(c)(8) or 4(a)(2). When a bank holding company gives notice to a Reserve Bank for approval to engage in, or retain or acquire shares in a company engaged in, a nonbank activity, the BHC must be of the opinion that the activity is closely related to banking and, assuming this test is met, that the activitiy is a proper incident thereto. In addition, a BHC that also is an FHC must provide 60 days' prior written notice to its Reserve Bank to engage in an activity that is complementary to a financial activity under section 4(k)(1)(B). In considering such a notice, the Board must determine whether performance of the activity can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

As an exception to the general rule, no prior notice is required for a bank holding company that is qualified under section 4(j)(4) of the BHC Act to engage de novo, directly or through a subsidiary, in an activity that the Board permitted under section 225.28 of Regulation Y before November 12, 1999. After passage of the Gramm-Leach-Bliley Act of 1999, this list of activities cannot be expanded. For all bank holding companies that are not qualified under section 4(j)(4), for all other nonbanking activities based on section 4(c)(8) or section 4(a)(2), and for all activities that are complementary to a financial activity under section 4(k)(1)(B), the bank holding company must provide the appropriate prior written notice of its proposal to its Reserve Bank.[1] The Board must review the notice without disapproving it each time the bank holding company wishes to engage in a proposed activity. The inspection objective and procedures set forth below can be implemented for each of the activities summarized in subsequent sections.

3600.0.1 INSPECTION OBJECTIVE

1. To determine what financial effect nonbanking activities have on the parent and the bank subsidiaries, and if there is any degree of exposure in the activities because of a lack of appropriate audit systems and controls.

3600.0.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy and determine if any factors or trends could have an adverse impact on the parent holding company or the bank subsidiaries.
2. Review the adequacy of the company's policies, procedures, practices, internal controls, and audit coverage regarding nonbanking activities, and whether they are adhered to.

1. A bank holding company that is qualified under section 4(j)(4) of the BHC Act may provide 12 calendar days' prior written notice before engaging by acquisition in an activity permitted under section 225.28 or engaging in an activity based on section 4(c)(8) and approved by the Board by order.

Two bank holding companies (Company A) and (Company B) had requested the Board to determine whether their planned nonbank subsidiary activities were of the kind described in Section 4(c)(8) of the BHC Act. The applications had been filed prior to the passage of the Bank Holding Company Act Amendments of 1970. The applicants proposed to expand their activities under a "pool reserve plan" to include correspondent banks. Such activities were limited to subsidiary banks.

The "pool reserve plan" was described as a method of pooling of loss reserves with respect to term loans to small businesses and the establishment of uniform credit standards in that regard. The "pool reserve plan" permitted banks to adopt a uniform and liberal credit policy in extending credit and the usual method of exchanging participations between the banks.

The General Counsel of the Board of Governors determined, on October 14, 1971, pursuant to delegated authority, that the proposed activities would be "so closely related to banking or managing or controlling banks as to be a proper incident thereto" in accordance with Section 4(c)(8) of the BHC Act, as amended by the BHC Act Amendments of 1970. The approval (1971 FRB 1037) included the following conditions that:

1. The subsidiary was to amend its charter so that the charter would authorize it to perform its functions, and make its services available to banks, but not to lenders other than banks, and to amend its proposed contracts with correspondent banks;
2. Any correspondent banks could terminate their contract with the subsidiary respecting future transactions upon 90-day prior written notice, and that;
3. The subsidiary be subject to the same limitations with the respect to the ownership of any collateral acquired in the course of the conduct of its proposed activities as were its parents, (Company A and Company B).

3600.5.1 NEW YORK INVESTMENT COMPANY

On May 10, 1977, the Board approved an application of a foreign-owned domestic bank to form a holding company, and, at the same time, for that holding company to acquire substantially all of the voting shares of an investment company organized and operating under article XII of the New York State Banking Law (a New York investment company).

The investment company at that time was engaged in providing lending and international banking services, including letters of credit, acceptances, and other financing facilities in connection with exports and imports, international transfers of funds, and foreign-exchange services; investments and foreign-exchange transactions for its own account; leasing improved real estate and data processing equipment; and maintenance of credit balances incidental to or related to the foregoing activities. Although the holding company believed that certain of the activities of the New York investment company had already been determined by the Board to be permissible for bank holding companies, it requested approval of its application on the basis that *all* the activities that a New York investment company is permitted to engage in under New York law are closely related to banking. A New York investment company had not previously been determined by the Board to be an activity permissible for bank holding companies.

The Board noted that the structural and competitive circumstances under which a New York investment company operates are unique to New York and have served in the past as a means for foreign-bank entry into New York in cases where entry through a direct branch or agency was either unavailable or undesirable for the purposes sought. Most of the lending and banking services offered by these companies are also offered by commercial banks generally and, in this connection, compete with foreign banking organizations and domestic commercial banks and their Edge corporation subsidiaries. However, under article XII of the New York State Banking Law, a New York investment company is permitted to engage in various other activities which the Board does not consider to be closely related to banking.

Based on the foregoing, the Board's approval in this case was limited to and contingent upon the New York investment company's (1) continuing to engage principally in transactions involving international or foreign commerce, and not accept demand deposits; (2) complying with all Board or legislatively imposed reserve and interest-rate requirements; (3) divesting of offices in another state within two years; (4) confining activities of its foreign branch to those permitted in the Board's order; and (5) not engaging in the activities of underwriting, selling, or distributing securities; buying or selling coin and bullion; or acting as a financial agent of the U.S. government or as a depositary of public moneys of the United States, or in any new activity which New York investment companies by subsequent enactment may be permitted to engage in, without the prior approval of the Board. (See 1977 FRB 595.)

3600.5.2 ENGAGING IN BANKING ACTIVITIES THROUGH FOREIGN BRANCHES OF A NONBANK COMPANY

A bank holding company applied for the Board's approval to retain direct or indirect ownership of a subsidiary, "CBC," a Delaware-chartered corporation, after it established branches in Nassau and Luxembourg, to engage in certain commercial banking activities. The activities included accepting funds in U.S. dollars or foreign currency in wholesale money markets in amounts over $100,000, making commercial loans in amounts over $100,000, placing funds with and making loans and advances to subsidiary and affiliated organizations, engaging in foreign-exchange transactions, and other activities constituting commercial banking outside the United States. CBC held the shares of a number of nonbanking subsidiaries of the BHC pursuant to section 4(c)(1)(C) of the BHC Act, which permits a subsidiary of a bank holding company to perform services for its parent company.

The purpose of the proposal was to provide the BHC with increased flexibility in funding its domestic operations by allowing CBC to gain access to the offshore wholesale money market. The proposed foreign branches of CBC, by obtaining banking licenses, would give direct access to Eurocurrency interbank markets, and the activities of the proposed branches were expected to be viewed as an integral part of a large U.S.–headquartered entity, making the branches competitive in the offshore interbank markets.

The Board decided that the lending and banking services that the proposed branches would offer were generally offered by commercial banks, and thus are permissible activities of foreign branches of domestic banks and foreign subsidiaries of bank holding companies. The proposed activities of CBC's branches were substantially similar to activities that the Board had previously approved under section 4(c)(8) of the BHC Act for the foreign branches of the New York investment company, incorporated under article XII of the New York Banking Law (see 1977 FRB 595 and 1979 FRB 667). CBC did not propose to engage in any activity that would not be permitted for a separately incorporated foreign subsidiary of a bank holding company. The Board, therefore, ruled that the proposed activities of CBC were closely related to banking (1982 FRB 251).

CBC proposed to engage in no banking activities in the United States, stating that its only U.S. activities would consist of its indirect nonbanking activities through subsidiaries. The subsidiaries would be funded through funds raised by the proposed foreign branches. In this connection, the BHC committed to accepting no placement of or deposits from,[1] or extending no credit to (other than a subsidiary or affiliated organization) a United States resident.[2] The BHC committed that the liabilities to CBC of any person, other than an affiliate, would not exceed 10 percent of the capital and surplus of CBC. The Board felt that these prudential conditions were adequate to meet any supervisory concerns to which the proposal might give rise and thus approved the application, subject to the obtaining of the necessary licensing requirements of the countries involved.

1. A placement or deposit received from a foreign branch, office, subsidiary, affiliate, or other foreign establishment (''foreign affiliate'') controlled by one or more domestic corporations is not regarded as a placement or deposit received from a U.S. resident if such funds are used in its foreign branches or that of other foreign affiliates of the controlling domestic corporation(s).

2. Credit extended to a foreign affiliate, controlled by one or more domestic corporations, is not regarded as credit extended to a U.S. resident if the proceeds will be used in its foreign business or that of other foreign affiliates of the controlling domestic corporation(s).

A domestic bank holding company (the BHC) and a foreign banking organization (the FBO), subject to the BHC Act, applied for the Board's permission to engage in operating a securities exchange under the authority of section 4(c)(8) of the BHC Act and section 225.24 of Regulation Y. The BHC proposed to control approximately 17 percent of the voting shares of group (the group), and the FBO planned to control approximately another 11 percent of the voting shares of the group. The group owned about 54.1 percent of a financial network subsidiary (FNS), which operated an electronic securities exchange (the exchange) for the secondary trading of equity and equity-related securities listed on the London Stock Exchange (LSE). The BHC and FBO indicated that the group planned to establish an office in the United States. In anticipation of the establishment of this office, the BHC and FBO requested the Board's approval to acquire their interests in the group. A BHC must obtain the Board's approval if a foreign company held by the BHC seeks to engage in business in the United States.

The exchange is a screen-based electronic market that provides securities trade matching, trade execution, and related services to U.S. and foreign market makers, broker-dealers, and institutional investors that become members of the exchange. Members may access the exchange and enter bid and ask quotations using electronic terminals that are linked to designated financial networks (for example, a Bloomberg terminal) or through a personal computer linked directly to the exchange. The exchange can be accessed from terminals located anywhere in the world. Trading, however, may occur only during the operating hours of the LSE. Orders entered in the exchange's system appear on separate electronic order books for each security, which display the best bid and ask quotes for the security in descending order. The exchange automatically and continuously matches equal bid and ask offers for each listed security on a first-come, first-served basis.

FNS does not take a principal position in securities, clear or settle the securities transactions executed on the exchange, or assume any principal risk for securities trades executed on the exchange. FNS and its shareholders are not obligated to guarantee any member's trades. Each member of the exchange must be a member of the London Clearing House, or must appoint a member of the London Clearing House to clear the member's trades on the exchange. Trades matched by the exchange are registered at the end of each business day with the London Clearing House in the name of the appropriate clearing member. London Clearing House then becomes the counterparty to each side of the trade until the trade is settled. The trade is settled through a designated system operated by a corporation established by the Bank of England to settle uncertificated U.K. equities.

The exchange is a recognized investment exchange under section 37(3) of the U.K. Financial Services Act of 1986, and is regulated and supervised by the U.K. Financial Services Authority (FSA), under the securities laws of the United Kingdom. While FNS makes its services available to customers in the United States, the SEC has granted it a limited volume exception from the registration requirements of the Securities Exchange Act of 1934. The SEC exemptive order permits FNS to operate in the United States without registering as a securities exchange provided (1) the exchange's average daily volume of trades involving U.S. members does not exceed $40 million, and (2) the exchange's worldwide average daily volume does not exceed 10 percent of the average daily trading volume on the LSE. The SEC exemptive order requires the exchange to comply with other conditions that are designed to ensure orderly and fair markets and to protect U.S. investors.

The Board had not previously determined by regulation or order that the operation of a securities exchange is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. The principal function of a securities exchange is to provide a centralized facility for the execution, clearance, and settlement of securities transactions. The Board indicated in its order that banks and BHCs are authorized to provide securities brokerage services to their customers and, as part of those services, to execute and clear such transactions on a securities exchange. The Board also noted that BHC subsidiaries authorized to act as dealers in securities (section 20 subsidiaries) may provide securities execution, clearance, and settlement services in connection with their dealer operations. In addition, the Board noted that broker or dealer subsidiaries of banks and BHCs often become members of securities exchanges and thus acquire a small ownership (less than 5 percent) in a mutually owned exchange (for example, the New York Stock Exchange). Through the development of these relationships, banks and BHCs have gained considerable experience with and knowledge of the rules and operations of securities exchanges.

Banks and BHCs also provide services that are functionally and operationally similar to those of the exchange. Banks and BHC subsidiaries acting as securities brokers may execute cross-trades for their customers and thereby match equal bid and offer orders received from them. In addition, section 20 subsidiaries may, if authorized, act as a specialist or market maker on a securities exchange such as the NYSE or NASDAQ. A specialist generally maintains a book of current buy and sell orders received from other brokers and matches equal bid and offer quotes for execution. Market makers on NASDAQ also publish bid and ask prices at which they stand ready to execute transactions in the relevant security.

For the above reasons, and based on all the facts on record, the Board concluded that operating a securities exchange is an activity that is closely related to banking for the purposes of section 4(c)(8) of the BHC Act. The application was approved on November 8, 1999. See 2000 FRB 61 for the order and more specific information regarding the Board's approval.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2007, this section is amended to include another Board order in which the Board approved a notice for a foreign bank to act as a certification authority (CA) in connection with financial and nonfinancial transactions and to engage in related data processing activities. The bank planned to engage in the activities by entering into an agreement with a newly organized, wholly owned indirect subsidiary of the bank. (See 2006 FRB C150.) The proposed CA nonbanking activities are slightly different, but are consistent with those CA nonbanking activities that were previously approved by the Board (discussed below).

3600.7.1 ACTING AS CERTIFICATION AUTHORITY IN CONNECTION WITH FINANCIAL AND NONFINANCIAL TRANSACTIONS

A foreign banking organization (FBO)[1] subject to the BHC Act and several bank holding companies (BHCs), deemed to be BHCs (all referred to as the notificants) within the meaning of the BHC Act, requested the Board's approval under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y (12 C.F.R. 225.24) to retain 12.5 percent of the voting interests in Indent Company (Indent), and to engage through Indent and other nonbank subsidiaries in acting as a CA in the United States in connection with financial and nonfinancial transactions and other related activities. Indent represents a joint venture among the notificants and other commercial banks and foreign banking organizations. As proposed, Indent would act as the global rulemaking and coordinating body for a network of financial institutions that would act as CAs and thereby provide services designed to verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and other "open" electronic networks. To provide these services, Indent and its network of participating financial institutions (the identity system) would use digital certificates and digital signatures created through the use of public-key cryptography.

In a CA system using public-key cryptography, a company generates (or is assigned) a public-key/private-key pair and registers with a CA as the unique "owner" of the key pair.[2] Private keys and public keys are a set of different but related mathematical functions that can be used to encrypt and decrypt electronic communications. A message encrypted by a particular private key can be decrypted only by its corresponding public key. Although a private key and its corresponding public key are related, a private key cannot feasibly be derived from its corresponding public key. Thus, while a private key must be kept confidential by the company that is the registered owner of the key pair, the company's public key can be made publicly available without jeopardizing the confidentiality of the company's private key.

A company sending a business communication (for example, a purchase order) to another entity over an open electronic network like the Internet uses its confidential private key to digitally sign the message being sent. A digital signature is a compressed and encrypted version of the message to which it is attached. The entity receiving the digitally signed message then uses the sender's public key to decrypt the digital signature.[3] If the receiver successfully decodes the signature with the sender's public key, the receiver can be assured that the message was created using the sender's private key.[4]

To be assured that the message was actually sent by the purported sender, however, the receiver must confirm that the private-key/public-key pair used to sign and decode the message is uniquely "owned" by the purported sender. A CA provides this assurance by issuing "digital certificates" certifying that the relevant private-key/public-key pair is uniquely associated with the message sender and by verifying upon request the validity of such digital certificates.

1. Foreign banks may engage in permissible nonbanking activities in the United States directly through a U.S. branch or agency. A foreign bank, however, must receive the Board's approval under section 4(c)(8) of the BHC Act to engage in the United States in activities that are deemed to be closely related to banking.

2. A number of nonbanking companies currently operate CA systems that rely on public-key cryptography to provide identity-authentication services to senders and receivers of electronic communications.

3. The sender's public key may be attached to the digitally signed communication, or the receiver of the message may obtain the sender's public key from a publicly available database.

4. The receiver also can confirm that the message was not altered after it was signed by comparing the message received with the decrypted version of the message text embedded in the digital signature.

The notificants and other financial institutions participating in the identity system (participants)[5] would create unique private-key/public-key pairs for, and issue digital certificates on behalf of, eligible customers that contract with one of the participants to receive Indent identity-authentication services.[6] Each participant would act as a repository for the digital certificates that it has issued, that is, it would maintain a database containing information on the status of the outstanding, expired, or revoked digital certificates that it has issued to customers. The participants also would verify for third parties the validity of digital certificates issued to their customers and, upon request of the third party, may provide an explicit warranty as to the validity of the customers' digital certificates.[7] The participants also may process and transmit verification and warranty requests received from customers concerning digital certificates issued by other participants in the identity system. In addition, the participants may provide customers with a limited range of software and hardware that is required for customers to use the identity system.[8]

Indent would provide the infrastructure framework within which the participants would act as CAs and provide related services. The primary function of Indent would be to act as the "root certification authority" of the identity system, that is, issuing digital certificates to the participants that establish their status as CAs in the identity system and authenticating for customers of, and the other participants in, the identity system the identity of the participants.[9] Indent also would (1) establish and maintain the operating rules governing the identity system, including the minimum technical requirements for digital certificates and other components of the system; (2) monitor compliance by the participants with the identity system's operating rules and technical standards; and (3) monitor collateral requirements and aggregate warranty exposure for the participants in the identity system.[10]

Section 4(c)(8) of the BHC Act provides that a bank holding company may, with the Board's approval, engage in any activity that the Board determines to be closely related to banking. The Board previously has authorized BHCs under section 4(c)(8) of the BHC Act to act as CAs and provide identity-authentication services in connection with payment-related and other financial transactions conducted over electronic networks.[11] The Board has not previously authorized BHCs under section 4(c)(8) to act as CAs or provide identity-authentication services in connection with nonfinancial transactions.

Banks and BHCs have long provided identity-authentication services in connection with nonfinancial transactions conducted by third parties and for their own traditional banking and lending activities. For example, banks and BHCs are authorized to provide notary services to customers.[12] The role of a notary is to authenticate signatures on financial or nonfinancial documents for the benefit of third parties.[13] To verify a signature on a paper-based document, a notary must verify the identity of the person signing

5. Participation in the identity system is available only to organizations that are engaged primarily in the business of providing financial services; are subject to regulation and examination by a government authority in their home country; and that meet certain eligibility criteria, such as minimum capital requirements and debt-rating criteria. A participant also must agree to be bound by the identity system operating rules and to execute certain participation agreements. Financial institutions would not be required to purchase an ownership interest in Indent to become a participant.

6. The participants may provide identity system–related services only to customers that have agreed to be bound by applicable provisions of Indent's operating rules and have signed the appropriate customer agreements. Indent's operating rules allow the participants to provide identity system–related services only to business entities, such as corporations and governmental organizations, and not to natural persons. Indent's operating rules and customer agreements would make each customer contractually responsible for ensuring that its private key is kept confidential.

7. The operating rules of the identity system would provide that a company relying on a digital certificate issued by the participant would have recourse against the participant only if the company purchased an explicit warranty from the participant, and then only up to the amount of the purchased warranty. The participant that issues a digital certificate could refuse to issue a warranty for a digital certificate for any bona fide reason. The identity system would limit the aggregate amount of warranties that the participant may have outstanding at any one time, and would require each participant to post collateral with Indent to cover its warranty exposure.

8. For example, the participants may provide smart cards containing digital certificates and smart-card readers to their customers.

9. Digital certificates issued by the participant to a customer are digitally signed by the participant with its own private key and are accompanied by a digital certificate issued by Indent. The digital certificates Indent issues would certify that the participant is an authorized participant in the identity system and that the private key the participant uses to digitally sign its certificates is uniquely associated with it, thereby authenticating the identity of the participant.

10. The activities of the notificants and Indent would be limited to providing the identity-authentication and related services described above. The notificants and Indent would not provide a general encryption or electronic message service, or any warranty of the underlying financial or nonfinancial transactions between customers whose identities are authenticated through the use of the identity system.

11. See Regulation Y, section 225.28(b)(14); 1997 FRB 602, 606; and 1982 FRB 505, 510.

12. See 1998 FRB 481.

13. 58 Am. Jur. 2d *Notaries Public* § 31 (2d ed. 1989).

the document. The Board noted that the role a CA serves with respect to electronic documents is functionally similar to the role a notary serves with respect to paper-based documents.[14]

Banks have traditionally identified their customers to third parties through the issuance of letters of introduction or letters of reference.[15] In addition, banks and BHCs routinely authenticate the identity of customers and noncustomers in connection with their authorized check-cashing functions.[16]

Banks and BHCs also have long been authorized to issue signature guarantees to issuers of securities and their transfer agents in connection with the transfer of securities.[17] A bank issuing a signature guarantee warrants that the customer's signature endorsing a certificated security or authorizing the transfer of an uncertificated security is authentic. The issuing bank also warrants that the signer was an appropriate person to endorse the security or authorization (or, if the signature is by an agent, that the agent had actual authority to act on behalf of the appropriate person) and that the signer had legal capacity to sign. In light of these warranties, a bank providing a signature guarantee must verify the identity of the customer providing the endorsement or signing the instruction.[18]

Identity-authentication services are an integral part of many traditional banking functions. Banks and BHCs have developed sophisticated methods for authenticating the identity of customers and noncustomers that transact business or communicate with the bank or BHC through electronic means or otherwise. Many of these activities are operationally and functionally similar to the proposed activities, and make banks and BHCs particularly well equipped to provide the proposed services. For example, banks and BHCs maintain systems to electronically authenticate the identity of persons engaged in credit and debit card, automated teller machine (ATM), home banking, and wire transfer transactions with the institution.[19] Banks and BHCs also electronically authenticate the identity of persons in connection with the check and credit card verification services they are authorized to provide to merchants and other businesses.[20]

The Board noted that state banks and national banks have recently been authorized to act as CAs and to provide identity-authentication services in connection with financial and nonfinancial transactions conducted over electronic networks. Based on the foregoing, the Board concludes that acting as a CA and, more generally, authenticating the identity of customers conducting financial and nonfinancial transactions are activities that are closely related to banking within the meaning of section 4(c)(8) of the BHC Act.

Indent and the notificants also propose to engage in a number of activities as part of and in connection with their proposed CA activities. These activities include (1) processing, transmitting, and storing data necessary for the operation of the identity system, such as digital certificates, requests for verification of digital certificates, and warranty requests; (2) developing and marketing software and hardware necessary for operating the identity system; and (3) complying with, monitoring, and enforcing the collateral-posting requirements associated with identity warranties. In addition, Indent would establish operating policies, procedures, and guidelines for the identity system.

The Board's Regulation Y permits BHCs to provide data processing and data transmission services and facilities (including software and hardware) for the processing and transmission of financial, banking, or economic data, and to engage in activities related to making, acquiring, brokering, or servicing extensions of credit, such as posting collateral and monitoring collateral requirements.[21] Regulation Y also permits BHCs to engage in incidental activities that are

14. The American Bar Association, for example, has noted that the issuance of digital certificates by CAs is "analogous to traditional certification processes undertaken by notaries with respect to documents executed with pen and ink." "Digital Signature Guidelines," published by the Information Security Committee of the Electronic Commerce and Information Technology Division, Section of Science and Technology, American Bar Association. (Aug. 1, 1996), p. 54.

15. Banks have drafted letters of introduction or letters of reference on behalf of their customers for the purpose of introducing the customer to other banks or third parties with which the customer seeks to do business.

16. Under the Uniform Commercial Code (UCC), a bank that accepts a check for deposit warrants to the drawee bank that all endorsements on the check are genuine, and the bank is liable to the drawee bank for the amount of the check plus expenses and lost interest if an endorsement on the check was forged.

17. Broker-dealer subsidiaries of BHCs also have provided signature guarantees.

18. A bank issuing a signature guarantee is liable to the issuer of the security or its transfer agent for any loss that results from a breach of any of these warranties by the bank.

19. Article 4A of the UCC encourages banks to develop and maintain commercially reasonable security procedures, such as algorithms or other encryption devices, for authenticating the identity of customers that transmit wire transfer instructions to the bank.

20. See Regulation Y, section 225.28(b)(2)(iii) and 1985 FRB 648.

21. See Regulation Y, section 225.28(b)(2) and (14). A BHC may develop and sell hardware and software that is

necessary to the conduct of an activity that is closely related to banking. Indent and the notificants have represented that they would engage in the additional activities only in connection with their CA activities and would not engage in such activities separate or apart from their CA activities. The notificants also have committed that the data processing and data transmission activities of the notificants and Indent, including any proposed development or sale of hardware and software, will comply with the Board's regulations and interpretations. In light of the nature of these additional activities and the fact that they would be conducted only in connection with the CA activities of Indent and the notificants, and all the other facts of record, the Board concludes that these activities are encompassed within the activities previously approved by the Board by regulation or are incidental to the permissible CA activities of Indent and the notificants and, therefore, are permissible under Regulation Y.[22]

Based on the facts stated in the Board's order, the Board determined that the certification authority and other activities discussed were closely related to banking under section 4(c)(8) of the BHC Act. The Board issued its approval order on November 10, 1999. (See 2000 FRB 56). See the Board's order for more specific information and for the more detailed information and references in the order's footnotes.

The Board approved another notice for a foreign bank, specifically a foreign banking organization that is subject to the BHC Act.[23] The foreign bank had requested the Board's approval under sections 4(c)(8) and 4(j) of the BHC Act[24] and section 225.24 of the Board's Regulation Y[25] to act as a CA in connection with financial and nonfinancial transactions and to engage in related data processing activities. It was proposed that the agreement be assigned to a newly organized wholly owned indirect subsidiary of the bank, CLX.

The proposed activities would be undertaken within the Identity Trust System (ITS), which would serve as a central rulemaking and coordinating body for a global network of institutions that would act as digital CAs. The CAs would verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and on other "open" electronic networks. To provide these services, ITS and its network of participating financial institutions would use digital signatures created with encryption technology. These digital signatures would uniquely identify participants in the ITS who send signed messages over electronic networks. The CAs would issue digital certificates that certify that the digital signature is uniquely associated with a particular message sender so that the message recipient can be assured of the identity of its trading partner.

As a certification authority, CLX would provide the technical systems and support necessary for banks to verify and authenticate the identity of customers conducting electronic transactions and to register digital certificates to customers. These services would be provided to the foreign banking organization as well as to other banks that enter into contracts with CLX.[26] The foreign bank, and any other banks to which CLX may provide services, would be responsible for performing the due diligence on customers that request digital credentials, a role referred to as "registration authority." Bank and other registration authorities would register the digital certificates issued to their customers, and CLX would maintain a database of all certificates issued through its registration authorities. CLX would also provide registration authorities with the software and hardware required to use the ITS.

In this order, the Board referenced its previous approval (2000 FRB 56) in which it determined that the CA activities conducted in connection with financial and nonfinancial transactions and data processing were activities that are closely related to banking for the purposes of section 4(c)(8) of the BHC Act. Also for this latter order, the Board found that the foreign bank's proposed activities were consistent with those that it had previously approved. The foreign bank committed that it would conduct its proposed nonbanking activities in accor-

designed and marketed for processing and transmitting financial, banking, or economic data. It may also develop and sell general purpose hardware so long as it does not constitute more than 30 percent of the cost of any packaged offering.

22. The notificants may engage in data processing and data transmission activities, including the development and sale of hardware and software, pursuant to this order only to the extent such activities are necessary to permit the proper operation of the identity system. The notificants and Indent also must conduct their data processing and data transmission activities subject to the software and hardware limitations in Regulation Y.

23. As a foreign bank operating an agency in the United States, the foreign bank is subject to the BHC Act by operation of section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)).

24. 12 U.S.C. 1843(c)(8) and 1843(j).

25. 12 C.F.R. 225.24.

26. These banks would also have to enter into agreements to participate with ITS.

dance with the limitations set forth in Regulation Y and the Board's above-mentioned previous order governing these proposed activities. The Board approved the notice on June 8, 2006 (2006 FRB C149).

3600.7.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Acting as a certification authority for financial and nonfinancial transactions and related data processing activities.	12 U.S.C. 1843(c)(8)	225.28(b)(14)		2000 FRB 56 2006 FRB 149

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

A bank holding company (the applicant) applied under section 4(c)(8) of the Bank Holding Company Act and the Board's Regulation Y to engage de novo through a wholly owned subsidiary (the company) in privately placing limited partnership interests in a group of partnerships having a limited number of investors. The company was to serve as the investment adviser, administrator, and sole general partner of a series of seven partnerships (the partnerships) that would be sold to a number of institutional investors. The company would maintain an equity interest of approximately 1.25 percent of the total capitalization in each partnership.

The partnerships were to be engaged solely in investing in limited amounts of debt and equity securities, including interests in real estate investment equity trusts (REITs).[1] The partnerships, together with the applicant and its other subsidiaries, were not to hold more than 5 percent of any class of voting securities of any issuer, and not more than 25 percent of the total equity of any issuer.[2] The equity investments were to be held in accordance with section 4(c)(6) of the BHC Act and section 225.22(d)(5) of Regulation Y.

The company also proposed to privately place limited partnership interests with new sophisticated institutional investors and possibly form similar additional partnerships in the future. The company was not to privately place debt securities issued by the partnerships without prior approval from the Federal Reserve System. The applicant committed that the private placement of limited partnership interests would conform to the limitations and conditions for private placements in previous Board orders approving private-placement activities (for example, 1990 FRB 26 and 1989 FRB 829).[3] Each investor was required to have an initial minimum investment of $100,000. Investors with $250,000 or more under management by the company, however, would be permitted to invest in any partnership in any amount. The applicant would continue the company's practice of allowing existing investors in a partnership to add to their investment in the partnership in any amount. The application was approved on June 28, 1994 (1994 FRB 736).

Subsequently, another bank holding company (the BHC applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y to engage de novo, through a wholly owned asset-management subsidiary (AMS), in establishing and serving as the general partner of limited partnerships (the limited partnerships) that would invest in a wide variety of commodities and exchange-traded and over-the-counter instruments including those specified in the Board order. AMS would be the general partner of each partnership and would hold a nominal equity interest in each one. In this case, AMS would not provide investment advice directly to the limited partnerships, but would employ unaffiliated investment advisers to manage the investments of the limited partnerships, pursuant to parameters set by AMS. Interests in the limited partnerships would be privately placed with institutional customers by the BHC applicant's subsidiary banks.

One or more of the limited partnerships could invest a substantial portion of their assets in commodity pools, which would require the applicant to register as a commodity pool operator (CPO). The interests purchased by the limited partnerships would consist of less than 5 percent of the outstanding voting securities of any commodity pool and less than 10 percent of the total equity of any commodity pool. The applicant proposed that the limited partnerships purchase such assets with debt. It further stated that it would not permit any limited partnership that invested in distressed debt instruments to use borrowed funds to purchase or carry distressed debt instruments or to use the distressed debt instruments as collateral in acquiring other assets. The applicant also indicated that the leverage employed by the limited partnerships would include margin credit from broker-dealers, reverse repurchase agreements, and short sales.

The limited partnerships would invest in debt and equity instruments and distressed debt instruments.[4] The applicant stated that invest-

1. The partnerships were not to invest in futures contracts or options on futures contracts on any financial or nonfinancial commodity, or knowingly invest in debt that, upon acquisition, is in default without the prior approval of the Federal Reserve System. The applicant further committed that it would not use the investments of the partnerships to obtain or exercise control over any issuer of securities owned or held by the partnerships. Also, no directors, officers, or employees of the applicant and its affiliates will serve as directors, officers, or employees of any issuer of which the applicant and its affiliates held more than 10 percent ownership of total equity.

2. The applicant committed that all subordinated debt of an issuer would be subject to this 25 percent limit.

3. See the current Regulation Y, section 225.28(b)(7)(iii), regarding private-placement services.

4. The Board had previously permitted bank holding com-

ments in debt and equity securities and distressed debt would be made in accordance with the BHC Act's limitations and those of previous Board decisions. (See 1995 FRB 1128 and section 3104.0.)

The limited partnerships, together with the applicant and its subsidiaries, would make investments not greater than 5 percent of any class of voting securities of any issuer, and not greater than 25 percent of the total equity, including the subordinated debt, of any issuer. No directors, officers, or employees of the applicant would serve as directors, officers, and employees of any issuer of which the applicant and its subsidiaries (that is, the limited partnerships) would hold more than 10 percent of the total equity. For this case, the Board required AMS to consolidate the assets and liabilities of the limited partnerships in the financial statements of AMS for regulatory capital purposes. In addition, AMS was required to establish an appropriate risk-management structure consisting of investment and position limits for each investment adviser before engaging in the proposed activities. Compliance and trading limits would be monitored by computerized systems to be established by the applicant. The Board approved the notice on April 24, 1996, subject to all the facts of record and the commitments furnished. See 1996 FRB 569. For more recent Board orders whereby bank holding companies propose to act as a CPO and to control a private limited partnership that invested solely in permissible investments for a bank holding company, see 1999 FRB 209, 1998 FRB 852, and 1998 FRB 361.

panies to sponsor, organize, and manage closed-end investment companies and unregistered limited partnerships that invest in securities.

3600.13.1 SERVING AS AND CONTROLLING A PRIVATE LIMITED PARTNERSHIP AS A COMMODITY POOL OPERATOR

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through a wholly owned asset-management subsidiary (ASM) that would be established to serve as the general partner of limited partnerships (the partnerships) that would invest in a wide variety of commodities and exchange-traded and over-the-counter instruments, including interests in investment funds that invest in futures and options on futures on financial and nonfinancial commodities (commodity pools). It was indicated that the partnerships would not directly invest in futures or options on futures contracts for purposes other than hedging. The partnerships would purchase and sell derivative contracts on precious metals and financial commodities, instruments, and indices for hedging purposes. It was further stated that one of the limited partnerships may invest a substantial portion of its assets in commodity pools, which would require the ASM (the general partner) to become a registered commodity pool operator (CPO) with the Commodity Futures Trading Commission (CFTC). As such, the ASM would register as a CPO with the CFTC, and a portion of the general partner's activities would become subject to the recordkeeping, reporting, fiduciary standards, and other requirements of the Commodity Exchange Act (7 U.S.C. 2 et seq.), CFTC, and National Futures Association.

The Board previously has found that a subsidiary of a state member bank may serve as the CPO of investment funds engaged in purchasing and selling futures and options on futures on certain commodities.[1] In addition, the Board has permitted bank holding companies to trade futures and options on futures on financial and nonfinancial commodities.[2] For these reasons, the Board has concluded that serving as a CPO, and controlling as a CPO a private limited partnership that invests solely in investments that a bank holding company is permitted to make directly, under the circumstances of this case (1996 FRB 569) are closely related to banking. See also 1998 FRB 1075, 1998 FRB 852–854, 1998 FRB 361, and 1994 FRB 736.

1. See 1996 FRB 239.
2. See 1995 FRB 185.

3600.17.1 ENGAGING IN TITLE INSURANCE AGENCY ACTIVITIES PURSUANT TO REGULATION Y

A bank holding company applied under section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y to acquire all the outstanding shares of a title insurance agency. The title insurance agency is to conduct activities pursuant to exemption G of the Garn–St Germain Depository Institutions Act of 1982 (the act) and section 225.28(b)(11)(vii) of Regulation Y. Title VI of the act amended section 4(c)(8) of the BHC Act to provide that insurance agency, brokerage, and underwriting activities are not "closely related to banking" and thus are not permissible activities for bank holding companies, unless the activities are included within one of seven specific exemptions (A through G) in section 4(c)(8).

The applicant claimed that it was authorized to operate a title insurance agency under exemption G, which authorizes those bank holding companies that engaged in insurance agency activities before 1971 to engage, or control a company engaged in, insurance agency activities. The company has been engaged in the sale of insurance related to extensions of credit by its subsidiary banks since 1939.

The bank holding company applicant was one of 16 active companies with grandfather rights under exemption G.[1] Previously, the Board determined (1985 FRB 171) that those companies that had received Board approval to engage in general insurance agency activities before 1971 would be grandfathered under exemption G with respect to the sale of any type of insurance that is within the scope of general insurance agency activities—even an insurance agency activity (such as title insurance) not actually offered by the applicant bank holding company before 1971. The Board found that there is no requirement in the statute that a company qualifying for exemption G engage only in those insurance agency activities it conducted with Board approval before 1971. Thus, although the Board may not have specifically approved title insurance before 1971, provided the proposed activity is encompassed within the authorization of insurance agency activities, the activity falls within exemption G.

The Board determined selling title insurance through a title insurance agency to be permissible pursuant to exemption G and the Board's regulations. The Board approved the application on November 17, 1988 (1989 FRB 31).

1. There are currently 12 companies remaining.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section has been revised to incorporate a name change to the Financial Industry Regulatory Authority, or FINRA (formerly, the National Association of Securities Dealers, or NASD).

3600.21.1 UNDERWRITING AND DEALING IN COMMERCIAL PAPER TO A LIMITED EXTENT

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to underwrite and deal in third-party commercial paper to a limited extent. As proposed, the activity will be conducted through a commercial finance subsidiary (the company). The company is to act for issuers as an underwriter of commercial paper, purchasing commercial paper for resale to institutional investors such as banks, insurance companies, mutual funds, and nonfinancial businesses. In addition, the company may place commercial paper as agent for issuers and advise issuers on the rates and maturities of proposed issues that are likely to be accepted in the market—activities previously approved by the Board (1987 FRB 138). The activities in this order (1987 FRB 367) differ from those previously authorized (1987 FRB 138) in that the applicant will underwrite and deal in commercial paper as principal.

The Board may not approve a proposal of a member bank affiliate if upon consummation it would be "engaged principally" in the flotation, underwriting, public sale, or distribution of commercial paper (hereafter referred to as "underwriting and dealing in") within the meaning of the former section 20 of the Glass-Steagall Act (12 U.S.C. 377). The Board concluded that even if placement of commercial paper were deemed to constitute an activity, the commercial lending subsidiary would not be "engaged principally" in underwriting and dealing in securities. The subsidiary's activity was not substantial under a former 5 percent limit on the subsidiary's gross income (increased to 25 percent, effective March 6, 1997) from its commercial paper activities and a former 5 percent limit on its market share. The company is required to restrict its commercial paper activities so it does not exceed these limits.

The Board concluded that underwriting and dealing in commercial paper is closely related to banking on the same basis as acting as placement agent and adviser to issuers in commercial paper (1987 FRB 138). Banks provide services that are operationally and functionally similar to the services of underwriting and dealing in commercial paper. Banking organizations are particularly well equipped to provide such services. In the Board's view, the underwriting and dealing activity represents a natural extension of commercial lending activities traditionally conducted by banks, involving little additional risk or new conflicts of interest, and potentially yielding significant public benefits in the form of increased competition and convenience.

The Board concluded that the applicant could conduct the activities to the extent and in the manner described in the order, consistent with the former section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHC Act. The Board's approval extended only to commercial paper underwriting, dealing, placement, and advisory activity conducted in accordance with the limitations stated in the order (1987 FRB 367).

3600.21.2 ENGAGE IN UNDERWRITING AND DEALING, TO A LIMITED EXTENT, IN MUNICIPAL REVENUE BONDS, MORTGAGE-RELATED SECURITIES, AND COMMERCIAL PAPER

On April 30, 1987, the Board approved by order the applications of three bank holding companies to engage through subsidiaries in underwriting and dealing in commercial paper, one- to four-family mortgage-backed securities, and municipal revenue bonds.[1] (For a complete description of the nonbanking activities authorized by the Board in this order, see 1987 FRB 473.) The subsidiaries are to be involved in underwriting and dealing in U.S. government securities as their major activity. Board approval

1. The applicants had previously received Board approval under section 4(c)(8) of the BHC Act for the subsidiaries mentioned in the order to engage in underwriting and dealing in U.S. government and agency and state municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act. The newly proposed underwriting and dealing activities were approved in addition to the previously approved activities.

could only occur if the affiliates would not be ''principally engaged'' in underwriting and dealing in ''securities'' under the provisions of the former section 20 of the Glass-Steagall Act.

A hearing was held on February 3, 1987, because of the important legal and factual issues involved. The Board reaffirmed its finding in its previous decisions (1987 FRB 138 and 367) that the applicants were not principally engaged in the proposed securities activities if they limited their underwriting and dealing income from these securities to 5 percent of the total gross income of the affiliate, and if they limited their market share in each of these securities to 5 percent of the total domestic market.[2] The Board established a number of conditions to ensure that the underwriting activity would be consistent with safe and sound banking practices and would avoid conflicts of interest, undue concentration of resources, and other adverse effects.

The Board determined, consistent with its previous underwriting and dealing decisions in administering the Glass-Steagall Act, that a range of between 5 percent and 10 percent of gross revenue and market share is the appropriate framework for determining whether an affiliate is engaged principally in securities activities. The lower end of the range—5 percent—was the level applied at the time. The Board noted that it would review this level within a year on the basis of experience gained from operations to determine whether a higher level would be permissible. On September 21, 1989, the Board modified section 20 orders to increase from 5 percent to 10 percent the revenue limit on the amount of total revenues a section 20 subsidiary may derive from ineligible securities underwriting and dealing activities (increased to 25 percent, effective March 6, 1997) (1989 FRB 751).[3]

The Board's approval of the applications extends only to the activities conducted within the limitations of the order and is subject to the gross revenue limitation discussed above. Two of the applicants also proposed to underwrite and deal in consumer-receivable-related securities (CRRs). Although the companies noted certain similarities between these securities and mortgage-related securities, the Board did not believe that the record before the Board provided a sufficient basis for it to make a formal finding (as required by the BHC Act) that underwriting and dealing in CRRs is closely related to banking and a proper incident thereto. The Board noted that the market for CRRs was relatively new and untested compared with the market for one- to four-family mortgage-related securities and municipal revenue bonds. The Board indicated that it would reconsider the matter within 60 days on the basis of more complete information to be submitted by the applicants regarding the types of assets that would be securitized, the manner in which this would be accomplished, and other matters bearing on risk.

In a subsequent order, six BHCs applied for and received the Board's conditional approval (1987 FRB 731) for the activity, but the Board stayed its order for the same period of time applicable to the stay issued by the Second Circuit Court of Appeals (see footnote 2 and section 3600.21.3). After approving the order set out in 1987 FRB 731, the Board approved several other orders that rely on this order and the limitations imposed therein. (See the following Board orders: 1987 FRB 607, 616, 618, 620, 622, 731, 738, 742, 928; 1988 FRB 133, 500, 699, 700, 706, 819; 1989 FRB 33, 190, 396, 398, 520, 645, 647; 1990 FRB 79, 158, 256, 461, 554, 568, 573, 652, 682, 756; 1991 FRB 954; 1992 FRB 338; 1993 FRB 141, 716; and 1994 FRB 249, 346.)

The major difference between the three applications decided on April 30, 1987, and the two applications previously approved by the Board (1987 FRB 138 and 367) is that the underwriting would take place in an affiliate engaged in underwriting and dealing in U.S. government securities. This arrangement raised the major legal question of whether these government securities could serve as a basis for measuring the principal activity of the affiliate. In its approval, the Board took into account the fact that the Glass-Steagall Act specifically

2. The U.S. Court of Appeals for the Second Circuit upheld the Board's determination that the underwriting subsidiaries would not be engaged principally in ineligible securities underwriting and dealing under the above revenue limitation; the U.S. Supreme Court declined to review that decision (*Securities Industry Association v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 108 S.Ct. 697 (1988)). The Supreme Court also let stand the lower court's determination that the 5 percent market share limitation was not adequately supported by the facts of record, thus sustaining elimination of the market share test that had been invalidated by the U.S. Court of Appeals. Accordingly, the Board decided not to impose a market share limitation on orders approved on August 4 and 8, 1988.

3. The Board in this order also modified its section 20 orders to permit underwriting and dealing in securities of affiliates if the securities are rated by a nonaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Corporation, or represent interests in such obligations.

allows member banks to underwrite U.S. government securities and that the act intends affiliates to have a broader scope for underwriting than member banks. On that basis, the Board had previously allowed affiliates of member banks to engage in underwriting of U.S. government securities.

3600.21.3 ENGAGE IN LIMITED UNDERWRITING AND DEALING IN CONSUMER-RECEIVABLE-RELATED SECURITIES

Six bank holding companies applied for the Board's approval to engage in limited underwriting and dealing in consumer-receivable-related securities (CRRs). CRRs, which were first issued in 1985, consist of debt obligations that are secured by or represent an interest in a diversified pool of loans to or receivables from consumers, such as loans to individuals to finance the purchase of automobiles or personal credit card accounts.

The Board concluded that underwriting and dealing in CRRs is an activity closely related to banking on the basis that banks provide services that are operationally and functionally so similar to the services proposed that banking organizations are particularly well equipped to provide them. In accordance with section 16 of the Glass-Steagall Act, banks underwrite and deal in certain mortgage-related securities that are issued or guaranteed by the United States or by U.S. government agencies. Some of the securities represent interests in pools of mortgage loans for residential housing purposes made by banks and other financial institutions. Such securities are very similar to CRRs.

Both CRRs and bank-eligible mortgage-related securities represent interests in pools of loans made by financial institutions to individuals to finance the purchase of housing or consumer goods and services.

The techniques involved in underwriting and dealing in bank-eligible mortgage-related securities are also very similar to those that would be involved in conducting the approved activity with respect to CRRs. In each case, the underwriter must perform substantially identical functions of evaluating prepayment risk, analyzing credit and cash flow from a pool of numerous individuals' loans, negotiating or bidding, and distributing and dealing.

In addition, banks now directly perform some of the functions involved in the approved activity. Banks select the consumer loans that form the pool of interests that are then sold to investors. Banks also advise issuers of CRRs and assist issuers in privately placing these securities.

Because of the similarity between securities involved in CRRs and the previously approved bank-ineligible one- to four-family mortgage-related securities nonbanking activities set forth in a previous order (1987 FRB 473), the Board required that this activity be conducted in accordance with the same requirements established in that order. This includes a requirement that the securities be rated for investment quality by a nationally recognized agency.

The Board concluded, based on the reasons set forth in its previous order (1987 FRB 473), that the approved activity would not result in a violation of the former section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking. The Board's approval of these applications is restricted to underwriting and dealing to a limited extent in securities representing an interest in or backed by a diversified pool of loans to or receivables from individuals for the purchase of consumer goods and services, and the limitations of section 225.25(b)(16) of Regulation Y (1987 FRB 731).

3600.21.4 LIMITED UNDERWRITING AND DEALING IN DEBT AND EQUITY SECURITIES

Five bank holding companies applied for the Board's approval under section 4(c)(8) of the BHC Act for their wholly owned subsidiaries to underwrite and deal in, on a limited basis—

1. debt securities, including, without limitation, sovereign debt securities, corporate debt, debt securities convertible into equity securities, and securities issued by a trust or other vehicle secured by or representing interests in debt obligations; and
2. equity securities, including, without limitation, common stock, preferred stock, American Depositary Receipts, and other direct and indirect equity ownership interests in corporations and other entities.

Section 16 of the Banking Act of 1933 (the Glass-Steagall Act) prohibits a member bank from underwriting and dealing in these securities (referred to hereafter as "bank-ineligible securities"). However, as far as the Glass-Steagall Act is concerned, an affiliate of a member bank may underwrite and deal in bank-ineligible securities so long as it is not engaged principally or substantially in that activity (12 U.S.C. 377).

The applicants had previously received Board approval to underwrite and deal in U.S. government and agency securities and state and municipal securities that state member banks are specifically authorized to deal in under section 16 of the Glass-Steagall Act (referred to hereafter as "bank-eligible securities"). The Board had also authorized the subsidiaries to underwrite and deal in commercial paper, one- to four-family mortgage-backed securities, municipal revenue bonds, and consumer-receivable-related securities—all securities that member banks may not underwrite or deal in under section 16 of the Glass-Steagall Act.[4]

To ensure that the subsidiaries would not be principally or substantially engaged in underwriting or dealing in the ineligible securities in violation of the former section 20 of the Glass-Steagall Act, the Board's approval was made subject to the requirement that gross revenues from those ineligible securities activities would not exceed 5 percent of the subsidiary's total gross revenues on average (moving average) over any two-year period. (See 1989 FRB 192 and 196–197.) The Board increased this level to 10 percent on September 5, 1989.

The subsidiaries are also subject to a framework of structural and operating limitations established to avoid the potential for conflicts of interest, unsound banking practices, unfair competition, loss of public confidence in affiliate banks, and other adverse effects from the conduct of the bank-ineligible securities underwriting and dealing activity.

The Board recognized that underwriting and dealing in securities is a natural extension of activities currently conducted by banks, involving manageable risks and potential conflicts of interest when conducted in an organizational structure that insulates these activities from banking activities supported by the federal safety net of deposit insurance and access to Federal Reserve lending. The Board has acknowledged that certain bank holding companies have an existing expertise in securities underwriting, dealing, brokerage, investment advisory activities, and broad financial skills that make them well equipped to provide the new services.

4. See the following Board orders: 1987 FRB 473, 607, 616, 618, 620, 622, 731, 738, 742, 928; 1988 FRB 133, 500, 699, 706, 819; 1989 FRB 33, 190, 396, 398, 520, 645, 647; 1990 FRB 79, 158, 256, 461, 554, 568, 573, 652, 682, 756; 1991 FRB 672; 1993 FRB 133, 719; and 1994 FRB 249, 449.

The Board's approval of each application is subject to the conditions stated in previous orders (see 1989 FRB 192; 1990 FRB 158, 455, 573, 652, 683, 756; 1991 FRB 672; 1993 FRB 133, 719; and 1994 FRB 249, 449). The conditions consist of structural and operating limitations designed to avoid conflicts of interest and potential adverse effects, and other conditions designed to ensure safe and sound operations. The conditions include requirements, limitations, and prohibitions with regard to—

1. capital adequacy;
2. credit extensions to customers of the underwriting subsidiary;
3. maintaining the separateness of an underwriting affiliate's activity;
4. disclosures by the underwriting subsidiary;
5. marketing activities on behalf of an underwriting subsidiary;
6. investment advice by bank or thrift affiliates;
7. extensions of credit to the underwriting subsidiary and to purchasers or issuers of ineligible securities (or to major users of projects funded by industrial revenue bonds);
8. transfers of information;
9. reporting and recordkeeping requirements;
10. transfer of activities and formation of subsidiaries of an underwriting subsidiary to engage in underwriting and dealing; and
11. reciprocal arrangements and prohibitions against discriminatory treatment regarding unaffiliated securities firms.

3600.21.5 ACTING AS A DEALER–MANAGER IN CONNECTION WITH CASH-TENDER AND EXCHANGE-OFFER TRANSACTIONS

In connection with a bank holding company application to underwrite and deal in, to a limited extent, all types of equity securities through its section 20 nonbanking subsidiary, an applicant also proposed to act as a dealer–manager in connection with cash-tender and exchange-offer transactions. Dealer–managers generally act as agent for tender or exchange offerors in arranging or facilitating mergers, acquisitions, and other corporate transactions. All-cash tender offers do not, of themselves, involve the issuance, public sale, or distribution of securities. The Board thus concluded that all revenues derived from the section 20 company acting as a dealer–manager in connection with such tender offers may be treated as bank-eligible revenues for purposes of determining compliance with the Board's 10 percent revenue limitation (changed to 25 percent, effective March 6, 1997) on bank-ineligible securities activities. The Board approved the application on November 24, 1993 (see 1994 FRB 49, footnote 5).

3600.21.6 UNDERWRITING "PRIVATE OWNERSHIP" INDUSTRIAL DEVELOPMENT BONDS

A bank holding company (the notificant) provided notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its proposal to engage de novo through its section 20 subsidiary (the company) in underwriting, to a limited extent, certain "private ownership" industrial development bonds. The bonds are issued for the provision of the following governmental services: water facilities, sewer facilities, solid waste disposal facilities, electric energy and gas facilities, and local district heating or cooling facilities (collectively, traditional governmental services). The notificant controls one bank subsidiary.

The company is currently engaged in limited underwriting and dealing in certain municipal revenue bonds, activities permissible under section 20 of the Glass-Steagall Act (12 U.S.C. 377).[5] The company is a broker–dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) and is a member of the Financial Industry Regulatory Authority (FINRA). Thus, the company is subject to the recordkeeping and reporting obligations, fiduciary standards, and other requirements of the Securities Exchange Act of 1934, the SEC, and the FINRA. The notificant engages directly and through subsidiaries in other permissible nonbanking activities.

The Board previously determined that the activities of underwriting and dealing in municipal revenue bonds, including industrial development bonds, are so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act.[6] Certain bank holding companies previously requested approval to underwrite and deal in only municipal revenue bonds, as opposed to a full range of debt securities. Their requests were limited to underwriting and dealing in industrial development bonds that are "public ownership" industrial development bonds. Public ownership industrial development bonds are those "tax-exempt bonds where the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner for federal income tax purposes of the financed facility."[7]

The notificant plans to engage through the company in underwriting private ownership industrial development bonds issued solely for the provision of traditional governmental services. It committed to conduct this activity subject to the same limitations and other conditions that govern underwriting and dealing in public ownership industrial development bonds.[8]

The underwriting risk and the risk analysis required to underwrite private ownership industrial development bonds issued for traditional governmental services is essentially the same as the risk and analysis related to underwriting traditional public ownership bonds. For each, the funds for the repayment of the bonds are derived from revenue generated by the financed facility, including revenue resulting from a service contract between the owner/lessor of the financed facility and a state or local government or political subdivision, pursuant to which the state or local government or political subdivision agrees to purchase the output of the facility.[9] The notificant committed that all the pri-

5. See 1993 FRB 716.

6. *Citicorp, J.P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation*, 1987 FRB 473, *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988), as modified by order approving modifications to section 20 orders, 1989 FRB 751 ("*Citicorp/Morgan/Bankers Trust*"). See also *J.P. Morgan & Co. Incorporated, et al.*, 1989 FRB 192, *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 900 F.2d 360 (D.C. Cir. 1990).

7. See 1987 FRB 502. Examples of financed facilities include airports and mass-commuting facilities.

8. *Citicorp/Morgan/Bankers Trust*. All the bonds that the notificant proposed that the company underwrite would qualify as "exempt facility bonds" under the Internal Revenue Code (the code). See 26 U.S.C. 142. The types of exempt facility bonds that the company would underwrite may, subject to certain volume caps and other limitations, be tax-exempt under the code even if the proceeds of the bonds are used to finance facilities that are privately owned. See 26 U.S.C. 103, 141, 142, 146, and 147.

9. Typically, in the case of public ownership bonds, the governmental unit that issues the bonds owns the financed facility and repays the bonds from the revenue generated by the facility and this service contract. The governmental unit

vate ownership bonds that the company would underwrite would be rated ''investment quality'' by a nationally recognized rating agency to the same extent as are the municipal revenue bonds that the company currently underwrites.

Considering these circumstances, the Board concluded that underwriting and dealing in private ownership bonds issued for the provision of traditional governmental services is a permissible activity if conducted subject to the conditions and prudential limitations set forth in *Citicorp/Morgan/Bankers Trust* (1987 FRB 473 and 1989 FRB 751 (Modification Order)) and agreed to in 1993 FRB 716. The notification was approved on October 24, 1995 (see 1995 FRB 1116).

may also enter into a contract with a third party to operate the financed facility. In the case of the private ownership bonds that the notificant plans to underwrite, the governmental unit that issues the bonds either uses the proceeds of the bonds to acquire or construct a facility, which the governmental unit then leases to a third party, or lends the proceeds of the bonds to a third party to acquire or construct the facility. The third party agrees to make lease payments or loan repayments to the governmental unit that enable the governmental unit to pay debt service on the bonds. As security for the lease or loan agreement, the third party assigns and pledges the revenues generated by the facility and a service contract with a state or local government or political subdivision.

A foreign bank subject to the Bank Holding Company Act applied for the Board's approval to engage in various nonbanking activities, one being to purchase mortgage loans and to issue securities for its own account, through a wholly owned subsidiary or third party servicers, and to sell securities guaranteed by the Government National Mortgage Association (GNMA). Because National Banks are specifically authorized under the Glass–Steagall Act (12 U.S.C. 24) to issue and sell securities guaranteed by GNMA, as well as to underwrite and deal in such securities, the Board concluded that the issuance and sale of GNMA securities is closely related to banking (1988 FRB 573). In addition, the Board determined that the statutory exemption reflects a Congressional determination that GNMA securities are not the type of securities that would lead to unsound speculation or that the public interest in the issuance and sale of GNMA securities by banks outweighs any potential harm resulting therefrom. Also, the Board previously determined that underwriting and dealing in GNMA certificates is of sufficiently low risk to be generally permissible activities for bank holding companies (12 C.F.R. 225.25(b)(16)).

A foreign bank, subject to Section 4 of the BHC Act, applied for the Board's permission to acquire, through its wholly owned subsidiary, all the shares of a company located in New York, New York. The acquired company would engage in several nonbanking activities. Two of the activities, not previously approved by the Board for BHCs, consisted of acting as a sales tax refund agent for the State of Louisiana and Cashing U.S. Dollar Payroll Checks Drawn on Unaffiliated Banks. Both activities were found to be closely related to banking subject to the facts and conditions found in the Board order and briefly discussed below. The application was approved on August 15, 1990 (1990 FRB 860).

3600.24.1 ACTING AS A SALES TAX REFUND AGENT FOR THE STATE OF LOUISIANA

The company being acquired serves as the State's exclusive sales tax refund agent for its tax-free shopping program for foreign visitors. Under the program, foreign visitors present sales invoices evidencing sales taxes paid in Louisiana to the company's office in the state. It refunds the tax in U.S. dollars to the visitor, less a handling fee. A portion of the handling fee is then remitted to the State and local tax authorities refund to the company the amount of tax refunds advanced. The Board found the activity to be closely related to banking since banks: (1) routinely forward to taxing authorities tax receipts delivered to the bank on taxes due; (2) commonly act as fiscal agent for government authorities which involves disbursing funds on behalf of state and local governments.

3600.24.2 CASHING U.S. DOLLAR PAYROLL CHECKS DRAWN ON UNAFFILIATED BANKS

The company being acquired also cashes, and the Applicant plans to continue cashing, U.S. dollar payroll checks on a limited basis, primarily to accommodate employees in airport facilities that lack banking services, but where the company maintains offices. Since check cashing is a fundamental banking activity performed routinely by banks, and the company being acquired proposed to cash only checks drawn on unaffiliated banks, the Board found the activity to be closely related to banking. The Board stipulated, however, that the Applicant was not to use the acquired company's offices as branches of the Applicant or any affiliated bank.

A bank holding company (the notificant) requested the Board's approval, under section 4(c)(8) of the BHC Act and section 225.24(a) of Regulation Y, to acquire through its wholly owned subsidiary a cash-express company, certain assets of an exchange company, and another firm to engage in various nonbanking activities. Many of the nonbanking activities had previously been determined by the Board to be closely related to banking in Regulation Y, by order, or by interpretation. In addition to those nonbanking activities already approved, the notificant requested the Board's approval to engage in providing various governmental service activities at the offices of the cash-express company:

1. postage stamps and postage-paid envelopes
2. vehicle registration services, including the sale, distribution, and renewal of license plates and license tags for motor vehicles
3. public-transportation tickets and tokens
4. notary public services

The Board noted that banks are permitted to provide customer access to the type of government services involved in the proposal, whereby the banks may be acting in an agency capacity or accomplishing the distribution of some of the services using automated teller machines (ATMs).[1] The Board thus concluded that the proposed nonbank activities are closely related to banking. Based on all the facts and commitments provided by the notificant, and the representations and conditions relied upon in reaching a decision, the Board approved the proposal on April 2, 1998 (1998 FRB 481).

1. See 12 C.F.R. 7.1010 and OCC Interpretive Letter No. 718 (March 14, 1996) (postage stamps, acting as an agent for the state in selling and renewing license plates and license tags, and public-transportation tickets from ATMs). See also OCC Conditional Approval Letter No. 267 (January 12, 1988)(notary services).

Permissible Activities by Board Order (Real Estate Settlement Through a Permissible Title Insurance Agency) Section 3600.26

A BHC Applicant requested the Board's permission under section 4(c)(8) of the BHC Act to acquire all the outstanding shares of a company engaged in title insurance agency and real estate settlement activities. The Board previously determined that title insurance agency activities are permissible under section 4(c)(8)(G) of the BHC Act, for which the BHC Applicant qualifies.

The real estate settlement services consist of: (1) reviewing the status of the title in the title commitment, resolving any exceptions to the title, and reviewing the purchase agreement to identify any requirement in it in order to ensure compliance with them; (2) verifying payoffs on existing loans secured by the real estate and verifying the amount of and then calculating the pro rating of special assessments and taxes on the property; (3) obtaining an updated title insurance commitment to the date of closing, preparing the required checks, deeds, affidavits, and obtaining any authorization letters needed; (4) establishing a time and place for the closing, conducting the closing, and ensuring that all parties properly execute all appropriate documents and meet all commitments; (5) collecting and disbursing funds for the parties, holding funds in escrow pending satisfaction of certain commitments, preparing the HUD settlement statement, the deed of trust, mortgage notes, the Truth-in-Lending statement, and purchaser's affidavits; and (6) recording all of the documents required under law.

In reviewing the proposed activity, the Board noted that real estate settlement services are provided by the Applicant's bank subsidiaries in connection with their origination of mortgage loans, and banks within the Applicant's state are generally permitted to conduct real estate settlement activities. It was further noted that banks routinely prepare collateral security agreements and other documentation required to close loans in accordance with federal and state lending requirements as part of the general lending activities authorized under the Board's Regulation Y.

The Board concluded that aspects of the proposed real estate settlement activities are directly linked to permissible title insurance agency activities by BHCs. These activities can directly affect the insured risks under a title insurance policy. Title insurance agents have special experience in assessing potential title defects that can arise in real estate settlement. Title insurance agents thus have the expertise to generally engage in real estate settlements.

For these reasons, the proposed real estate settlement activities conducted through a permissible title insurance agency, were deemed by the Board to be closely related to banking for purposes of section 4(c)(8) of the BHC Act. The Board approved the application by order on October 15, 1990 (1990 FRB 1058).

A bank holding company (the applicant) applied under sections 3(a)(3) and 4(c)(8) of the BHC Act to acquire another company (the company), thereby indirectly acquiring its subsidiary (the subcompany) as well as the subsidiary bank and nonbank companies of the company and the subcompany. Upon consummation of the transaction, the company and subcompany would be subject to the provisions of the BHC Act. Both companies applied for permission under section 3(a)(1) of the BHC Act to become a bank holding company.

The applicant also applied for the Board's permission to engage, through one subsidiary of the subcompany (the adviser), in providing administrative and certain other services to mutual funds, nonbanking activities that the Board has not previously considered under section 4(c)(8) of the BHC Act. The applicant also applied for the Board's permission to acquire certain other nonbanking subsidiaries of the company (as listed in appendix B of the order) to engage in making or servicing loans, providing trust services, and providing investment advisory nonbanking services pursuant to section 225.28(b)(1), (b)(5), and (b)(6) of Regulation Y.

In addition, the applicant provided notice of its intent to indirectly acquire a foreign trust company, a trust administration company, and an advisory company. The companies engage in activities that are permissible under section 211.10 of Regulation K.

3600.27.1 GLASS-STEAGALL ACT ISSUES IN PROVIDING ADMINISTRATIVE SERVICES

The administrative services the applicant proposed to provide through the adviser and its affiliates raised a number of issues under the Glass-Steagall Act. Under that act, a company that owns a member bank may not control "through stock ownership or in any other manner" a company that engages principally in distributing, underwriting, or issuing securities.

Because mutual funds continuously issue and redeem securities, the Board in 1972 issued an interpretation setting out its position on the Glass-Steagall Act as it governs the relationship between mutual funds and companies that own member banks (12 C.F.R. 225.125). The Board found that the Glass-Steagall Act prohibits affiliates of banks from sponsoring, organizing, or controlling mutual funds or distributing their shares.

The Board also found, however, that the Glass-Steagall Act does not prohibit all relationships between a bank holding company and a mutual fund and that it is permissible, under the BHC Act and the Glass-Steagall Act, for bank holding companies to provide investment advice to mutual funds. Also, the Board found that the Glass-Steagall Act does not prohibit bank holding companies from providing certain other services to mutual funds, such as acting as custodian, transfer agent, or registrar.[1] Banks and affiliates of banks may serve as investment adviser, transfer agent, custodian, and registrar. *They may not act as distributor to the fund.* The application raised the question whether it was consistent with the Glass-Steagall Act for an affiliate of a member bank to act as an administrator to a mutual fund.

3600.27.2 PERMISSIBILITY OF PROPOSED ADMINISTRATIVE-SERVICES ACTIVITIES

The adviser furnishes a variety of services to open-end investment companies (mutual funds) and closed-end investment companies in the United States. Because certain of the activities of the adviser and its affiliates are prohibited by the Glass-Steagall Act, the applicant has taken steps and has committed to terminate the

1. The Board imposed a number of restrictions on the relationship between bank holding companies and mutual funds to avoid conflicts of interest and to address potential safety-and-soundness concerns. The Board's rule includes restrictions preventing a bank holding company or any of its subsidiaries from—

- acting as investment adviser to any investment company that has a name similar to the holding company or any of its subsidiary banks;
- purchasing for its own account shares of any investment company for which the holding company serves as investment adviser;
- purchasing in its sole discretion in a fiduciary capacity shares of an investment company advised by the holding company; or
- extending credit to an investment company advised by the holding company as collateral for a loan used to purchase shares of the investment company.

In addition, the rule requires that, in cases in which a customer purchases or sells securities of the fund through the holding company or is advised by the holding company to purchase shares of the fund, the customer be informed in writing of the holding company's involvement with the fund, and be informed that the shares of the fund are not federally insured and are not guaranteed by, or obligations of, a bank.

adviser's role as a sponsor of new mutual funds. The applicant also committed that it would not acquire those of the adviser's subsidiaries that engaged in the distribution of mutual fund shares. The applicant further committed that it would not be involved in the distribution of the shares of any mutual fund. The applicant represented to the Board, that, after the acquisition of the company, neither the adviser nor any of its affiliates would be obligated by any agreement to engage in any sales activities in connection with any mutual fund's shares and would not enter into any distribution agreement with any mutual fund, unless permitted to do so by a change in current law.

The adviser will not—

1. engage in the development of marketing plans except to give advice to the distributor regarding regulatory compliance;
2. engage in advertising activities with respect to the funds and will not be involved in the preparation of a fund's sales literature, except to review it for the sole purpose of ensuring compliance with pertinent regulatory requirements; or
3. permit employees of the adviser to engage in sales activities at meetings or seminars (such activities would be conducted solely by the fund's distributor).

It was noted that the applicant did not propose providing administrative services to those mutual funds that are marketed and sold primarily to customers of any of the applicant's subsidiary banks.

The Board believes that it is permissible under the Glass-Steagall Act for the applicant to provide the following administrative services to mutual funds as proposed:

1. maintaining and preserving the records of the fund, including financial and corporate records
2. computing the fund's net asset value, dividends, and performance data and financial information regarding the fund
3. furnishing statistical and research data
4. preparing and filing with the Securities and Exchange Commission (SEC) and state securities regulators registration statements, notices, reports, and other material required to be filed under applicable laws
5. preparing reports and other informational materials regarding the fund, including proxies and other shareholder communications, and reviewing prospectuses
6. providing legal and regulatory advice to the fund in connection with its other administrative functions
7. providing office facilities and clerical support for the fund
8. developing and implementing procedures for monitoring compliance with regulatory requirements and compliance with the fund's investment objectives, policies, and restrictions as established by the fund's board
9. providing routine fund accounting services and liaison with outside auditors
10. preparing and filing tax returns
11. reviewing and arranging for payment of fund expenses
12. providing communication and coordination services with regard to the fund's investment adviser, transfer agent, custodian, distributor, and other service organizations that render recordkeeping or shareholder communication services
13. reviewing and providing advice to the distributor, fund, and investment adviser regarding sales literature and marketing plans to ensure regulatory compliance
14. providing the distributor's personnel with information about fund performance and administration
15. participating in seminars, meetings, and conferences designed to present information to brokers and investment companies, but not in connection with the sale of shares of the funds to the public, concerning the operation of the funds, including administrative services provided by the bank holding company to the funds
16. assisting existing funds in the development of additional portfolios
17. providing reports to the fund's board regarding fund activities

A mutual fund administrator provides services that are essentially ministerial or clerical. The administrator does not have policymaking authority or control over the mutual fund. The policymaking functions rest with the board of directors of the mutual fund. The board of directors is responsible for the selection and review of the major contractors to the fund, including the investment adviser and, in certain circumstances, the administrator.

The Investment Company Act of 1940 requires that at least 40 percent of the board of directors of a mutual fund be disinterested persons who are not affiliated with the investment adviser, with any person that the SEC has determined to have a material business or professional relationship with the fund, with any employee or officer of the fund, with any registered broker or dealer, or with any other interested or affiliated person. These unaffiliated board members must approve the fund's contracts with its investment adviser, underwriter, and often its administrator. The applicant committed that the adviser will provide administrative services only to mutual funds whose board of directors consists of a majority of disinterested persons.

In situations in which the applicant's subsidiaries serve as administrator to the mutual fund, the Board permitted one representative of the administrator to serve as a director of the fund. The applicant contended that such an interlocking director would facilitate the provision of administrative services by providing the fund with a person knowledgeable in the operation of the fund who would be in a position to advise the board of directors on administration.

The applicant proposed that a director interlock would be used only in situations in which a company unaffiliated with it serves as the investment adviser to the mutual fund. With regard to the adviser's serving as an administrator, this interlocking director would be deemed an interested person and would be excluded from those actions that must be taken by disinterested board members, such as the approval of an investment advisory contract or a contract for the administrator. The applicant committed that the adviser would serve as administrator only to mutual funds for which a majority of the board of directors are disinterested individuals. The Board believed that, in this proposed arrangement, the applicant would not control a mutual fund if one employee of the adviser or an affiliate[2] would serve as a director of a mutual fund to which the advisor provides administrative services.

The applicant plans, in a small number of cases, to provide mutual funds with a combination of administrative, investment advisory, and other services. The OCC has permitted national banks that serve as investment adviser to mutual funds also to provide some administrative services to those mutual funds. In addition, a number of national banks have been providing these and other services as "subadministrator" to mutual funds that are advised by the bank or an affiliate.

In the Board's opinion, permitting a bank holding company that serves as investment adviser to a mutual fund and also in essence provides ministerial or supporting functions as administrator to that fund would not significantly increase the bank holding company's ability to control the mutual fund. In other words, the adviser would not, by virtue of becoming an administrator to a fund that it or an affiliate advises, become involved in policymaking functions of these funds to a greater extent than when it provides solely investment advisory services. The Board believes that control would continue to rest with the board of directors of the mutual fund.

With regard to providing a combination of advisory and administrative services, the applicant further committed that it would not have any director or officer interlocks with these mutual funds. It would also not have any director or officer interlocks with mutual funds to which it provides both advisory and administrative services.

In providing the combination of services, the applicant would be subject to the Board's interpretation on investment advisory activities (12 C.F.R. 225.125) and would therefore be required to conform the adviser's activities to the interpretation within two years. On this condition, and subject to the commitments made by the applicant, the Board concluded that the proposal was permissible under the Glass-Steagall Act.

3600.27.3 BOARD'S CONCLUSION ON PROVIDING ADMINISTRATIVE SERVICES

The Board found the applicant's proposed activities to be closely related to banking because (1) it had previously determined by regulation that a bank holding company could act as investment adviser to a mutual fund; (2) national banks, including national bank trust departments, provide administrative services to mutual funds; and (3) it had also permitted bank holding companies to provide certain individual financial data processing services (calculation of investment values and tax consulting) by a mutual fund administrator. The Board thus approved the application on April 21, 1993 (1993 FRB 626), based on the facts of record and all of the commitments and representations made by the applicant, and subject to the terms and conditions set forth in the order.

2. This director cannot serve as an officer, director, or employee of the applicant, its bank, or any subsidiary bank or bank holding company of the applicant.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section has been revised to incorporate a name change to the Financial Industry Regulatory Authority, or FINRA (formerly, the National Association of Securities Dealers, or NASD).

A foreign banking organization (FBO), subject to the provisions of the Bank Holding Company Act, had requested the Board's approval to acquire, through a wholly owned subsidiary (the company), substantially all the assets of an asset-management partnership (the partnership). The company would be an investment adviser registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. The company's acquisition of the partnership would also include a membership interest in a services firm that would provide transfer-agency services to mutual funds advised by the company (the funds).

The FBO, among other things, proposed to provide marketing support to a mutual fund by directly contacting broker-dealers, 401(k) plan providers, financial planners, insurance companies, and other financial intermediaries to recommend the funds. It would be primarily responsible for the development of marketing plans and the preparation of advertising and sales literature materials for the funds. The Board had not previously considered whether a bank holding company could provide promotional or marketing services to the extent that was proposed.

3600.28.1 CONTROL CONSIDERATIONS INVOLVING PROMOTIONAL AND MARKETING ACTIVITIES

Under the Glass-Steagall Act, a company that owns a member bank may not own or control "through stock ownership or in any other manner" a company that engages principally in distributing, underwriting, or issuing securities.[1] The Board has found that this provision prohibits affiliates of banks from sponsoring, organizing, or controlling a mutual fund. The Board previously has determined, however, that the Glass-Steagall Act does not prohibit a bank holding company from providing advisory and administrative services to a mutual fund.[2]

The proposed promotional and marketing activities would not, it was believed, cause the FBO to control the funds or to be involved in the underwriting and distribution of the funds' securities to the public. The proposed promotional activities involved contact only with financial intermediaries. The activities are similar to the activities previously approved by the Board. The Board had previously permitted bank holding companies to present information about the operations of the mutual funds advised and administered by the bank holding company at meetings or seminars for brokers of mutual funds.[3] In addition, the Office of the Comptroller of the Currency (OCC) had also authorized subsidiaries of national banks to provide marketing and advertising support to mutual funds in connection with their brokerage and advisory services.

As for the distribution and sales of the funds, it was proposed that an independent distributor be given that responsibility.[4] The independent distributor would serve as the principal underwriter of the funds and would enter into sales agreements with financial intermediaries to sell shares of the funds on their behalf.[5] Actual sales would be conducted by the independent distributor or by an independent broker–dealer for the funds.

The FBO did not propose to solicit retail customers to purchase shares in particular funds, to accept orders for the purchase of shares, or to engage in any retail sales activities. Neither the company nor any of its employees would receive transaction-based income or commissions in connection with the company's promotional or marketing activities.

The company would have primary responsibility for preparing the advertising and marketing materials. The independent distributor, however, would be responsible for placing all

1. 12 U.S.C. 221a and 377.

2. See 12 C.F.R. 225.28(b)(6) and 12 C.F.R. 225.125.

3. See 1993 FRB 626 (footnote 15).

4. The FBO committed that none of its U.S. affiliates, including the company, would be obligated by any agreement to engage in any sales activities with regard to shares of the funds, nor would such affiliates enter into any distribution agreement with the funds without the prior approval of the Board.

5. The funds could enter into distribution agreements with intermediaries, but in no event could the company enter into such agreements.

advertisements. The independent distributor would also have legal responsibility, under the rules of the Financial Industry Regulatory Authority (FINRA), for the form and use of all advertising and sales literature prepared by the company, and would also be responsible for filing these materials with the FINRA or SEC.

For the reasons cited, the Board believed that the promotional and marketing activities proposed by the FBO would not involve the company in the underwriting or distribution of shares of the funds for the purposes of the Glass-Steagall Act.

3600.28.2 MANAGEMENT INTERLOCK CONTROL CONSIDERATIONS

The FBO also proposed that the chief executive officer serve as the chairman of the four-member board of trustees of the funds and that no more than three officers or employees of the company serve as junior-level officers of the funds. The employees would serve as assistant secretary, assistant treasurer, or assistant vice president of the funds and would be supervised by the board of trustees or senior-level officers. These employees would have no policymaking authority at the funds and would not be responsible for, or involved in, making recommendations on policy decisions. No employee or officer of the company would serve as a senior-level officer of the funds.

The Board had previously authorized a bank holding company to have director and officer interlocks with mutual funds that the bank holding company advises or administers.[6] The Board concluded that the proposed interlocks between the company and the funds, in this case, would not compromise the independence of the boards of trustees of the funds, compromise the independent distribution of the funds, or result in control of the funds by the FBO.

Based on the facts given, the Board concluded that the control of the funds would rest with the independent members of the boards of trustees of the funds and that the proposed interlocks between the company and the funds would not compromise the independence of the boards of the funds or permit the FBO to control the funds. The Board concluded that the proposal was consistent with the Glass-Steagall Act. The notice was approved on June 16, 1997. See 1997 FRB 679, 1998 FRB 1075–77, 1998 FRB 852–853, and 1998 FRB 680–82.

6. See 1996 FRB 1129.

A bank holding company gave notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its intention to engage de novo through its mortgage subsidiary in providing employment histories to third parties for a fee.

The employment histories to be provided by the mortgage subsidiary would include the names of past and current employers of an individual and the salary and length of employment for each position, if the individual has consented to the release of such information. The mortgage subsidiary would compile an individual's employment history from information available from state departments of employment services and other similar sources. This information would be provided for a fee to any third-party credit grantor for the purpose of assessing the creditworthiness of a prospective borrower.[1]

3600.29.1 CREDIT-RELATED EMPLOYMENT HISTORIES

The mortgage subsidiary will provide employment histories to third-party credit grantors, including depository and nondepository grantors, for use in making decisions to extend credit only with the express consent of the individual involved. The bank holding company committed that the mortgage subsidiary will comply with the Fair Credit Reporting Act (15 U.S.C. 1681 et seq.) (FCRA) and all applicable state and federal laws and regulations.

In the normal course of their lending activities, banks collect and analyze employment and salary information, including names of past and current employers and salary histories. The Board previously determined that providing past credit information, which includes employment history information, to a credit grantor who is considering a borrower's application for credit is an activity that is closely related to banking and permissible for bank holding companies.[2] Accordingly, the Board concluded that providing employment histories to third-party credit grantors for use in making decisions to extend credit is an activity that is closely related to banking.

3600.29.2 NON-CREDIT-RELATED EMPLOYMENT HISTORIES

The bank holding company also intends to provide employment histories to third-party depository institutions and their affiliates, including credit unions and their affiliates, for use in the regular course of their business, including the hiring of employees. The mortgage subsidiary would provide this information to such entities only with the express consent of the individual involved. Regardless of whether the customer is a third-party depository institution or other credit grantor, the activity would only involve providing employment information. The bank holding company does not plan to provide any additional service, such as analyzing an individual's creditworthiness. The bank holding company committed that its mortgage subsidiary will comply with the FCRA and all applicable state and federal laws and regulations in performing the proposed activity.

The Board had not previously determined whether providing such employment information to third parties for a fee is closely related to banking under section 4 of the BHC Act and, therefore, permissible for bank holding companies. The Board had previously permitted bank holding companies to provide employment information, including employment histories, to depository institutions and their affiliates in connection with the provision of career counseling services (see section 3600.15.1.1).[3] To the extent that these organizations use the information to be provided by the mortgage subsidiary for other purposes, it will only be used in connection with the operation of their banking business.

The Board thus concluded that providing employment histories for use by depository institutions and their affiliates in the regular course of their business is an activity that is closely related to banking. For these reasons, the Board, on May 8, 1995, approved the bank holding company's notice to provide such employment information (1995 FRB 732). The

1. Credit grantors could include lessors if the leasing transaction was the functional equivalent of an extension of credit.

2. See Regulation Y, section 225.25(b)(24) (12 C.F.R. 225.25(b)(24)). The bank holding company committed that it would not promote its mortgage subsidiary as a provider of employment information to non–depository institutions for general business purposes unrelated to credit decisions.

3. See 1994 FRB 51.

approval was specifically conditioned on compliance with the commitments made in connection with the notice.

3600.30.1 REAL ESTATE TITLE ABSTRACTING ACTIVITIES

A bank holding company (the notificant) gave notice under section 4(c)(8) of the Bank Holding Company Act (the BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its intention to acquire a title abstracting company (the company) and thereby engage in real estate title abstracting in the state of Iowa.[1] Real estate title abstracting, as proposed by the notificant, is limited to reporting factual information concerning the interests or ownership of selected real property. An abstracter obtains this information by performing a title search of records maintained at a local public records office to determine the ownership history of the property, including any liens, encumbrances, mortgages, or future interests affecting it. The abstracter then prepares a written report, also known as an "abstract of title," that recites the results of the title search. Because Iowa state law does not permit the sale of title insurance, real estate lenders obtain the opinion of an attorney certifying that title to a particular parcel of real property is free of defects. The abstract of title provides the factual information necessary for the attorney to determine whether a lender would have an unencumbered security interest in the property to be mortgaged.

The notificant proposes to provide real estate title abstracting services to affiliated and unaffiliated lenders in an Iowa county. The company would perform the proposed activities in connection with real estate loans made by affiliates or unaffiliated companies and, in certain cases, when no financing is provided, such as in connection with intrafamily transfers of real estate and property distributed as part of estate planning.

The notificant would not provide any insurance against title defects, guarantee any title, or provide any certification with respect to a title. The notificant would be liable for damages caused by negligence in performing a title search but would not be responsible for any defects in the title.[2] The equivalent of title insurance in Iowa is provided by the attorney who certifies that the title is free from defects. The Board has not previously determined that providing real estate title abstracting is closely related to banking under section 4(c)(8) of the BHC Act and, therefore, permissible for bank holding companies.

The Board believes that the proposed real estate title abstracting activities are integrally related to the provision of loans secured by real estate. A bank must be aware of any encumbrances on property that serves as collateral for a loan made by the bank. Banks in the state typically rely on an attorney's opinion, based on information in an abstract of title, to determine that they have a secured position in real estate serving as collateral. The abstract of title provides information necessary to determine the adequacy of the real estate collateral for the loan and is an integral part of secured real estate lending in Iowa. Thus, the bank has a particular need for the information in the abstract of title. Accordingly, the Board believes that the proposed activities are integrally related to the provision of secured real estate lending and, therefore, are closely related to banking.

The Office of the Comptroller of the Currency (OCC) has authorized national banks to conduct this activity.[3] The OCC has concluded that the performance of a title search and the preparation of an abstract of title are necessary parts of the real estate lending process and that it would be convenient and useful under the applicable standards in the National Bank Act for national banks to be able to perform these tasks themselves.[4]

The proposed activities are not equivalent to providing title insurance—an activity that is not generally permissible under section 4(c)(8) of the BHC Act.[5] Title insurance generally includes providing an indemnification against losses resulting from a title defect discovered after the conveyance of property. Title insurance typically protects a purchaser or lender against claims not identified by a title search or claims not specifically exempted by the title insurance policy. The notificant does not propose to certify or guarantee title and would not be liable to the purchaser or the lender for any title defects.

1. The notificant would merge the company into its wholly owned leasing subsidiary.
2. Title abstracters may insure against liability for negligence by purchasing an errors and omissions policy.
3. OCC Interpretative Letter No. 450, September 22, 1988.
4. National banks are not permitted to sell title insurance.
5. Section 4(c)(8) provides that insurance agency, brokerage, and underwriting activities are not "closely related to banking" and, thus, are not permissible activities for bank holding companies, unless the activities are included within one of seven specific exemptions (A through G) in section 4(c)(8) (12 U.S.C. 1843(c)(8)(A)–(G)).

The Board concluded, based on all the facts of record, that the proposed activities are closely related to banking and approved the notice on June 30, 1995. (See 1995 FRB 805.) Approval of the proposal was specifically conditioned on the notificant's compliance with the commitments made in connection with the notice.

3600.30.2 AIRCRAFT TITLE ABSTRACTING ACTIVITIES

An attorney representing a bank holding company (BHC) requested an opinion as to whether the providing of title abstracts on U.S.-registered aircraft would be a permissible activity for a new subsidiary of a BHC. The aircraft title abstracting activities would be limited to reporting factual information concerning the ownership history of the relevant aircraft and the existence of liens or encumbrances affecting the aircraft. The information would be obtained by performing a title search of records. The title search would be documented in a written report, known as an "abstract of title," describing the factual information located by the title search concerning the existing title owner of the aircraft, previous transfers of the aircraft's title, and the existence of any liens or encumbrances affecting title to the aircraft.[6] The subsidiary would provide the information to affiliated and unaffiliated lenders and other parties in connection with aircraft financing and sales transactions. The aircraft title abstracting activities would not include providing insurance against defects in the title of any aircraft, guarantee any aircraft title, or provide any certification with respect to an aircraft title. Based on facts and information provided and other facts, the Legal Division staff issued an opinion on October 7, 2002, that concluded that the proposed aircraft title abstracting to be conducted by the subsidiary would be within the scope of the title abstracting activities previously authorized by the Board on June 30, 1995. (See 1995 FRB 805, 806.)

6. The attorney requesting the opinion reported that federal law requires that all changes in title of, and liens and encumbrances affecting, U.S.-registered aircraft must be filed with the Federal Aviation Administration.

A bank holding company (BHC), that has elected to be a financial holding company within the meaning of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) (the BHC Act) inquired if it would be permissible under the BHC Act and the Board's Regulation Y (12 C.F.R. 225) for the BHC to engage in ''commodity purchase and forward sale'' (CPFS) transactions as a method of financing the commodity inventories of its customers.[1]

Two alternative structures were described for the CPFS transactions. In the first structure, the BHC would purchase a commodity from its customer and simultaneously enter into a forward sale agreement under which the customer would be obligated to repurchase the commodity from the BHC at a predetermined price on a predetermined future date. The second structure is similar to the first structure except that it would involve a third party, either as the initial seller of the commodity to the BHC or as the ultimate purchaser of the commodity from the BHC. During the term of a CPFS transaction, the BHC would hold title to the underlying commodity, would mark the commodity to market on a daily basis, and would call for additional margin if the market value of the commodity falls below a specific collateral threshold.

The BHC Act permits bank holding companies to engage in any activity that the Board had determined by regulation or order as of November 11, 1999, ''to be so closely related to banking as to be a proper incident thereto.''[2] The Board had determined by regulation issued prior to November 11, 1999, that ''[m]aking, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others'' is such an activity.[3]

Under the proposed CPFS transactions, the BHC would earn a fixed return on a CPFS transaction, just as it would on an ordinary secured loan, and its risk exposure would effectively be limited to counterparty credit risk. The BHC would subject any prospective CPFS counterparty to the same credit-review process used for loan applicants, and the BHC's internal credit-review personnel would also review outstanding CPFS arrangements. As proposed, the BHC would never enter into an agreement to purchase a commodity unless it simultaneously enters into an agreement to sell the commodity to a creditworthy counterparty on a fixed future date at a fixed price. The BHC indicated that a fixed future sale price would be equal to the initial purchase price plus a fixed interest component (and thus would not vary based on movements in the price of the commodity). In other words, unless the ultimate purchaser defaults, the BHC would be repaid its principal plus a fixed amount of interest at maturity of the transaction. In addition, the BHC would not bear any commodity price risk; the price it would receive for the commodities on the maturity date of the transaction would be fixed on the date it enters into the transaction. If the ultimate purchaser defaults on its obligation to purchase the underlying commodity upon maturity, the BHC would have a claim against this purchaser to recover the equivalent of principal and interest. The BHC could then sell the commodity into the market to mitigate credit losses in the same manner as it would liquidate any collateral supporting a loan in default. Any commodities acquired by the BHC as a result of counterparty default would be held in accordance with the limits applicable to assets acquired by a BHC in the course of collecting a debt previously contracted.[4]

Moreover, the BHC represented that all non-price risks and costs of owning the commodity during the term of the CPFS transaction, such as storage risk and the cost of insurance, would be borne by the ultimate purchaser. In all cases, although the BHC would take title to the underlying commodity at the inception of a CPFS transaction, it would take title in the form of a warehouse receipt only; that is, the commodity would continue to be stored in a licensed warehouse owned and operated by an entity other than the BHC. The commodity would not be physically moved as a result of the transaction. The BHC would acquire title to the underlying commodity in a CPFS transaction as an incident

1. The BHC indicated that the commodities involved in these transactions would include agricultural commodities (such as corn, wheat, soybeans and other legumes, cotton, cocoa, coffee, sugar, various oilseeds and oils, and dairy products), live cattle, timber, and exchange-traded metals. The BHC's CPFS transactions would, in all cases, involve commodities (1) for which contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission or (2) which the BHC can show, to Board staff's satisfaction, have readily-available price quotes and are traded regularly in global commodity markets.

2. See 12 U.S.C. 1843(c)(8).

3. See 12 C.F.R. 225.28(b)(1).

4. See 12 C.F.R. 225.22(d)(1).

to the financing it provides to its customers and not for speculative purposes. The BHC represented that the BHC does not and will not hold itself out as making a market in the commodity. In addition, the BHC also represented that the BHC does not and will not (1) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities or (2) process, refine, or otherwise alter commodities.

The BHC would account for the CPFS transaction as an ''asset purchased under an agreement to resell'' and would recognize profit and loss on the transaction on an accrual basis, in a manner similar to a traditional loan. During the term of the transaction, the ultimate purchaser counterparty in a CPFS transaction would generally record the underlying commodity as an asset on its balance sheet and would record its obligation to purchase the commodity as a short-term debt liability.

The interpretation noted that the Board had previously found a three-party commodity financing arrangement similar to the BHC's proposed three-party CPFS transactions to be an extension of credit permissible for BHCs under Regulation Y. In a 1973 order, the Board approved as a permissible lending activity for bank holding companies an arrangement under which a BHC would finance a utility's coal purchases by purchasing from a third party, and taking title to, a quantity of coal on a monthly basis at the direction of the utility customer. (See 1973 FRB 698.) The BHC would store the coal on the premises of the utility under a lease arrangement with the utility. The utility would use the coal continuously throughout the following month and would pay the BHC monthly for the amount of coal used, at a price equal to the BHC's acquisition cost for the coal plus a fixed amount of interest. The utility explicitly bore the risk of loss or damage to the coal during storage. If the utility defaulted, the BHC had the right to sell the coal to cover its losses and the right to sue the utility for any shortfall in the liquidation proceeds. As with the proposed CPFS transactions, the utility's motive for the transaction was to obtain financing for its commodities inventory.

Based on the information the BHC provided and the Board's precedents, Board legal staff opined that the proposed CPFS transactions are within the scope of permissible lending activities for BHCs under section 225.28(b)(1) of Regulation Y. The BHC should have policies and procedures to identify whether a CPFS transaction would create heightened legal or reputational risk to the BHC, and to manage any such risk. In particular, the BHC should have policies and procedures to identify whether a particular CPFS transaction (1) lacks economic substance or business purpose; (2) may be designed by the counterparty for questionable accounting, regulatory, or tax purposes; or (3) may be accounted for or disclosed by the counterparty in a way that is misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

The Board legal staff's opinion is limited solely to the permissibility of the proposed CPFS activities described above under Regulation Y and does not address the permissibility of any other activities or authorize the BHC to engage in any other activities in the United States. (See the Board's staff legal interpretation dated May 15, 2006.)

A foreign bank (that qualifies as a financial holding company under section 4(k) of the BHC Act and is treated as a bank holding company (BHC) under section 4(c)(9) of the BHC Act requested a confirmation from the Board's legal staff on whether certain volumetric-production-payment (VPP) transactions involving physical commodities would be considered as extensions of credit that are permissible for a BHC under section 4(c)(8) of the BHC Act and section 225.28(b)(1) of the Board's Regulation Y.[1]

In 2004, the Board approved a proposal by the BHC to engage in physical-commodity trading as an activity that is complementary to the BHC's commodity derivatives activities.[2] The order limited the value of physical commodities that the BHC may hold under this authority to 5 percent of the BHC's tier 1 capital. The BHC also requested confirmation that VPP transactions and any physical commodities delivered to the BHC under a VPP would not count against the 5 percent of tier 1 capital limit.

A VPP is a royalty interest, typically in a hydrocarbon (such as oil or natural gas) reserve that entitles the VPP holder, in exchange for an upfront payment, to receive specified quantities of hydrocarbons on a regular basis during the life of the VPP transaction. A VPP is considered to be a real property interest in most states. Relying on its physical-commodity trading authority, the BHC had already entered into two VPP transactions in the United States. In each of these transactions, a wholly owned, consolidated, U.S. special-purpose-vehicle subsidiary of the BHC (the SPV) had acquired a VPP from a hydrocarbon producer (the customer) in exchange for cash.[3] The VPP transactions are designed to provide funding to the customers. The VPP does not give the BHC the right to control production of the oil or gas, and the BHC is therefore dependent on the customer meeting its contractual obligation to produce the agreed-upon volume of oil or gas according to the agreed-upon schedule.

Simultaneously with its purchase of the VPP interest from the customer, the SPV and the BHC enter into an agreement under which the BHC makes an upfront payment to the SPV and the SPV agrees to deliver to the BHC the volumes of oil or gas to be received by the SPV from the customer under the VPP. As the SPV delivers the oil or gas to the BHC under this agreement, the BHC arranges to sell it, either back to the customer or into the marketplace, at the then-current market price for the commodity.

The BHC also may decide to temporarily retain hydrocarbons it acquires pursuant to a VPP in order, for example, to take advantage of an anticipated rise in price for the relevant commodity. The BHC agreed that any hydrocarbons acquired under a VPP will be counted against the BHC's 5 percent of tier 1 capital limit under the order if they are not immediately sold to a third party. The BHC represented that it hedges its commodity-price risk from the VPP by entering into a fixed-rate commodity swap with a third party (which may be the customer) that converts the BHC's variable proceeds from the periodic sale of the oil or gas into fixed-rate payments. Accordingly, in the absence of counterparty defaults, by the end of the VPP term the BHC will have recouped the original amount advanced to the customer plus a fixed return.

The BHC stated that the VPP transactions generally are treated as loans for U.S. federal income tax purposes. In addition, the BHC indicated that it will treat VPP transactions as loans for accounting purposes. Board staff stated that it expects (1) the BHC will follow generally accepted accounting principles in reporting any VPP transactions and (2) all of the BHC's VPP transactions will be entered into for legitimate business purposes.

The BHC argued that a VPP transaction is very similar to a traditional lending arrangement because the discounted present value of the hydrocarbons to be delivered to the BHC over the life of a VPP transaction is estimated to equal the purchase price paid by the BHC for the VPP interest plus a margin meant to cover the BHC's cost of funds, risk associated with the transaction, and a fixed profit. Importantly, the VPP does not give the BHC any variable upside potential if there is excess production from the producer's hydrocarbon reserve.[4] Moreover, the commodity-price swap hedges the BHC's commodity-price risk associated with the VPP, thus guaranteeing the BHC a return of principal and a fixed amount of interest if nei-

1. 12 C.F.R. 225.28(b)(1).
2. See 2004 FRB 215.
3. [TEXT REDACTED]

4. If the reserve produces more hydrocarbons than are subject to the VPP, the production is for the benefit of the producer. If the reserve underproduces in a given period during the life of the VPP, the BHC would be entitled to an appropriate amount of overproduction in subsequent months (and extra reimbursement to reflect default interest).

ther the producer nor the swap counterparty defaults. Accordingly, the VPP transactions are not designed to serve as a vehicle for the BHC to take on commodity-price risk, own commodities, or engage in commodity dealing.[5]

As described above, as part of a VPP transaction, the BHC will hold a royalty interest in a hydrocarbon reserve and will periodically take title, if only momentarily, to physical commodities. The Board has previously concluded, however, that ownership of commodities in connection with a financing transaction does not prevent the transaction from being treated as a form of credit extension permissible for a BHC if the economics of the transaction are substantially the same as those of a loan.[6]

Based on the information provided by the BHC's counsel, Board legal staff opined that the above-described VPP transactions are a form of permissible lending activity for BHCs under section 225.28(b)(1) of Regulation Y when entered into for the purpose of providing financing to a third-party customer. Any commodities that the BHC receives pursuant to a VPP transaction and that are not immediately sold to third parties would be subject to the 5 percent of tier 1 capital limit on the value of commodities that the BHC may hold under its physical-commodity-trading authority.

The staff opinion informed the BHC that it should have in place policies and procedures to (1) identify whether a VPP transaction would create heightened legal or reputational risk to the BHC and (2) manage any such risk. In particular, the BHC should have policies and procedures to identify whether a particular VPP transaction (1) lacks economic substance or business purpose; (2) may be designed by the counterparty for questionable accounting, regulatory, or tax purposes; or (3) may be accounted for or disclosed by the counterparty in a way that is misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

The staff opinion is limited solely to the permissibility of the VPP transactions described in the opinion under Regulation Y. The opinion does not address the permissibility of any other activities or authorize the BHC to engage in any other activities in the United States. (See the Board legal staff's opinion dated May 15, 2006.)

5. As noted above, the BHC has the authority to engage in physical-commodity trading, including making and taking delivery of physical commodities, and may use this authority to retain ownership of hydrocarbons delivered under a VPP in order to benefit from anticipated changes in hydrocarbon prices.

6. See 1973 FRB 698.

Impermissible Activities

Section 3700.0

The BHC Act states that a nonbank activity is impermissible unless explicitly exempt from the general prohibition of section 4. While this could cause an unlimited list of impermissible activities, the Board has compiled a list of activities which have been specifically determined to be impermissible (see Manual section 3000.0, Appendix 3).

The inspection objective is to determine whether a specific activity conducted by a bank holding company or its subsidiary is permissible for the bank holding company. The Board has ruled specific activities to be impermissible although it has stated also that certain impermissible activities may be engaged in under limited special circumstances.

In addition, a bank holding company may be entitled to grandfather privileges which are considered as either permanent (where there is no deadline for termination of an activity) or temporary, in which case the activity must have been terminated prior to December 31, 1980. A holding company may be granted an exemption from section 4 of the Act (i.e., family, hardships, etc.) which allows it to engage in activities that would otherwise be impermissible. Because of the variety of factors which must be considered, the examiner should exercise care when determining the permissibility of an activity for a bank holding company.

The subsections of this chapter present a *selected number* of those activities which have been determined to be impermissible for bank holding companies. While an activity is permissible only after it has been determined as such by the Board, it must be remembered that in determining permissibility, the Board has in some instances (i.e., data processing services, courier services, etc.) included restrictions which would limit the overall nature or performance of the activity. Therefore, even the permissible activities may become impermissible if the actions of the bank holding company are not in accordance with the stated restrictions.

The Board of Governors has ruled that land development[1] is impermissible for bank holding companies. However, for land acquired through foreclosure, a limited amount of development may be allowed in an effort to minimize the potential loss on the project. Each case must be considered separately to determine if it warrants additional development.

The basic determination of impermissibility was established by the Board in denying a portion of the application by UB Financial Corp., Phoenix, Arizona, to retain the H. S. Pickrell Company, Phoenix, Arizona (1972 FRB 429). The order stated in part, "The Board is of the opinion that the activities of purchasing and selling of land or participating as a joint venturer in real estate development are not so closely related to banking as to be a proper incident thereto, and that insofar as the application pertains to those activities, it should be denied."

The determination that limited development for land acquired through foreclosure is permissible is contained in a Board order dated November 1, 1973, in connection with an application by Liberty National Corporation, Oklahoma City, Oklahoma, to retain Liberty Mortgage Company, Oklahoma City, Oklahoma (1973 FRB 919), in which it is indicated that a limited amount of real estate development might be permissible if necessary to minimize losses on real estate acquired in connection with debts previously contracted.

1. The Board, by specific order, has permitted a limited incursion into this area as an accommodation to BHCs acquiring thrifts or to thrifts that qualify as "banks" and seek to form bank holding companies (1986 FRB 487, 731)

3700.2.1 PREMIUM FUNDING

Insurance premium funding, sometimes known as equity funding, is the financing of the sales of mutual fund shares and life insurance policies as a package. It should not be confused with loans made to an insured for the purpose of paying premiums on hazard insurance (insurance premium financing); in that case the lender may be named loss payee or owner of the policy and the lender has the right to submit the policy for cancellation in order to collect the amount owed. Insurance premium financing is a permissible activity pursuant to Section 225.25(b)(1) of Regulation Y (Refer to 1974 FRB 310).

The Board has determined insurance premium funding to be impermissible for bank holding companies (12 C.F.R. 225.126). This determination is based on the policies contained in sections 20, 21, and 32 of the Banking Act of 1933 (the Glass–Steagall Act Provisions) as described in the opinion of the United States Supreme Court in Investment Company Institute v. Camp, 401 U.S. 617 (1971).

"In the Board's opinion, the Glass–Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize or control a mutual fund" (12 C.F.R. 225.125). In enacting the Glass–Steagall Act, Congress indicated that affiliations of commercial banks and securities companies give rise to a potential conflict of interest and unsound banking practices. Pursuant to section 4(c)(8) of the Act, the Board is required to consider whether the performance of a particular nonbank activity by a holding company produces benefits to the public that outweigh possible adverse effects, such as potential conflict of interest and unsound banking practices. Therefore, the potential conflict of interest and unsound banking practices arising in the affiliation of commercial banks and mutual funds precludes the Board from approving insurance premium funding as a permissible banking activity.

3700.2.2 LIFE INSURANCE UNDERWRITING

The life insurance discussed in this section is that life insurance which is not sold in connection with a credit transaction by a bank holding company or its subsidiary. The Board has ruled that this activity is impermissible for bank holding companies (12 C.F.R. 225.126). The Board developed its position during consideration of the application of First Oklahoma Bancorporation, Inc., Oklahoma City, Oklahoma, for prior approval pursuant to section 4(c)(8) of the Act to acquire sufficient additional shares of Underwriters Life Insurance Company, Oklahoma City, Oklahoma, so as to own at least 80 per cent of the outstanding shares and thereby to engage in the activity of underwriting life insurance not sold in connection with a credit transaction by a bank holding company or a subsidiary.

In acting on the First Oklahoma application, the Board relied on an earlier decision denying an application by Transamerica Corporation, San Francisco, California, to retain its shares of Occidental Life Insurance Company of California (1957 FRB 1014). In the Transamerica case, a hearing examiner found that the life insurance underwriting activities of Occidental were not so closely related to banking to be a proper incident to managing and controlling banks. In the First Oklahoma case, the application was presented on the question of whether the activities of Underwriters Life were so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board determined in First Oklahoma, that there was no reasonable basis for the contention that the activities of Underwriters Life were permissible.

The activity of acting as an underwriter (reinsurer) for credit life and credit accident and health (disability) insurance is, however, considered a permissible activity (12 C.F.R. 225.135).

3700.2.3 SALE OF LEVEL-TERM LIFE INSURANCE

The Board has stated that the sale of level-term life insurance is not covered by section 225.25(b)(8)(ii) of Regulation Y. This position was stated in its order approving the application by Fidelity Corporation of Pennsylvania, Rosemount, Pennsylvania, to acquire Local Finance Corporation, Providence, Rhode Island, excepting those proposed activities of level-term life insurance sales (1973 FRB 472). Insurance that does not decline in coverage as the outstanding loan balance is reduced results in the insured party carrying more insurance than is necessary to cover the outstanding loan balance. Because of this position, the Board would not allow the sale of this type of insurance by the applicant and its subsidiary.

3700.2.4 UNDERWRITING REAL ESTATE MORTGAGE GUARANTEE INSURANCE

Mortgage guaranty insurance is essentially a limited guarantee of a mortgage loan. Such insurance typically covers the top 20 or 25 percent of a mortgage loan. In the event of default by the borrower, the lender acquires title to the property and then submits a claim to the insurer. The insurer then has a choice of two options: (1) take title to the property and pay the lender the unpaid principal and interest; or (2) pay the lender the 20 or 25 percent insured portion of the loan, with the lender retaining title to the property.

The Board has determined that "the underwriting of mortgage guarantee insurance is principally a credit determination, similar to those made by banks in their regular course of business" (1974 FRB 727). Therefore, this activity is considered closely related to banking for purposes of permissibility under section 4(c)(8) of the Act. However, the Board noted that the private mortgage insurance industry was relatively young and still developing with a limited, untested, operating history. In addition, the Board believed that the times were such that it was "desirable for bank holding companies generally to slow their present rate of expansion and direct their energies toward strong and efficient operations within their existing activities, rather than toward expansion into new activities" (the go-slow policy), and, therefore, concluded that it would not be appropriate to adopt the underwriting of mortgage guarantee insurance as permissible for bank holding companies.

3700.2.5 UNDERWRITING PROPERTY AND CASUALTY INSURANCE

On May 12, 1978, the Board denied NCNB Corporation's application to retain its indirect subsidiaries, Superior Insurance Company and Superior Claim Service, both of Florence, North Carolina. These companies engaged, respectively in the activities of underwriting property and casualty insurance related to extensions of credit by NCNB's affiliates, in adjusting insurance claims and in appraising and valuing property in connection therewith. Neither of these activities had previously been determined by the Board to be closely related to banking. The Board concluded that the circumstances presented did not provide a reasonable basis for believing that the proposed activity was closely related to banking or managing and controlling banks (1978 FRB 506).

3700.2.6 TITLE INSURANCE

The Board issued a letter (See Board letter re Independence Bancorp, Inc., dated 3/17/86) to a bank holding company which filed an application with the Board to acquire a *de novo* title abstract company which planned to engage in, among other things, the sale of title insurance. The sale of title insurance had not been previously approved by the Board as a permissible nonbanking activity. In responding to the application, the Board determined that the proposed title insurance activities were not closely related to banking.

The Board's discretion to decide what types of insurance activities are closely related to banking was removed by the Garn–St Germain Depository Institutions Act of 1982 ("Garn Act"), which amended section 4(c)(8) of the BHC Act. The Garn Act stated that "it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker. . . ." The Garn Act lists certain specific exceptions to this general prohibition, none of which permits the sale of title insurance. The Board thus concluded that the Garn Act does not allow it the discretion to approve this type of nonbanking activity.

3700.3.1 BROKERAGE

Real estate brokerage is the negotiating of a real estate contract between a buyer and seller for which the broker receives a fee or commission and in which the broker takes no possessory interest in the subject matter of the contract. The Board has stated that this activity is considered impermissible for bank holding companies. The Board's position was expressed in its order approving an application by Boatmen's Bancshares, Inc., St. Louis, Missouri, to acquire Williams, Kurrus and Company, St. Louis, Missouri (1972 FRB 428). The Board stated that it had determined that real estate brokerage activities were not so closely related to banking or managing or controlling banks as to be a proper incident thereto. Since Boatman's had not demonstrated to the Board's satisfaction that the real estate brokerage field activities are so closely related to banking or managing or controlling banks as to be a proper incident thereto, the Board approved the Boatman's application on the condition that Boatman's terminate its real estate brokerage activities.

3700.3.2 SYNDICATION

The Board ruled that this activity is not permissible for bank holding companies. The Board's position was developed during consideration of the application of BankAmerica Corporation, San Francisco, California, for prior Board approval to engage *de novo* under section 4(c)(8) of the Act in the activity of real estate syndication through a subsidiary, BankAmerica Realty Services, Inc., San Francisco, California. The Board concluded that the subsidiary's proposed activities of organizing, promoting, selling partnership interests, and acting as the sole general partner of real estate syndicates went beyond the functions performed by an advisory company to a real estate investment trust permissible under section 225.25(b)(4) of Regulation Y.

The Board also stated that it felt that the policies contained in sections 20 and 32 of the Banking Act of 1933 (the Glass–Steagall Act Provisions) must be considered in conjunction with section 4(c)(8) of the Act. These policies, described in the opinion of the United States Supreme Court in Investment Company Institute v. Camp, 401 U.S. 617 (1971), forbid a bank holding company to sponsor, organize or control an open-ended investment company (mutual fund) or a closed-end investment company primarily or frequently engaged in the issuance, sale and distribution of securities. Because the activities of real estate syndication resemble the issuance, sale and distribution of securities of a closed-end investment company, this activity is not permissible for a bank holding company (12 C.F.R. 225.125).

The Board has stated that general management consulting is not so closely related to banking or managing or controlling banks as to be a proper incident thereto. This ruling is contained in the Board's order denying the application of First Commerce Corporation, New Orleans, Louisiana, to acquire W. R. Smolkin & Associates, Inc., New Orleans, Louisiana. In its order the Board describes general management consulting as follows:

". . . including, but not limited to, the provision of analysis or advice as to a firm's (i) purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints; (ii) production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards; (iii) marketing operations, such as market testing, advertising programs, market development, packaging, and brand development; (iv) planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals; (v) personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations; (vi) internal operations, such as taxes, corporate organization, budgeting systems, budget control, data processing systems evaluation, and efficiency evaluation; or (vii) research operations, such as product development, basic research, and product design and innovation." (1972 FRB 674) The Board denied the case and determined that the activity of providing general management consulting services could lead to unwanted conflict of interest situations for BHCs that advised clients that were also customers of its own subsidiary banks. The Board also desired to maintain a distinct separation between banking and commerce.

In its order denying the application of Marine Midland Banks, Inc., Buffalo, New York, to acquire Carter H. Golembe Associates, Inc., Washington, D.C., the Board further defines the concept of management consulting by stating that Golembe, ". . . provides consulting services on a confidential basis to banks, bank holding companies and bankers' associations. It makes bank feasibility studies and renders advice with respect to geographic expansion, product extension, mergers and acquisitions and applications to State and federal regulatory agencies. A portion of Golembe's consulting services also relates to internal bank operations, such as marketing, trust and bank credit card operations and loan or interest rate policies. Other studies and analyses are performed upon request of individual banks. Golembe also provides advice with respect to the organization and operation of State Bankers' associations and serves as a consultant to various banking groups with respect to legislative and regulatory matters affecting the banking industry. The foregoing consulting services furnished by Golembe are considered by the Board to be but a specialized form of management consulting." (1972 FRB 676)

Management consulting to nonaffiliated commercial banks and nonbank depository institutions has been determined by the Board to be a permissible activity for bank holding companies under section 4(c)(8) of the Act (Regulation Y, section 225.25(b)11, as amended).

The Board has ruled that this activity is impermissible for bank holding companies. However, bank holding companies may conduct property management activities for three types of property as follows:

1. Property held in a fiduciary capacity;
2. Property owned by the holding company or its subsidiary for its own bank and bank-related operations;
3. Property acquired by the holding company or its subsidiary as a result of a default on a debt previously contracted.

The Board announced on June 30, 1972, that it would not include this general activity on the list of permissible activities. Because the Board did not intend to limit any authority given by statute or regulation to a holding company or its subsidiary concerning property management, the Board described in its order the three types of property, as shown above, for which a holding company or its subsidiary could engage in property management activities (1972 FRB 652).

In addition to the prohibition of property management activities in general, the Board has ruled that the operation of a commercial parking lot is impermissible. In its order approving the application by Multibank Financial Corporation, Boston, Massachusetts, to acquire the B. M. C. Durfee Trust Company, Fall River, Massachusetts, a commercial bank, the Board stated that operating a commercial parking lot was not considered closely related to banking and conditioned its approval on divestment of the parking lot operation (1973 FRB 679).

The Board through its rulemaking authority did not include operating a travel agency on the list of permissible activities for bank holding companies. This activity is considered not to be closely related to banking or managing or controlling banks (1976 FRB 148). The Board referenced a decision of the United States Court of Appeals for the District of Columbia, Courier Association vs. Board, 516 F. 2d 1229 (1975).

The Board felt the only relevant criteria for this activity was whether banks have generally provided the service. The Board noted that there were few bank-affiliated travel agencies, most of which had only been recently established. The Board concluded that operating a travel agency was not closely related to banking.

On June 1, 1978, the Comptroller of the Currency issued Banking Circular No. 108, which requested all national banks then operating travel agencies, to divest themselves of those agencies within a reasonable period of time not to exceed three years. The Comptroller's office concluded that the continued operation of a travel agency by a national bank is inappropriate and may expose the bank to a substantial risk of loss by litigation. This action by the Comptroller precludes bank holding companies from relying on section 4(c)(5) of the Act to conduct travel agencies. Thus, holding companies have no authority to engage in travel agency activities under the Act unless grandfathered.

On April 2, 1979, the Board issued a letter, a copy of which went directly to all bank holding companies engaging in the activity of operating a travel agency pursuant to section 4(c)(5) of the Act, indicating that no bank holding companies could engage in the activity solely pursuant to section 4(c)(5) and that those engaged in such activity had to terminate the activity by December 31, 1980 (Z–8421 on office copy only).

Subsequently, a bank holding company applied to the Board to acquire a company (''Company'') that engages in a variety of data processing and data transmission activities for customers. The Company's data bases that are provided to customers included a program by which customers could receive airline and hotel information and could make airline and hotel reservations. The Board determined that the receipt of such information and the ability to make airline and hotel reservations was not closely related to banking. Accordingly, the Board required, as a condition for approval of the application, the bank holding company to eliminate the travel reservation service from the roster of third party data base programs provided by Company (Refer to 1986 FRB 497).

As part of the Security Pacific Corporation's (bank holding company) application to acquire Duff & Phelps, Inc. (Company), which engaged in investment advisory, investment management, and financial advisory services, the Board, on December 11, 1984, denied the Applicant's request to engage in the activity of providing credit ratings on bonds, preferred stock and commercial paper. Private credit ratings were included as part of the investment research reports sold to institutional investors. The Company also provided credit ratings on a fee basis for companies that request public disclosure. As part of the public rating process, the rated company is given the opportunity to make a presentation to the Company's Credit Rating Committee.

In this situation, the Security Pacific Corporation had a vested interest in the ratings of the corporations to which it lends in the ratings of municipal bonds it underwrites, in the ratings of the commercial paper and municipal bonds for which it provides backup lines of credit, and in the ratings of fixed-income securities which it holds for trades. Numerous potential conflicts existed such as: possible inadvertent releases of confidential information obtained during the credit rating process; the advance release to the Applicant of credit ratings for companies to which the Applicant had very large loans outstanding; the potential for pressures by the Applicant on the Company to modify favorably the credit rating of one of the Applicant's major customers; and the subtle pressure on the Company's staff resulting from ownership by Applicant about companies in which the Applicant had a substantial interest. Similar conflicts could have also arisen between the Company's credit rating function and the Applicant's investment of trust assets.

The Applicant acknowledged the potential conflicts but argued that various steps could be taken to ameliorate them and bring them within a manageable framework. The Applicant therefore proposed a number of techniques for isolating the credit rating activities of the Company from influence by the Applicant, including the establishment of a separate corporation with a number of independent directors, a prohibition on contacts between the Applicant and the members of the Company's Credit Rating Committee, and also certain record keeping requirements for that committee.

The Board considered these positive suggestions as well as others to assure full disclosure of the relationships between the Applicant and any of the companies that would be rated by the Company as well as a prohibition on the Company rating the Applicant's securities, securities which the Applicant has underwritten, or securities for which the Applicant provided a guarantee or backup letter of credit. The Board, however, believed that the conflicts in the relationship between a major lender and a credit rating company were so pervasive that they could not be overcome through adoption of an information barrier. The employees of the Company would inevitably be aware of interests of the Applicant in firms being rated by them and, it seems reasonable to assume that this knowledge could, at times, influence their decisions.

The Board's concerns regarding conflicts of interest with respect to the credit rating activity were not based on any doubts regarding the integrity of the parties to the application, but rather were based on the Board's responsibility to assess the possible adverse effects that might be associated with an affiliation between a bank holding company and a public credit rating organization. Thus the Board was acting in furtherance of one of the general purposes of the Bank Holding Company Act, "to prevent possible future problems rather than to solve existing ones." The Board, in view of the pervasive conflicts of interest between the Applicant's existing operations and the Company's credit rating business, decided against approving the performance of public credit ratings.

Currency options are a new and innovative aspect of foreign exchange. A currency option represents the contractual right (but not the obligation) to purchase or sell a predetermined amount of currency at a specific price at any time before a specific date. Currency-options advocates argue that currency options eliminate the risk of a loss due to exchange movements and give the holder a chance to profit if the currency fluctuation is favorable. They require a premium to be paid when the contract is entered into. The premiums can run from about 1.5 percent to 5 percent, depending on the expiration date and the exercise price of the option.

Currency options are traded on two types of markets: the over-the-counter, or interbank market, and on three regulated exchanges, the Chicago Mercantile Exchange (CME), the Chicago Board Options Exchange (CBOE), and the Philadelphia Exchange (PHLX). The CBOE, a securities exchange, uses multiple "market makers" instead of specialist positions; the CME, a commodities exchange, like other commodities exchanges, does not use specialist positions.

Most of the writing of currency options is currently done by banks which will customize the option, with maturity dates and currency values in excess of the standardized exchange contracts. Banks developed the over-the-counter market where they trade currency options among themselves, and banks are also the largest customers on the exchanges where they hedge the risks associated with their foreign-exchange positions.

In general, the specialist system is unique to securities exchanges, and specialists exist for the purpose of achieving certain market results. Commodity exchanges do not use the services of specialists. The rules of the Securities and Exchange Commission permit the designation of specialists to "engage in a course of dealings for . . . their . . . own account to assist in the maintenance, so far as practicable, of a fair and orderly market . . ." provided that the securities exchanges adopt the following types of rules governing specialists: minimum capital requirements, rules to suspend or remove specialists if they fail to perform their designated market functions, rules restricting dealing activities to those reasonably necessary to permit the specialist to maintain a fair and orderly market or necessary to permit him or her to act as an odd-lot dealer, provisions governing his or her brokerage activities in specialist securities, and procedures to provide for the effective and systematic surveillance of the activities of specialists (17 C.F.R. 240.11(b)(1)). In addition, the IRS formerly granted special tax treatment to specialists transactions.

The rules of the PHLX require that odd-lot orders must be given to the specialist. The specialist functions as a broker with respect to certain transactions that cannot be executed by floor traders immediately, for example, stop-loss orders and limit orders. All such orders are given to the specialist for execution and become part of his "book"; PHLX rules address priority of orders (customers' orders receive priority) and conflicts of interest by governing specialists' trades and those of affiliated persons and firms in "securities" in which the person is designated as specialist.

There is one specialist position for each currency option traded on the PHLX, and the primary function of a specialist is to act as market maker, as necessary, for its assigned currency option. The specialist thus undertakes all activity, including dealing for its own account, to the extent necessary, as required to maintain a fair and orderly market in options on a particular currency. In essence, the specialist makes a continuous two-sided market in the assigned currency option when market forces do not.

Although currency options are functionally equivalent to other instruments which banks regularly deal in for their own account, the applicant's proposed activities were not considered as closely related to banking. The applicant's analysis did not focus on the critical components of the proposed specialist activities, which are distinct from the foreign-exchange brokerage and dealing activities generally conducted by banks. Because the proposed specialist activities are to be carried out in the context of market making on a regulated exchange, they were significantly different from the foreign-exchange activities currently conducted by banks. When a bank engages in foreign-exchange trading, it does so to service the needs of its customers and to generate trading profits. However, unlike traditional foreign-exchange trading, bank customers are not serviced directly by a specialist. Instead, the exchange benefits from the specialist's efforts if markets are perceived to be deep and liquid. Depth and liquidity make the contracts viable and the exchange profitable, and do not directly benefit the bank's customers.

The applicant's original proposal implicitly acknowledged that banks have not traditionally been involved with trading on stock exchanges, and thus have not generally possessed the experience and expertise in trading, hedging, and managing aggregate exposure required for the successful operation of a specialist position. The applicants originally proposed to engage in the activities through a joint venture because they lacked the requisite trading expertise to profitably undertake the activity alone. In its discussion of the management of risk exposure of the specialist, the applicants originally stated, "The choice of the appropriate hedge to start with and the monitoring over the life of the option of that hedge are specialized and difficult tasks that require expertise and experience." Conducting exchange specialist activities requires the floor-trading experience and back-office capabilities of an experienced exchange member.

As of December 1984, only one commercial bank, Bank of America, acted as a specialist in exchange-traded currency options. In January 1984, the Office of the Comptroller of the Currency granted permission for Bank of America to act as the specialist in PHLX-traded options on the Deutschemark through a joint venture subsidiary with Tague Securities Corporation. The Board, however, was not bound to a determination that specialist activities were closely related to banking simply because one bank engages in the activity. Bank of America apparently considered it necessary to conduct its specialist activity through a joint venture with a securities firm, which reinforced the view that the activity requires experience and expertise not generally possessed by banks.

Given the applicant's acknowledgment of the importance of floor-trading expertise and experience to the specialist function, and the substantive absence of bank involvement in such an activity, the Board concluded that the proposed activities were not closely related to banking and thus denied the applicant's request.

A bank holding company applied to acquire all the voting shares of a company ("Company") that engages in a variety of data processing and data transmission activities for customers such as securities and commodities exchanges, brokerage firms, commercial banks, savings and loan associations, insurance companies, and investment managers. In addition to engaging in other nonbanking activities, the company designs and assembles the hardware that is used in connection with the services it provides. The Board had not previously considered whether the assembly of hardware designed for the processing and transmission of banking, financial and economic data is closely related to banking or permissible as an incidental activity.

The bank holding company stated that Company's assembly of hardware was incidental to its provision of data processing services because such assembly was necessary to assure the availability, reliability, and quality of components used by Company, and that stock quotation firms like Company could only assure such product characteristics by the design and assembly of the hardware that provides the quotation information. In support of the argument, the bank holding company asserted that competitors of Company also design and assemble the hardware that provides the Company service.

In view of the fact that finished hardware of the type provided by Company is available, and, in fact, is marketed by companies providing services similar to Company, the Board found that the continuation of Company's design and assembly of hardware activities could not be considered "necessary" to the Company's provision of its permissible data processing services, and thus could not be considered incidental to Company's provision of permissible services. As a condition for approval of the bank holding company's application to acquire all of the voting shares of Company, the Board required the bank holding company to divest of Company's hardware assembly activities within two years of the acquisition (Refer to 1986 FRB 497).

In 1971 and again in 1984, the Board issued for public comment proposals to expand the activities permissible to bank holding companies under section 4(c)(8). Included in those proposals was the provision of armored car services. The proposals would have authorized bank holding companies to provide fully insured transportation of cash, securities, and valuables (primarily between commercial customers and financial institutions) and such ancillary services as coin wrapping, change delivery, mail delivery, payroll-check cashing, servicing of automatic teller machines, and leasing safes to commercial customers.

In response to both the 1971 and 1984 proposals, the Board received various comments against adding this activity to the Regulation Y list of permissible nonbanking activities, primarily from armored car operators and their trade associations. The commenters maintained that the activity is not closely related to banking but, rather, is essentially a transportation activity requiring no banking expertise.

In view of the issues raised by the comments on this activity and the minimal interest by bank holding companies, the Board decided not to add the activity to the Regulation Y list of permissible activities. However, the Board stated it would consider individual applications for this activity (1973 FRB 898); 51 *Federal Register* 39,999 (1986). The Board expressed no opinion as to whether the activity would meet the *National Courier* test and would be a proper incident to banking.

In 1988, a bank holding company (the applicant) filed an application to engage in armored car activities through a de novo nonbank subsidiary. After notice of the application was published, the Board received comments opposing the proposal and was requested to order a formal hearing. In response, the Board published an order requiring a formal public administrative hearing on the application. One issue, among others, that the Board directed to be considered was whether the proposed armored car services were "so closely related to banking or managing or controlling banks as to be a proper incident thereto" under section 4(c)(8) of the BHC Act.

An administrative hearing was held on June 16 and July 11, 1989, before an administrative law judge (ALJ). The ALJ issued a recommended decision in which he concluded that the proposed armored car activities were not "closely related to banking" and recommended that the Board deny the application. The ALJ found that none of the *National Courier* criteria were demonstrated by the record. The ALJ's conclusion relied on certain operational distinctions between the proposed armored car services and the services banks traditionally perform themselves.

Following receipt of exceptions to the recommended decision, the Board reviewed the entire record of the proceedings and determined that the ALJ had erred in concluding that armored car services were not "closely related to banking." The Board concluded that, even accepting the factual findings, the slight operational distinctions cited in the recommended decision were not significant. The Board found that although there may be some distinctions between bank-provided armored car services and the proposed full-service, for-hire armored car service, the nature of the customers served and the economic basis of the services provided do not fundamentally alter the nature of the services. It was therefore clear to the Board that the services then provided by the applicant as well as other banks and bank holding companies to themselves and their customers are sufficiently "operationally and functionally similar" to the proposed service as to equip banking organizations particularly well to perform the proposed service, and hence fulfill the second *National Courier* test.

The Board also noted that bank holding companies are permitted to provide courier services for unaffiliated parties under section 225.25(b)(10) of Regulation Y. The only essential difference between the two services relates to the intrinsic value of the materials transported. The Board concluded that the services themselves were certainly functionally and operationally similar, thereby lending additional support to its favorable finding under the second *National Courier* test.

The Board also found that the third *National Courier* test was met, that the applicant had demonstrated "the dependence of banks on a specialized form of the proposed services." The Board found that the record amply demonstrated that banks are highly dependent upon the specialized transportation services provided by armored cars, which transport cash and valuables with a high degree of security. The applicant was proposing to engage in just those specialized services; it did not propose to start a general moving or trucking service. The record therefore supported a determination that the third *National Courier* test was also satisfied. Accordingly, the Board found, based on the record before it, that providing for-hire armored car services to the general public was an activity that is closely related to banking.

This determination, however, is only one of two steps needed for the Board to approve a nonbank activity for a bank holding company. The Board must also find that the activity is a "proper incident thereto." On this issue, the ALJ declined to make any factual or legal determinations concerning the proper-incident test or state branching laws. However, under the Board's rules (12 C.F.R. 262.4 (1990)), the ALJ was required to provide a recommended decision with regard to *all* unresolved issues prior to a final Board determination (12 C.F.R. 263.11). A final disposition on the application therefore was not possible at that juncture, and the Board remanded the case to the ALJ for a recommended decision on the proper-incident standard and other unresolved issues (see 1990 FRB 676).

In accordance with the Board's remand order, a second formal hearing was held before the ALJ. Additional evidence and post-hearing briefs were submitted, including evidence on the proper-incident test, in support of this and other unresolved issues. The ALJ then issued his supplemental decision, which again recommended denial of the application. The ALJ found that, in this case, the applicant's record failed to provide a definitive proposal on which the Board could make a determination under the proper-incident test. The ALJ found that the applicant had offered only a skeletal structure and operation plan that was fleshed out only to a limited extent at the hearings. In addition, the ALJ found the application and other facts of record to be deficient with regard to possible public benefits and adverse effects. The ALJ further determined that the record had not shown that the proposed activity, as structured, would be lawful under the branch-banking laws of the states in which the applicant proposed to operate.

Based on its review of the ALJ's supplemental decision and the remainder of the record, the Board determined that the record failed to support a finding that the proposed armored car activities, in this particular instance, would be a "proper incident" to banking. The Board therefore adopted the ALJ's recommendation to deny the application, but only on the narrow grounds of inconsistency of the proposal, as then structured, with section 23B of the Federal Reserve Act.

In its order, the Board stressed that the burden of proof is upon an applicant to establish that the nonbanking activity it proposes to conduct—in this case the provision of armored car services—is *not only* closely related to banking, *but also* a "proper incident thereto." The Board's review of the entire proceeding disclosed certain aspects of the application that appeared on its face to violate the arm's-length transaction requirement of section FRA 23B. In the Board's view, a proposal to engage in nonbanking activities pursuant to section 4(c)(8) will not produce net benefits to the public, as required under the public-benefit test, if it violates the kind of statutory requirement, such as section 23B, that was specifically intended to prevent unsafe or unsound banking practices when a bank affiliate engages in nonbanking activities.

The first potential violation would arise from the fact that the proposed service by the bank holding company's nonbank subsidiary to its bank affiliate would cost more than the bank was paying for similar armored car services provided by an unaffiliated provider. The Board noted that although there may be a justification for the higher pricing structure that would meet the standards set forth in section 23B, no justification appeared in the record. The Board could therefore only conclude that the bank may not be obtaining services from the nonbank provider "on terms . . . at least as favorable to such bank . . . as those prevailing for comparable transactions with or involving other nonaffiliated companies," as required by section 23B.

The second potential violation of section 23B arose from the absence of a "precise breakdown of the services the nonbank subsidiary will purchase from the bank holding company's subsidiary bank and the projected cost of those services," as called for in the Board's prior order in this matter. The applicant provided no detailed cost figures for the wide variety of services the applicant's banking subsidiary was to provide to the nonbank subsidiary. The bank holding company proposed to charge the bank subsidiary an "estimated" percentage (the fee was admitted to have had no "factual basis" reflected in the record) of the nonbank subsidiary's direct operating expenses to cover all of the services provided by the bank holding company's banking subsidiary to its nonbanking subsidiary. Under section 23B, the provision of services by a bank to an affiliate must be paid for on an arm's-length basis. This requires, where there are no comparable transactions between a bank and a nonaffiliate, that the bank's provision of services to its affiliate be on terms that in good faith would be offered to, or would apply to, nonaffiliated companies. The Board found that the banking subsidiary would not in good faith have provided back-office services to an unaffiliated armored car company by charging a flat fee that had no factual basis and without determining the relationship of the fee to the actual costs of providing the services. Therefore, the potential violations of section 23B, on their face, constrained the Board to deny the application as it was structured (see 1993 FRB 352).

The Board noted its denial did not affect the Board's prior ruling in the case that armored car services are closely related to banking, and was without prejudice to the filing of a new proposal from which a favorable proper-incident finding could be made.

Impermissible Activities (Computer Output Microfilm Service) Section 3700.11

The authority of bank holding companies under section 225.25(b) of the Board's Regulation Y to engage in data processing activities is intended to limit those activities to providing facilities that perform banking functions, such as check collection, or other similar functions for customers that are depository or other similar institutions, such as mortgage companies. With respect to this activity, the Board issued an interpretation that authorizes bank holding companies to provide the formatting for computer output microfilm only as an output option for data otherwise permissibly processed by the holding company system (1982 FRB 552).

A foreign banking organization subject to the BHC Act applied for the Board's approval under section 4(c)(8) to engage *de novo* through its subsidiary (Company), in the exchange and clearance of: (1) exchange traded securities options and other securities and (2) futures and options on futures that relate to financial instruments. The proposed customer base was comprised primarily of market makers and other professional floor traders dealing for their own accounts. Most of the professional traders were expected to be market makers and specialists, including individuals, small partnerships, or small corporations, that were to trade primarily on the Chicago Board of Options Exchange (CBOE).[1]

Previously, the Board approved the execution and clearance of financial instruments as a permissible nonbanking activity.[2] Under Board precedent, the nonbanking subsidiary engaged in such services has generally serviced a broad range of retail and/or institutional customers. Under this proposal, Company was to clear trades for a specialized customer base comprised primarily of professional floor traders that executed trades for their own accounts.

Nonbanking subsidiaries of BHCs, operating in accordance with prior Board approvals, have generally performed both execution and clearance services. By performing both services, the nonbank subsidiary is able to control risk because it executes the majority of the transactions that it clears. The nonbank subsidiary can refuse to execute an order that it deems inappropriate or it can require additional funds or collateral from the customer *in advance of* and as a condition to executing the transaction.

Unlike prior Board cases, Company plans to provide primarily clearing services. As a clearing agent, it would guarantee the financial performance of its customers to the clearing organization of the exchanges on which it operates.[3]

After the start of trading on any day, Company would be obligated to settle each trade entered into by its customers even when the customer may not have the financial resources to honor its obligation. Since the trades have already been executed by the time that they would be presented to Company by these professional floor traders, Company would be unable to decline transactions that posed unacceptable risk. On an intraday basis, professional traders, who are not employees of Company and who trade in relatively volatile instruments, could expose Company to financial risks beyond the trader's capacity to repay and beyond Company's own resources.

The applicants proposed to limit the risk exposure created by Company's activities through the establishment of risk guidelines and procedures that were intended to monitor the intraday trading activities of its floor traders. No such system had been developed for the industry for monitoring the intraday activities of floor traders on a real-time basis. Most of Company's traders would primarily operate on exchanges that used an open outcry system rather than an electronic trading system. As a result, Company may not know its real-time committed positions until the end of the trading day and therefore the possibility existed that a floor trader could exceed Company's risk limits and incur substantial losses before Company could act to mitigate its credit risk exposure. Professional floor traders generally operate with much higher levels of leverage than the average brokerage customer of a securities firm. Since most of Company's customers were to be market makers, such traders could at times take positions contrary to the market.

1. Market makers on the CBOE are floor traders that perform a dealer function by trading for their own accounts, at their own risk, and for their own profit. Market makers compete with other market makers assigned to the same class of options. In contrast, floor brokers on the CBOE generally act only as an agent, executing customer and firm proprietary orders.

2. Refer to sections 225.25(b)(3) (trust companies engaging in agency activities related to the clearing of securities); 225.25(b)(15) (securities brokerage activities); 225.25(b)(18) (execution and clearance of futures and options on futures) of the Board's Regulation Y.

3. With this arrangement clearing firms may also be liable for the obligations of other members of the exchange. Generally, losses of a failed member firm are covered in the following order:

1. by the assets of the failed firm;
2. by the excess capital of the clearing organization;
3. by the guarantee fund of the clearing organization; and
4. by direct assessments made on surviving member firms.

Since member clearing firms are the ultimate source of capital for both the clearing association and the guarantee fund, the surviving firms will bear the ultimate burden of any loss.

Such circumstances potentially expose the clearing firms to substantial losses. If the clearing firm exhausts all or most of its capital in funding the obligations of floor traders that have lost substantial amounts of money in trading, parent companies of the clearing firm may have to cover the firm's remaining contingent liabilities. Such risks may be acceptable for some nonbanking institutions currently providing these services, but they may be inappropriate for U.S. domiciled banking organizations.

The Board carefully considered the benefits of the proposal, including the Applicants entry into a concentrated market, its experience with similar activities on foreign exchanges, and Company's proposed risk management systems. The Board concluded that the proposal, as it was currently structured (including the absence of an effective means to monitor and limit the potential credit risk exposure to the parent bank holding company) involved potential adverse effects that outweighed the potential public benefits. The Board thus determined that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act were not favorable. The application was denied by the Board on January 9, 1991 (1991 FRB 189).

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2015, footnote 1 is revised to indicate that SR-12-17/CA-12-14 supersedes SR-99-15. See section 2124.05 of this manual.

The Gramm-Leach-Bliley Act (the GLB Act) became effective on March 11, 2000. The GLB Act authorized affiliations among banks, securities firms, insurance firms, and other financial companies. To further this goal, the GLB Act amended section 4 of the BHC Act to allow a bank holding company (BHC) or foreign bank that qualifies as a financial holding company (FHC) to engage in a broad range of activities that (1) the GLB Act defines as financial in nature or incidental to a financial activity, or (2) the Board, in consultation with the Secretary of the Treasury, determines to be financial in nature or incidental to a financial activity. Furthermore, section 4 of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.

The GLB Act includes conditions that must be met for a BHC or a foreign bank to be deemed a "financial holding company" and engage in expanded activities. The GLB Act also allows an FHC to seek Board approval to engage in any activity that the Board determines (1) is complementary to a financial activity and (2) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that were permissible under section 4(c)(8) of the BHC Act before enactment of the GLB Act.

The GLB Act provides that, in most cases, an FHC may engage in or acquire the shares of a company that is engaged in financial activities without obtaining prior approval from the Board. An FHC is instead required to provide a *post-commencement* notice to the Board within 30 days after commencing a financial activity or acquiring a company. See section 4(k) of the BHC Act. Prior approval from the Board is required to acquire or engage in the activities of a savings association.

3900.0.1 FHC SUPERVISORY OVERSIGHT AUTHORITY

Under the GLB Act, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs. The GLB Act sets forth parameters for operating relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. There should be minimal, if any, noticeable change in the well-established relationships between the Federal Reserve as BHC (including FHC) supervisor and the bank and thrift supervisors (federal and state). The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. See SR-00-13.

3900.0.2 ROLES OF SUPERVISORS

The Federal Reserve is responsible for the consolidated supervision of FHCs. In this regard, the Federal Reserve will assess the holding company on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its depository institution subsidiaries. The manner in which the Federal Reserve fulfills this role will likely evolve along with the activities and structure of FHCs, and it may differ depending on the mix of banking, securities, and insurance activities of an FHC.

Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). The GLB Act did not alter the role of the Federal Reserve, as holding company supervisor, vis-a-vis the primary supervisors of FHC-associated bank and thrift subsidiaries. Traditionally, the Federal Reserve has relied to the fullest extent possible on those supervisors.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are supervised by their appropriate functional regulators. Such functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

3900.0.3 FHC SUPERVISION OBJECTIVES

The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with those activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

Accordingly, the Federal Reserve will focus on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess the internal policies, reports, and procedures and the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

FHC supervision is not intended to impose bank-like supervision on FHCs, nor is it intended to duplicate or replace supervision by the primary bank, thrift, or functional regulators of FHC subsidiaries. Rather, FHC supervision seeks to protect the depository institution subsidiaries of increasingly complex organizations with significant interrelated activities and risks, while not imposing an unduly duplicative or onerous burden on the subsidiaries of the organization. Effective financial holding company supervision requires—

1. strong, cooperative relationships between the Federal Reserve and primary bank, thrift, and functional regulators and foreign supervisors (these relationships respect the individual statutory authorities and responsibilities of the respective supervisors, but also allow for enhanced information flows and coordination so that individual responsibilities can be carried out effectively without creating duplication or excessive burden);
2. substantial reliance by the Federal Reserve on reports filed with or prepared by bank, thrift, and functional regulators, as well as on publicly available information for both regulated and nonregulated subsidiaries; and
3. continued reliance on the risk-focused supervision and examination process and on market discipline.

3900.0.4 FHC SUPERVISION IN PRACTICE

The supervisory activities of the Federal Reserve fall into three broad categories: (1) information gathering, assessments, and supervisory cooperation; (2) ongoing supervision; and (3) promotion of sound practices and improved disclosure.

3900.0.4.1 Information Gathering, Assessments, and Supervisory Cooperation

To fulfill its GLB Act responsibilities, the Federal Reserve needs to interact closely and exchange information with the primary bank, thrift, and functional regulators. The Federal Reserve will foster strong relationships with senior management and the boards of directors of FHCs, and have access to timely information from FHCs. These relationships will need to include heads of significant business lines and key internal-audit, control, and risk-management officials in order to understand how risk-management and internal-control policies and procedures established at the consolidated level are being implemented and assessed. To achieve these objectives, Federal Reserve supervisory staff will take the following actions:

1. *Regularly assess an FHC's centralized risk-management and control processes.* Such assessments are necessary to understand an organization's overall risk profile, identify material contributions to core risks, and determine how such risks are being managed and controlled on a consolidated basis.
2. *Perform limited, targeted transaction testing.* The purpose of this transaction testing is to verify that the risk-management systems of the FHC are adequately and appropriately measuring and managing areas of risk for the organization, and to confirm that laws and regulations applicable to the FHC and within the jurisdiction of the Federal Reserve are being observed.
3. *Have periodic discussions with FHC senior management and boards of directors.* Such discussions will enable the Federal Reserve to build relationships with key personnel and to understand changing activities and the evolving risk profile of the consolidated organization. Periodic discussions also will provide a forum for supervisory staff to present any findings or concerns related to the activities of the group as a whole or to business lines that cut across legal entities.
4. *Have periodic discussions with key personnel.* Discussions will be held with the personnel responsible for corporate management and control functions, such as heads of business lines, risk management, internal audit, and internal control.

When performing the above tasks, Federal Reserve supervisory staff, to the extent possible, will coordinate their actions with those of the primary bank, thrift, and functional regulators of the FHC's subsidiaries. For example, to understand the risks and risk-management systems of an FHC at the consolidated level, the Federal Reserve will need information concerning assets or liabilities booked in significant bank, thrift, and functionally regulated subsidiaries within the FHC group. The primary bank, thrift, and functional regulators of such subsidiaries also may need information from the FHC to perform their respective statutory mandates. To assist in sharing needed information, Federal Reserve supervisory staff should do the following:

1. *Have periodic meetings with the primary bank, thrift, and functional regulators of an FHC's subsidiaries.* The purpose of these meetings is to develop an understanding of the risk profiles of the individual regulated legal entities and their relation to the FHC's overall risk profile. These meetings also should be used, when appropriate, to share information regarding supervisory plans and to coordinate supervisory activities and follow-up, as needed.
2. *Review the examination findings of primary bank, thrift, and functional regulators (and their self-regulatory organizations) together with other relevant information.* The purpose of this review is to develop a consolidated picture of the FHC's financial condition and risk profile, the effectiveness of risk-management and internal-control policies, and the implications for the affiliated depository institutions.
3. *Make available to primary bank, thrift, and functional regulators, to the extent permissible, pertinent information regarding the FHC.* Included is information on the financial condition, risk-management policies, and operations of an FHC that may have a material impact on individual regulated subsidiaries, as well as information concerning transactions or relationships between the regulated subsidiaries and other subsidiaries within the FHC group. This process will assist supervisors in performing their statutory and supervisory responsibilities over regulated subsidiaries.
4. *Participate in the sharing of information among international supervisors, consistent with applicable law.* The purpose of this exchange is to ensure that an FHC's global activities are supervised on a consolidated basis and to minimize material gaps in supervision.
5. *Review internal-audit and management reports and publicly available information (including market information on equity and debt prices of the consolidated organization), as well as reports and statistics collected by other regulators, including regulators of depository institution subsidiaries.* To limit regulatory burden, this information should be obtained, to the fullest extent possible, from (1) the parent organization; (2) primary bank, thrift, and functional regulators of the FHC's regulated subsidiaries; and (3) publicly available sources, such as externally audited financial statements.

3900.0.4.2 Ongoing Supervision

3900.0.4.2.1 FHC Structure, Management, and the Applications Process

The Federal Reserve is responsible for understanding the consolidated organization's legal, organizational, and risk-management structure; major business activities; and risk exposures and risk-management systems. The Federal Reserve needs to understand the nature and degree of involvement of the board of directors in overseeing their organization's risk-management and control process at the consolidated group level. The Federal Reserve, when considering any formal application, declaration, or notification at the FHC level, will coordinate, as appropriate, with primary bank, thrift, and functional regulators.

3900.0.4.2.2 Reporting and Examination

The Federal Reserve will rely, to the fullest extent possible, on reports that an FHC or its subsidiaries are required to file with federal or state authorities (or self-regulatory organizations) or on reports that are prepared by the federal or state authorities. The Federal Reserve will rely on routinely prepared management reports, publicly reported information, and externally audited financial statements. The Federal Reserve also will rely to the fullest extent possible on the examination of an FHC's bank and nonbank subsidiaries by their appropriate primary bank, thrift, and functional regulators (and their self-regulatory organizations).

If supervisory staff requires a specialized report from a functionally regulated subsidiary of an FHC, staff will first request it from the subsidiary's appropriate functional regulator. In the event that the report is not made available to the Federal Reserve, supervisory staff may obtain the report directly from the functionally regulated subsidiary if it is necessary to assess—

1. a material risk to the FHC or any of its depository institution subsidiaries;
2. compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the FHC or a subsidiary; or
3. the FHC's systems for monitoring and controlling financial and operational risks that may pose a safety-and-soundness threat to a depository institution subsidiary.

The Federal Reserve may examine a functionally regulated subsidiary under certain circumstances. Before examining a functionally regulated subsidiary, supervisory staff should first seek to obtain the necessary information from the appropriate functional regulator. If an examination is determined to be necessary, the Federal Reserve should coordinate its actions with the appropriate functional regulator. An examination may be conducted when the Federal Reserve has reasonable cause to believe (or reasonably determines) that—

1. the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution,
2. the examination is necessary to be adequately informed about the FHC's systems for monitoring and controlling the financial and operational risks that may pose a safety-and-soundness risk to a depository institution subsidiary; or
3. the subsidiary is not in compliance with any federal law that the Board has specific jurisdiction to enforce (and the Board cannot determine compliance by examining the FHC or its affiliated depository institutions).

The Federal Reserve, consistent with its current practice, will continue relying to the fullest extent possible on the work performed by bank, thrift, and functional regulators to validate that material risks are measured and managed adequately at the regulated subsidiary level. Where necessary and appropriate, and consistent with (1) through (3) immediately above, the Federal Reserve may conduct or participate in reviews at banks, thrifts, or functionally regulated subsidiaries to validate that risk-management and internal-control policies established at the consolidated level are being implemented effectively.

For an FHC subsidiary that is not supervised by a bank, thrift, or functional regulator, the Federal Reserve will obtain information from the subsidiary, as appropriate and necessary, to assess the financial condition of the FHC as a whole. In addition, the Federal Reserve will conduct examinations of such subsidiaries, if necessary, to be informed about (1) the nature of the subsidiary's operations and financial condition, (2) the subsidiary's financial and operational risks that may pose a threat to the safety and soundness of any depository institution subsidiary of the FHC, and (3) the systems for monitoring and controlling such risks. Under the GLB Act, the Federal Reserve may not examine any subsidiary of an FHC that is an investment company registered with the SEC and that is not itself a BHC.

3900.0.4.2.3 Capital Adequacy

The Federal Reserve is responsible for assessing consolidated capital adequacy for FHCs, with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization. Capital adequacy will be assessed in relation to the risk profile of the consolidated organization. The Federal Reserve will review the FHC's internal risk assessment and related capital-analysis process for determining the adequacy of its overall capital position. Such a review will include consideration of current and future economic conditions, business-development plans for the future, possible stress scenarios, and internal risk-control and audit procedures. As BHCs, FHCs are subject to the Federal Reserve's holding company capital guidelines, which set forth minimum capital ratios that serve as tripwires for additional supervisory scrutiny and corrective action. The Federal Reserve will review these requirements as they apply to FHCs and may, if warranted, adapt the manner in which they apply to FHCs that engage in a broad range of financial activities.

Although the Federal Reserve is responsible for assessing the consolidated capital adequacy of FHCs, the primary bank, thrift, or functional regulators of FHC subsidiaries will continue to set and enforce applicable capital requirements for the regulated entities within their jurisdiction. Under the GLB Act, the Federal Reserve may not establish separate capital adequacy requirements for an FHC subsidiary that is in compliance with the capital requirements of its functional regulator.

Consistent with current practice, the Federal Reserve will continue to place significant reliance on the primary bank, thrift, or functional regulator's analysis of the capital adequacy of a regulated subsidiary. That analysis will be a significant input in the Federal Reserve's assessment of an FHC's consolidated capital adequacy, especially when a securities broker-dealer or insurance company is a predominant part of an FHC.

Several issues become particularly important when assessing the consolidated capital adequacy of FHCs with functionally regulated subsidiaries. The capital adequacy requirements that have been established for banking, securities, and insurance entities by their respective regulators reflect varying definitions of the elements of capital and varying approaches to asset and liability valuations. Yet techniques for assessing capital adequacy must be able to identify situations such as double or multiple leverage or double-gearing. In such cases, the actual capital protection may be overstated.

3900.0.4.2.4 Intra-Group Exposures and Concentrations

Intra-group exposures, including servicing arrangements and risk concentrations, have the potential to threaten the condition of regulated entities. Intra-group exposures may be significant at large, complex FHCs, especially those that operate their businesses on global lines that cut across legal entities within the firm. The Federal Reserve's focus in this area is the potential impact of intra-group exposures and concentrations on insured depository institution subsidiaries of an FHC.

Risk concentrations can take many forms, including exposures to one or more counterparties or related entities, industry sectors, and geographic regions. For risk concentrations, the holding company supervisor is uniquely positioned to understand the combinations of exposures within an organization across all legal entities. This understanding is critical at the group level—risk concentrations that are prudent on a legal-entity basis may aggregate to an unsafe level for the consolidated organization. The Federal Reserve will monitor intra-group exposures and risk concentrations as follows:

1. The appropriate primary bank and thrift regulators will continue to monitor and enforce section 23A and 23B restrictions at the bank or thrift level. The Federal Reserve will focus on assessing whether the FHC monitors and ensures compliance with these statutory requirements. The Federal Reserve plans to begin collecting data from each depository institution subsidiary of BHCs, including FHCs, on their covered transactions with affiliates that are subject to sections 23A and 23B and will share that data with primary bank and thrift regulators.
2. Functional regulators will continue to monitor and enforce any intra-group exposure restrictions that may apply to the regulated entities under their jurisdictions.
3. The Federal Reserve will focus on understanding and monitoring related-party expo-

sures at the group level (including areas such as servicing agreements, derivatives exposures, and payments-system exposures). An important emphasis will be the extent to which risk management in a group's subsidiary depository instutions depends on transactions with affiliates.

4. The Federal Reserve will focus on management's effectiveness in monitoring and controlling intra-group exposures and risk concentrations. The Federal Reserve will consider how an organization's risk-management processes measure and manage group-wide risk concentrations.

3900.0.4.2.5 Enforcement Powers

The Federal Reserve is authorized generally to take enforcement action against FHCs and their nonbank subsidiaries. The primary bank and thrift supervisors have the authority to take enforcement action against the banks and thrifts under their respective jurisdictions. Under the GLB Act, the Federal Reserve may take enforcement action against a functionally regulated subsidiary of an FHC, but only when such action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk either to (1) the financial safety, soundness, or stability of an affiliated depository institution or (2) the domestic or international payments system. In such circumstances, the Federal Reserve may only take the action if it is not reasonably possible to protect effectively against the material risk through an action directed at or against an affiliated depository institution.

Under any circumstances, the Board may take enforcement action against a functionally regulated subsidiary to enforce compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the subsidiary. If the Federal Reserve believes that an enforcement action against a functionally regulated entity is necessary, the Federal Reserve will notify the entity's appropriate functional regulator and, whenever practical, will coordinate such an action with any action taken by the functional regulator. It is expected that the Federal Reserve will not take an enforcement action against a functionally regulated subsidiary (or a person associated with the subsidiary) if the problem involves factors and statutes that are the primary responsibility of the functional regulator.

Under the existing bank holding company framework, the Federal Reserve coordinates enforcement actions with the primary bank and thrift regulators, possibly with some adaptation of the action for the holding company context (such as limitations on parent company debt or dividends). The Federal Reserve will continue to coordinate enforcement actions with these regulators. Similarly, the Federal Reserve will coordinate with functional regulators when formulating and issuing enforcement actions that involve or may have an impact on functionally regulated subsidiaries.

3900.0.4.3 Promotion of Sound Practices and Improved Disclosure

The Federal Reserve can promote sound practices in a number of ways, such as by monitoring trends in risk exposures and risk-management practices across the FHC population through a combination of efforts, including—

1. regular discussions, centered on specific issues and emerging risks, with FHC management;
2. regular meetings with primary bank, thrift, and functional regulators to explore and discuss issues of mutual interest or concern;
3. interagency working groups or specialty teams to gain early insight into risks that cut across the various entities of a conglomerate or groups of conglomerates; and
4. industry conferences on relevant topics of interest.

These initiatives will contribute to the development of sound practices that the Federal Reserve and the primary bank, thrift, and functional regulators can communicate to the senior management and boards of directors of the FHCs, as well as to the senior management of their bank and nonbank subsidiaries.

Improved transparency and public disclosure can meaningfully supplement the efforts of supervisors to monitor the increasingly complex and global activities of diversified banking organizations. Consistent with sound accounting principles, practices, and depository institution safety-and-soundness practices, the Federal Reserve will participate in efforts to enhance disclosures that will illuminate group-wide activities, risk exposures, risk management, controls, and intra-group exposures.

3900.0.4.4 Supervisory Response to Challenges Posed by FHCs

The Federal Reserve's response to the supervisory challenges of FHCs has been in the context of the consolidated supervision of BHCs.[1] Examples include greater reliance on risk-focused supervision; strengthening relationships with senior management; improving coordination with other federal, state, and international regulatory and supervisory authorities; greater reliance on specialty teams, sound-practices papers, and public disclosures; and simplification of the applications process.

The more diversified FHCs present new supervisory challenges. To address these challenges, the Federal Reserve will continue to strengthen—

1. cooperative arrangements with bank and thrift regulators, the SEC, the CFTC, state insurance and securities regulators, and foreign supervisors;
2. relationships with the FHC management and personnel responsible for significant risk-management functions and, when necessary, the management of the organization's nonbank subsidiaries;
3. information flows that provide supervisors with relevant, up-to-date information without imposing an unwarranted burden on financial organizations;
4. techniques for evaluating capital adequacy for FHCs engaged in an expanded range of nonbank financial activities;
5. public disclosures and market discipline;
6. techniques for assessing the overall risk profile of FHCs and the implications for affiliated depository institutions; and
7. incentives for FHCs to continually review and improve their risk-management processes, internal controls, and audit practices.

The Federal Reserve is committed to working constructively and cooperatively with all regulators involved in overseeing the activities of FHCs and their bank and nonbank subsidiaries.

1. The Federal Reserve's framework for supervising large complex banking organizations (LCBOs) is described in SR-12-17/CA-12-14, "Consolidated Supervision for Large Financial Institutions." See section 2124.05.

To become a financial holding company (FHC), a domestic bank holding company (BHC) must file a written declaration with the appropriate Federal Reserve Bank. This declaration should contain the following information:

1. A statement that the BHC elects to be an FHC.
2. The name and head-office address of the company and each depository institution controlled by the company. For purposes of the election process for both domestic BHCs and foreign banks, the term "depository institution" here means any national bank, state-chartered bank, federal branch of a foreign bank, insured branch of a foreign bank, savings association, savings bank, and industrial bank. It also includes any trust company that engages in the business of receiving deposits other than trust funds. (See 12 U.S.C. 1813.) A depository institution does not have to have FDIC insurance.
3. A certification that all depository institutions controlled by the company are well capitalized as of the date the company files its declaration.
4. The capital ratios for all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act), as of the close of the previous quarter, for each depository institution controlled by the company on the date the company files its declaration.
5. A certification that all depository institutions controlled by the company are well managed as of the date the company files its declaration.

A depository institution is well managed if, at the most recent inspection or examination or subsequent review by its appropriate federal banking agency, the institution received (1) at least a satisfactory composite rating and (2) at least a satisfactory rating for management, if such a rating is given. In the case of a depository institution that has not received an inspection or examination rating, a depository institution is well managed if the Board has determined, after a review of the depository institution's managerial and other resources and after consulting with the depository institution's appropriate federal and state banking agency, that the institution is well managed. In addition, a depository institution that results from the merger of two or more depository institutions that are well managed will be considered to be well managed unless the Board determines otherwise after consulting with the appropriate federal banking agency for each depository institution involved in the merger.

A depository institution that results from the merger of a depository institution that is well managed with one or more depository institutions that are not well managed or that have not been examined will be considered to be well managed, if the Board determines that the resulting institution is well managed. The Board makes this determination after a review of the managerial and other resources of the resulting institution and after consulting with the appropriate federal and state banking agencies for the institutions involved in the merger, as applicable.

The Gramm-Leach-Bliley Act (the GLB Act) also requires that all the insured depository institutions controlled by the FHC at the time of the declaration must be rated satisfactory or better under the Community Reinvestment Act (CRA). When determining whether the insured depository institutions controlled by a BHC meet the CRA requirement, the Federal Reserve excludes an institution that was acquired during the 12 months preceding the date the company filed its declaration. To qualify for this exception, (1) the company must have submitted the depository institution's affirmative correction plan to the appropriate federal banking agency and (2) the agency must have accepted the plan.

A BHC must file its declaration to become an FHC with the appropriate responsible Reserve Bank. A BHC's election to become an FHC is effective on the thirty-first day after the date that a complete declaration was received, unless the Board notifies the company before that time that the election is ineffective. The Board or the appropriate Federal Reserve Bank also may notify a BHC in writing that its election to become an FHC is effective before the thirty-first day after the date that a complete declaration was filed.

When an FHC's declaration becomes effective, it may engage in the expanded financial activities available to such companies. If, however, the Board has timely notified a BHC that its declaration is ineffective, the BHC will not be considered an FHC and may not begin to engage in any expanded activities.

A company that is not a BHC may simultaneously submit an application under section 3(a)(1) of the Bank Holding Company Act (BHC

Act) to become a BHC and to request to become an FHC on consummation of that transaction. The company must (1) state that it seeks to become an FHC on consummation of its section 3 proposal to become a BHC and (2) certify that each depository institution that would be controlled by the company on consummation of the section 3 proposal will be both well capitalized and well managed on the date of consummation. To coordinate action on these two requests, the acceptance of the declaration as complete does not occur until the date the company lawfully consummates its section 3 proposal and becomes a BHC. A simultaneous declaration will not be effective if the Board notifies the company at any time before consummation that (1) any depository institution that would be controlled by the company on consummation will not be well capitalized and well managed or (2) any insured depository institution that would be controlled by the company on consummation has not achieved at least a satisfactory rating at its most recent CRA examination. An insured depository institution that is controlled or would be controlled by a company filing a simultaneous declaration and section 3(a)(1) application to become a BHC may not be excluded for the purposes of evaluating the CRA performance record under this provision or the general FHC certification requirements of section 225.82(d) of Regulation Y.

In most cases, an FHC may, without providing prior notice to or obtaining prior approval from the Board, conduct an activity that is financial in nature or incidental to a financial activity (a financial activity). (See section 225.85(a)(1) of Regulation Y.) An FHC may conduct a financial activity by engaging directly in the activity or by acquiring and retaining the shares of any company that is engaged exclusively in one or more financial activities. An FHC may conduct a financial activity at any location inside or outside of the United States, subject to the laws of the jurisdiction in which the activity is conducted. A company acquired or to be acquired by an FHC also may engage in other activities that are permissible for an FHC, in accordance with any applicable notice, approval, or other requirements.

An FHC may acquire more than 5 percent of the voting shares or control of a company that is not engaged exclusively in activities that are financial in nature, incidental to financial activities, or otherwise permissible for the acquiring FHC. (See section 225.85(a)(3) of Regulation Y.) To do so, the acquisition must meet three requirements:

1. The company to be acquired must be substantially engaged in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act. A company is considered to be substantially engaged in permissible activities if at least 85 percent of the company's consolidated total annual gross revenues is derived from and at least 85 percent of the company's consolidated total assets is attributable to the conduct of activities that are financial in nature, incidental to a financial activity, or otherwise permissible for an FHC under section 4(c) of the BHC Act. An FHC's management should consult with Board staff if they are uncertain whether a proposed acquisition meets this standard.
2. The FHC must comply with the notice requirements of section 225.87 of Regulation Y. The acquired company must conform, terminate, or divest, within two years of the date the FHC acquires shares or control of the company, all activities that are not financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act. Although an FHC may acquire any percentage of shares or control of a company engaged in limited impermissible activities, the FHC needs only to provide a post-transaction notice if such an acquisition results in control of the company.
3. After being acquired by an FHC, the company engaged in impermissible activities may not engage in or acquire a company engaged in any activity that is not permissible for the FHC.

Section 225.85(c) of Regulation Y identifies two circumstances in which Board approval is still required to engage in financial activities. First, prior approval in accordance with section 4(j) of the BHC Act and section 225.24 of Regulation Y is required to acquire more than 5 percent of the voting shares or control of a savings association or any company that owns, operates, or controls a savings association. Second, the Board may, in the exercise of its supervisory authority, require an FHC to provide it with prior notice or obtain prior Board approval if circumstances warrant. The GLB Act did not change in any way the requirement that a company receive prior Board approval under section 3 of the BHC Act before acquiring shares or control of a bank.

Section 225.87(a) of Regulation Y requires an FHC that commences an activity, or that acquires control or shares of a company engaged in an activity under section 225.86 of Regulation Y, to provide written notice to the appropriate Reserve Bank within 30 calendar days after commencing the activities or consummating the acquisition. The notice must be provided on the FR Y-10 form, obtained from the Board or any Reserve Bank. This requirement also applies to an activity that the FHC may engage in under section 4(c)(8) of the BHC Act that is incorporated under section 4(k) of the act.

There are two circumstances in which notice to the Board is not required to engage in an activity: (1) when an FHC acquires shares of a company without acquiring control of the company, or (2) when an FHC is engaged in securities underwriting, dealing, or market-making activities described in section 4(k)(4)(E), merchant banking investment activities conducted pursuant to section 4(k)(4)(H), or insurance company investment activities conducted pursuant to section 4(k)(4)(I) of the BHC Act, and has provided the System with the appropriate notice regarding the relevant activity. (See section 225.87(b) of Regulation Y.) Under these circumstances, the FHC must provide written notice to the Board within 30 days after acquiring, as part of a merchant banking activity under section 4(k)(4)(H) or an insurance company investment activity under section 4(k)(4)(I) of the BHC Act, more than 5 percent of any company at a cost that exceeds 5 percent of the FHC's tier 1 capital or $200 million, whichever is less.

3901.0.1 SUPERVISORY CONCERNS

In some instances, a U.S. BHC or a foreign bank may meet the statutory requirements to be an FHC, but its capital strength and managerial resources are less than satisfactory on a consolidated basis. In this situation, the Federal Reserve may have supervisory concerns about the consolidated entity although it technically qualifies as an FHC. The Federal Reserve may, in the exercise of its supervisory authority, restrict or limit the conduct of new activities or future acquisitions of an FHC, or take other appropriate action, if it finds that the FHC does not have the financial or managerial resources to conduct the activity or make the acquisition. This supervisory action could be based, for example, on a determination that the company does not have adequate capital or risk-management systems to conduct a specific activity in a safe and sound manner and may involve the issuance of cease-and-desist orders, the execution of written agreements, or other appropriate supervisory action.

3901.0.2 HOLDING COMPANY FAILS TO CONTINUE MEETING FHC CAPITAL AND MANAGEMENT REQUIREMENTS

If a domestic bank holding company has made an effective election to be an FHC, and the Board finds that any depository institution subsidiary owned or controlled by the company ceases to be well capitalized or well managed, the company must execute an agreement acceptable to the Federal Reserve Board to comply with all applicable capital and management requirements. This agreement should be executed within 45 days after the Board notifies the company that it is not in compliance with the applicable requirements for an FHC. (See section 225.83 of Regulation Y.)

At the request of the bank holding company, the Federal Reserve Board may extend the 45-day period. The request should state why an extension is necessary. The agreement must explain the specific actions that the bank holding company will take to correct all areas of noncompliance, provide a schedule for all such actions, and provide any other information the Board may require, and be acceptable to the Board.

During the period of noncompliance, the Federal Reserve Board may impose limitations or conditions on the activities of the company. In addition, the company must obtain the Board's approval before conducting any of the activities that are newly authorized for FHCs by the GLB Act. Section 225.83 of Regulation Y also sets forth the consequences of failing to correct the noncompliance within a period of 180 days. Such consequences may include divestiture of ownership or control of any depository institution the company owns or controls, or the cessation of the expanded activities permitted for FHCs.

3901.0.3 DEPOSITORY INSTITUTION SUBSIDIARY FAILS TO MAINTAIN A SATISFACTORY OR BETTER CRA RATING

The Federal Reserve Board prohibits an FHC from engaging in any additional activity[1] or acquiring control of a company engaged in any activity under section 4(k) and 4(n) of the BHC Act if any insured depository institution controlled by the FHC fails to maintain a satisfactory or better CRA rating.

1. With respect to engaging in any additional activities, see section 225.84 of Regulation Y for the exceptions.

3901.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1843			
Definition of an FHC		225.81	4-056	
Election to become an FHC		225.82	4-056.1	
Failure to meet applicable capital and management requirements		225.83	4-056.2	
Consequences of the failure to maintain at least a satisfactory CRA rating		225.84	4-056.3	
Notices or approvals for FHCs to engage in financial activities		225.85	4-056.4	
Activities permissible for FHCs		228.86	4-056.5	
Post-commencement notice for FHC to engage in a financial activity		225.87	4-056.6	
Board determination that an FHC activity is financial in nature or incidental thereto		225.88	4-056.7	
Board approval for an FHC to engage in an activity that is complementary to a financial activity		225.89	4-056.8	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

3903.0.1 FINANCIAL HOLDING COMPANY QUALIFICATION REQUIREMENTS FOR FOREIGN BANKS

A foreign bank that owns or controls a U.S. bank (and any company that controls the foreign bank) must comply with the same requirements as a domestic bank holding company (BHC) that elects to be treated as a financial holding company (FHC). Either entity is thus able to engage in authorized financial activities under the Gramm-Leach-Bliley Act (GLB Act). If a foreign bank does not own a subsidiary bank in the United States, but instead operates through a branch, agency, or commercial lending company located in the United States, the foreign bank (and any company that controls the foreign bank) is subject to the Bank Holding Company Act (BHC Act) as if the foreign bank or company were a BHC. Such foreign banks may, like U.S. BHCs, also elect to be treated as FHCs. Foreign banks electing to be treated as FHCs must meet ‘‘well-capitalized’’ and ‘‘well-managed’’ standards comparable to those that are applicable to U.S. depository institutions. Futher, any U.S. branches of the foreign bank that are FDIC-insured must be rated satisfactory or better under the Community Reinvestment Act (CRA).[1] (See section 225.90 of Regulation Y.)

To be treated as an FHC, a foreign bank (or a company that owns or controls a foreign bank) that operates in the United States only through U.S. branches, agencies, or commercial lending subsidiaries must file a written declaration with the appropriate Reserve Bank. This declaration must contain items 1 through 6 below. Foreign banks or companies that operate in the United States through U.S. branches, agencies, or commercial lending companies and through a U.S. subsidiary bank are not required to provide item 1, but they must provide the items domestic BHCs are to provide.

1. a statement that the foreign bank or company elects to be treated as an FHC
2. the risk-based capital ratios and the amounts of tier 1 capital and total assets of the foreign bank as of the close of the most recent quarter, and as of the close of the most recent audited reporting period
3. a certification that the foreign bank meets the standards to be well capitalized that are set out in section 225.90(b)(1)(i) and (ii) or section 225.90(b)(2) of Regulation Y, as of the date the foreign bank or company files its election
4. a certification that the foreign bank is well managed, as defined in section 225.90(c)(1) of Regulation Y, as of the date the foreign bank or company files its election
5. a certification that all U.S. depository institutions controlled by the foreign bank or company (including thrifts and nonbank trust companies) are well capitalized and well managed as of the date the foreign bank or company files its election
6. the capital ratios and all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act) for all U.S. depository institution subsidiaries of the foreign bank or company as of the end of the previous quarter

The well-capitalized and well-managed tests in items 2, 3, and 4 above apply to each foreign bank that has U.S. operations in the form of a branch, agency, or commercial lending company subsidiary that is part of a foreign banking organization seeking certification as an FHC.

For those foreign banks whose home-country supervisors have adopted risk-based capital standards consistent with the Basel Accord, their tier 1 and total risk-based capital ratios, as calculated under the home-country standard, must be at least 6 percent and 10 percent, respectively. The Board will determine the comparability of the foreign bank’s capital under the listed comparability factors in section 225.92(e) of Regulation Y. Among these factors are the composition of the foreign bank’s capital, accounting standards, long-term debt ratings, the ratio of tier 1 capital to total assets, reliance on government support to meet capital requirements, the foreign bank’s anti–money laundering procedures, whether the foreign bank is subject to comprehensive consolidated supervision, and other factors that may affect the analysis of capital and management.[2] For those foreign banks whose

1. Under the GLB Act, the capital and management standards the Board must apply to foreign banking organizations that elect to become FHCs should be comparable to the standards applied to domestic institutions, giving due regard to the principle of national treatment and equality of competitive opportunity.

2. The Board may consider whether the overall level of the foreign bank’s capital and other factors indicate that addi-

home-country supervisors have not adopted the Basel Accord and for any other foreign banking organizations that otherwise do not meet the capital standards noted above, the foreign bank may be considered well capitalized by obtaining from the Board a prior determination that its capital is otherwise comparable to the capital that would be required of a U.S. banking organization to become an FHC. The pre-clearance process provided by section 225.91(c) of Regulation Y can be used to obtain this determination.

A foreign bank will be considered well managed if—

1. the branches, agencies, and commercial lending subsidiaries of the foreign bank have received at least a satisfactory composite rating at their most recent examination;[3]
2. the home-country supervisor of the foreign bank consents to the foreign bank expanding its activities in the United States to include FHC activities;[4] and
3. the Board determines that the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC.

The Board believes that, as a general rule, the top tier foreign bank in a foreign banking group that requests an FHC determination should be subject to comprehensive consolidated supervision by the home-country supervisor.

As a general matter, a foreign bank will *not* be determined to be well capitalized and well managed when it is not subject to comprehensive consolidated supervision. When a foreign bank has not been determined by the Board to be subject to comprehensive consolidated supervision, and the Board has not deemed any other bank from the country where the foreign bank is chartered to be subject to comprehensive consolidated supervision, the foreign bank must use the pre-clearance process provided by section 225.91(c) of Regulation Y—even if it otherwise meets the objective screening criteria. The Board may review a foreign bank's home-country supervision through the pre-clearance process and make a comprehensive consolidated supervision determination in that context. The Board will try to make a determination on pre-clearance requests within 30 days of receipt.[5]

There may be limited situations when an exceptionally strong bank from a country that has not yet fully implemented comprehensive consolidated supervision should be considered for FHC status. Such a foreign bank can qualify for FHC status if (1) the home-country supervisor has made significant progress in adopting and implementing arrangements for the consolidated supervision of its banks, and (2) the foreign bank demonstrates significant financial strength, such as through high levels of capital or exceptional asset quality. The Board anticipates, however, that a foreign bank that is not subject to comprehensive consolidated supervision will be granted FHC status only in rare instances.

As in the case of domestic BHCs, each U.S. depository institution subsidiary of a foreign bank is required to meet all the well-capitalized and well-managed standards in order for the foreign bank or company to obtain FHC status in the same manner as required for U.S. BHCs. In addition, all the U.S. insured depository institutions controlled by the foreign bank or company must be rated satisfactory or better under the CRA. If the foreign bank operates a U.S. branch that is FDIC-insured, the branch must be rated satisfactory or better under the CRA.

tional analysis should be undertaken to assess comparability. The Board will not impose a specific standard for the foreign bank's ratio of tier 1 capital to total assets (the leverage ratio), but a foreign bank's leverage ratio may be among the factors taken into account in the comparability review.

3. The Federal Reserve's foreign bank examination process includes the assignment of a combined assessment (the combined ROCA rating) of a foreign banking organization's (FBO's) U.S. branch, agency, and commercial lending operations through the regular examination cycle. (See SR-00-14.) The combined ROCA rating will be factored into the FBO's overall combined U.S. operations rating, which will continue to be a single composite rating that reflects the U.S. supervisors' collective assessment of all operations (that is, banking and nonbanking) of the FBO in the United States. If a foreign bank wishes to obtain FHC status, but does not have the assignment of a combined U.S. banking assessment as part of the regular examination cycle, the foreign bank can contact its responsible Federal Reserve Bank or engage in the pre-clearance process. If a foreign banking group contains more than one foreign bank with U.S. banking offices, each such foreign bank in the group must have a satisfactory composite U.S. banking assessment in order for the foreign banking group or any of its subsidiaries to obtain FHC status.

4. The home-country supervisor should consider the FBO's consolidated capital and management before providing its consent to the expansion. If the home country has no formal consent process, the Board will consult with the supervisor to assure itself that the supervisor considers the capital and management of the bank to satisfy its home-country standards and that the supervisor has no objections to the expansion.

5. If the Board makes an affirmative comprehensive consolidated supervision determination through the FHC pre-clearance process, the determination will be relied on for the foreign bank to establish additional branches and agencies under the Foreign Bank Supervision Enhancement Act.

An election by a foreign bank or company to be treated as an FHC will become effective on the thirty-first day after the date that an election was received by the appropriate Reserve Bank, unless the Board notifies the foreign bank or company before that time that the election is ineffective or unless the period for the Board's determination is extended with the consent of the foreign bank or company making the election. The date the Federal Reserve Bank receives the declaration should be considered the first day of the 30-day review period. The Board or the Reserve Bank also may notify a foreign bank or company in writing that its election to become an FHC is effective before the thirty-first day after the election was filed. A foreign bank or company should file the declaration (or pre-clearance request) with the responsible Reserve Bank.

If the election is determined to be effective, the foreign bank or company may engage in the financial activities available to FHCs. The GLB Act requires that an FHC that engages in an activity, or that acquires control or shares of a company engaged in an activity, under section 4(k) of the BHC Act provide written notice to the appropriate Reserve Bank within 30 calendar days after commencing the activities or acquisition. The notice should describe the activity commenced or identify the name of the company acquired and describe its activities.

3903.0.2 FOREIGN BANK FAILS TO CONTINUE MEETING FHC CAPITAL AND MANAGEMENT REQUIREMENTS

If a foreign bank or company has made an effective election, and the Board finds that the foreign bank; any foreign bank that is controlled by the foreign bank and maintains a U.S. branch, agency, or commercial lending company; or any U.S. depository institution owned or controlled by the foreign bank or company ceases to be well capitalized or well managed, the foreign bank or company must execute an agreement acceptable to the Federal Reserve Board to comply with all applicable capital and management requirements. This agreement should be executed within 45 days after the Board notifies the foreign bank or company that it is not in compliance with the applicable requirements for an FHC. (See section 225.93 of Regulation Y.) At the request of the foreign bank or company, the Board may extend the 45-day period. (The request should state why an extension is necessary.) The agreement must explain the specific actions that the foreign bank or company will take to correct all areas of noncompliance, provide a schedule for all such actions, provide any other information the Board may require, and be acceptable to the Board. During the period of noncompliance, the Board also may impose limitations or conditions on the U.S. activities of the foreign bank or company. Section 225.93 of Regulation Y also sets forth the consequences of failing to correct the noncompliance within a period of 180 days. Such consequences may include termination of the foreign bank's U.S. branches and agencies and divestiture of its commercial lending company subsidiaries, or cessation of the expanded activities permitted for FHCs. The foreign bank may also choose to cease engaging in activities not permitted for a foreign bank under sections 2(h) and 4(c) of the BHC Act.

3903.0.3 INSURED BRANCH FAILS TO MAINTAIN A SATISFACTORY OR BETTER CRA RATING

When an insured branch of a foreign bank, or an insured depository institution controlled by a foreign bank, fails to maintain a satisfactory or better CRA rating, section 225.94 of Regulation Y applies the provisions of section 225.84 to the foreign bank and to any company that owns or controls the foreign bank. For these purposes, the insured branch is treated as an "insured depository institution." An FHC is thus prohibited by the Board from engaging in any additional activity or acquiring control of a company engaged in activities under section 4(k) or 4(n) of the BHC Act.(See section 225.84 of Regulation Y.)

3903.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1841(h) 1843(c)			
Election of a foreign bank to become an FHC		225.91	4-057.2	
How elections by foreign banks to be an FHC become effective		225.92	4-057.3	
Foreign bank fails to satisfy capital and management requirements		225.93	4-057.4	
Foreign branch fails to retain a satisfactory CRA rating		225.94 225.84	4-057.7 4-056.5	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section was revised to include the Board's September 7, 2007, determination, by order, at the FDIC's request, that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance; permissible for an FHC under section 4 (k) of the BHC Act, as amended by the Gramm-Leach-Bliley (GLB) Act (see 2007 FRB C133). (An applicant had filed an application with the FDIC for deposit insurance for a proposed de novo industrial loan company.) The Board determined the activities to be financial in nature under section 4(k) of the BHC Act and complementary to a financial activity. The Board's determination is conditioned and based on the limitations it placed on the activities in the aggregate (that is, the specified percentages of the applicants' consolidated total assets, consolidated total annual revenues, and total capital).

The section is also amended for the Board's approvals of FHC notices, under section 4 of the BHC Act, to provide energy management services under energy management agreements and also, energy tolling. On December 4, 2007, the Board determined, by order, that an FHC's provision of energy management services is complementary to the financial activities of engaging as principal in physical commodity derivatives and the providing of financial and investment advisory services for derivative transactions. (See 2008 FRB C20.) On March 27, 2008, the Board also determined, by order, that an FHC's providing energy tolling is complementary to the financial activity of engaging in commodity derivatives activities (see 2008 FRB 60).

The section has been revised to also delete a reference to an interim Board rule that is final. See 225.4(g) of Regulation Y (12 C.F.R. 225.4(g)). This rule pertains to nonbank activities involving the underwriting and dealing in, or making a market in, bank-ineligible securities under section 4(k)(4)(E) of the BHC Act.

3905.0.1 NONBANK ACTIVITY AUTHORIZATIONS FOR FHCS

The Gramm-Leach-Bliley Act (the GLB Act) amended the Bank Holding Company Act (the BHC Act) to allow a BHC or foreign bank that qualifies as a financial holding company (FHC) to engage in a broad range of activities that the GLB Act defines as "financial in nature." Section 4(k)(4)(A)–(E) of the BHC Act defines the following activities as financial in nature:

1. lending, exchanging, transferring, investing for others, or safeguarding money or securities
2. insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any state
3. providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940)
4. issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly
5. underwriting, dealing in, or making a market in securities

The Board had previously determined that some of these activities were impermissible for BHCs, such as acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, and issuing annuity products. Permissible insurance activities as principal include reinsuring insurance products.

An FHC acting under section 4(k)(4)(B) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8).

Providing claims-administration and risk-management services. Legal counsel representing an FHC sought an opinion as to whether an insurance agency owned by an FHC may engage in certain insurance claims activities, as described below, under section 4(k)(4)(B) of the BHC Act. In particular, it was asked whether such an insurance agency may engage in the following claims-administration activities in connection with its insurance sales activities: (1) collecting insurance premiums; (2) holding insurance premiums in trust; (3) establishing an insurance claims–paying account; (4) adjusting insurance claims (which would include obtaining facts about claims, investigating the veracity of claims, and estimating losses relating to claims);

(5) negotiating with insureds and their representatives concerning insurance claims; and (6) paying and settling insurance claims. A representation was made that insurance agents typically perform these claims-administration services for an insurance underwriter in connection with insurance policies sold by the agents on behalf of an insurance underwriter.

With respect to the insurance risk-management activities provided in connection with insurance sales activities, a legal opinion was requested as to whether an insurance agency or broker owned by an FHC could engage in the following activities: (1) assessing the risks of a client seeking insurance and identifying the client's exposures to loss; (2) designing programs, policies, and systems (such as workplace safety programs) to reduce the client's risks; (3) advising clients about risk-management alternatives to insurance (such as self-insurance, securitization, or derivatives); and (4) negotiating insurance coverages, deductibles, and premiums for an insurance client. It was represented that insurance agents and brokers provide these risk-management services to their customers in connection with the sale of insurance products, including, in particular, commercial property and casualty insurance, and other insurance activities. It also was understood that the proposed risk-management services would (1) be related to managing insurable risks, (2) be advisory in nature, and (3) not allow the risk manager to control or perform operations of its clients.

Board staff noted that most states require a person performing one or more of the insurance claims–administration services listed above to be licensed by, or registered with, the appropriate insurance authority of the state as an insurance company, an insurance agent, or a third-party administrator (TPA).[1] The legislative history of the GLB Act also suggests that the Congress believed that insurance-related claims-administration services are a necessary part of the insurance sales and underwriting activities authorized by section 4(k)(4)(B).[2]

State insurance laws generally do not require companies that provide insurance risk-management services to obtain a special insurance license. However, states generally do require a license of any person who negotiates insurance coverages, deductibles, and premiums for another.[3]

In a legal opinion dated July 10, 2002, Board staff opined that the specific insurance claims–administration services listed above are encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act and that the services may be conducted by an FHC when they are provided by an insurance agent or broker in connection with its other insurance sales activities. In addition, Board staff believes that the specific insurance risk-management services listed above are encompassed within section 4(k)(4)(B) insurance activities and that the services may be conducted by an FHC if they (1) are provided by an insurance agent or broker in connection with its other insurance sales activities, (2) involve managing insurable risks, (3) are advisory in nature, and (4) do not allow the FHC to control, or perform operations of, the person to whom the services are provided.[4]

Acting as a third-party administrator. Other legal counsel representing a BHC that had elected to become an FHC requested an opinion on whether acting as a TPA on behalf of an insurance company is an activity that is permissible for an FHC under the BHC Act. The BHC proposed to invest in a company that acts as a TPA for licensed insurance companies that underwrite and sell credit life insurance. A TPA provides one or more insurance companies with administrative and related services that support and assist the sale of insurance products by the

1. For example, the Model Third Party Administrator Statute adopted by the National Association of Insurance Commissioners (NAIC) requires a person who collects premiums or adjusts or settles claims for an insurer in connection with the sale of life or health insurance policies or annuities to register with the relevant state insurance authority as a TPA if the person is not already registered with the state as an insurance company, agent, or broker. See the NAIC Model Third Party Administrator Statute, sections 1.A and 11 (1996).

The NAIC's Model Managing General Agents Act also requires a person to register with the relevant state insurance authority if the person adjusts or pays claims for an insurer and engages in certain other activities on behalf of an insurer. See NAIC Model Managing General Agents Act, sections 2.C and 3 (1993).

2. See H.R. Rep. No. 106-74, part I, p. 122 (1999) ("Activities such as administering, marketing, advising or assisting with . . . claim administration or similar programs shall be deemed to be incidental to insurance activities as described in [section 4(k)(4)(B)].").

3. See NAIC Producer Licensing Model Act, sections 2.K and 3 (2000).

4. A BHC or an FHC may provide advice to customers concerning financial matters, including insurance, self-insurance, securitizations, and derivatives, under 12 C.F.R. 225.28(b)(6), and may provide management consulting advice to customers regarding nonfinancial equity matters, such as workplace safety, subject to Regulation Y's limits and restrictions. See 12 C.F.R. 225.28(b)(9) (management consulting activities permissible for all bank holding companies) and 225.86(b)(1) (management consulting activities permissible for all FHCs).

insurance company. A TPA may provide some or all of the following services to an insurance company: (1) assisting the insurance company in designing its insurance programs (which would include policy and certificate development and issuance); (2) determining whether a prospective insured meets the insurance company's established underwriting guidelines; (3) collecting and processing insurance premiums; (4) processing, adjudicating, and paying claims on behalf of the insurance company; (5) investing excess cash and maintaining bank accounts for the insurance company; (6) establishing risk reserves for the insurance company; (7) advising on, and arranging for, reinsurance or stop-loss insurance for the insurance company; (8) preparing and filing tax returns and regulatory reports for the insurance company and providing other related services designed to ensure that the insurance company remains properly licensed and in compliance with applicable government regulations; (9) providing accounting and recordkeeping services to the insurance company in connection with its insurance activities; and (10) providing insurance-product sales training to employees of the insurance company. It was represented that the BHC may engage in some, but not all, of the activities in its capacity as a TPA.

The Board's staff noted that the activities listed above are directly related to the provision and sale of insurance by a third-party insurance company and constitute an integral part of the regulated insurance activities of the third-party insurance company. Consequently, most states require a person performing one or more of these services for an insurance company to be licensed by, or registered with, the appropriate insurance authority of the state either as an insurance company or agent or as a TPA. In addition to the previously stated requirements, the Model Third Party Administrator Statute (Model TPA Statute) requires a person to register as a TPA if the person accepts insurance contracts for an insurer that meet the insurer's underwriting guidelines, assists an insurer in the overall planning and coordination of its insurance program, or collects premiums or adjusts claims for an insurer.[5]

In a legal opinion dated July 10, 2002, the Board staff opined that the above-listed services are encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act when provided to, or on behalf of, an insurance company in connection with the sale or underwriting of insurance. Staff concluded that an FHC could, under section 4(k)(4)(B) of the BHC Act, provide these services to a third-party insurance company.

Section 4(k)(4)(F) of the BHC Act also defines as ''financial in nature'' any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by a regulation or order that was in effect on November 12, 1999. Section 225.86(a)(1) of Regulation Y cross-references the long-standing ''laundry list'' of nonbanking activities (at section 225.28(b)) permissible by regulation for BHCs. Section 225.86(a)(2) lists nonbanking activities approved for BHCs by Board order as of November 12, 1999.[6] All activities an FHC may engage in pursuant to section 225.86(a) must be conducted subject to the terms and conditions in Regulation Y and the Board orders authorizing those activities.

Section 4(k)(4)(G) of the BHC Act also defines ''financial in nature'' as any activity (1) in which a BHC may engage outside the United States and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad.[7] Section 225.86(b) lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad. These activities are—

1. providing management consulting services, including services to any person with respect to nonfinancial matters, as long as the services are advisory and do not allow the FHC to control the person to whom the services are provided (these services go beyond the

5. See the NAIC Model TPA Statute, sections 1.A and 11 (1996). A person generally does not have to register as a TPA if the person is currently registered with the state as an insurer or as an insurance agent or broker. See Model TPA Statute, section 1.A.(3) and (4).

Similarly, the NAIC's Model Managing General Agents Act requires a person to register with the relevant state insurance authority if the person manages all or part of the business of an insurer or, subject to certain conditions, accepts or rejects policies for the insurer and either adjusts or pays claims for the insurer or negotiates reinsurance for the insurer. See the NAIC Model Managing General Agents Act, sections 2.C and 3 (1993).

6. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

7. See sections 211.8 and 211.10 of Regulation K (12 C.F.R. 211.8 and 211.10).

management consulting services that are allowed under section 225.28(b)(9) of Regulation Y and are incorporated by reference at section 225.86(a)(1));
2. operating a travel agency in connection with financial services offered by the FHC or others; and
3. organizing, sponsoring, and managing a mutual fund, as long as the fund does not exercise managerial control over the companies in which it invests and the FHC reduces its ownership, if any, of the fund to less than 25 percent of the equity of the fund within one year (or such longer time as the Board permits) after sponsoring the fund.

The activities that a BHC is authorized to engage in outside the United States under sections 211.8 and 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property).[8] The remaining activities authorized by section 4(k)(4) of the BHC Act are defined to be "financial in nature" under section 4(k)(4)(H) and (I). These are merchant banking activities conducted under section 4(k)(4)(H) through a securities affiliate or an affiliate thereof, or through an affiliate of an insurance company (as defined in section 4(k)(4)(I)(ii)) when the affiliate is registered under the Investment Advisers Act of 1940 and provides investment advice to an insurance company or is an affiliate of such a registered company. Under section 4(k)(4)(I), these merchant banking activities may be conducted by an insurance company. These activities must be conducted in accordance with the restrictions and limitations under subpart J of Regulation Y, sections 225.170 through 225.177.

Section 4(k)(1)(A) of the BHC Act also allows FHCs to engage in activities that the Board, in coordination with the Secretary of the Treasury, determines to be financial in nature or incidental to such financial activity (section 4(k)(2)(A)). Section 225.86(d) of Regulation Y lists only one activity, acting as a finder, that has been authorized under this provision. (See section 3910.0 of this manual.)

The Board, in consultation with the Secretary of the Treasury, authorizes an FHC to engage in activities by Board order that are determined and approved to be financial in nature or incidental to a financial activity (section 228.86(e)). Only one activity has been approved by Board order under 225.86(e) in consultation with the Secretary of the Treasury: the acquisition, management, and operation in the United Kingdom of certain defined-benefit pension plans that are established by nonaffiliated third parties. This order was approved by the Board on October 12, 2007. (See section 3912.0 of this manual.)

Section 4(k)(1)(B) of the BHC Act allows FHCs to seek Board approval to engage in any activity that the Board determines to be complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Also with regard to section 4(k)(1)(B) of the BHC Act that an activity is complementary to a financial activity, the Board determined on September 7, 2007, by order, at the FDIC's request, that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance. (See 2007 FRB C133). An applicant had filed an application with the FDIC for deposit insurance for a proposed de novo industrial loan company. The Board determined the disease management and mail-order pharmacy activities to be financial in nature under section 4(k) of the BHC Act and activities that are complementary to a financial activity. The Board conditioned its determination based on the limitations it placed on the activities in the aggregate (that is, the specified percentages of the applicants' consolidated total assets, consolidated total annual revenues, and total capital).

Also with regard to other activities that are deemed to be complementary to a financial activity, the Board approved, on December 4, 2007, an FHC's request to provide energy management services to owners of power generation facilities under energy management agreements. This is an activity that is complementary to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivatives transactions. (See 2008 FRB C20.) In addition, the Board, on March 27, 2008, determined that providing energy tolling services is complementary to the financial activity of engaging in

8. The Board also has approved, under section 4(c)(13) of the BHC Act, activities in individual orders. Section 4(k)(4)(G) of the BHC Act does not authorize an FHC to engage in activities that the Board has authorized a BHC to provide in individual orders.

commodity derivatives activities. (See 2008 FRB C60).

Previously, the Board had approved physical commodity trading in commodities that were CFTC-approved for trading on a U.S. futures exchange (unless specifically excluded by the Board) or that were specifically approved by the Board. With the Board's approval of its March 27, 2008, order (2008 FRB C60), the Board specifically approved physical commodity trading in commodities not CFTC-approved for trading on a U.S. futures exchange. The Board recognized that a market-maker may not seek CFTC approval for a particular commodity if there is already an established foreign trading market, which may deter a U.S. exchange from listing a product. A derivatives contract that is based on a commodity that trades on a non-U.S. exchange may be subject to a regulatory structure comparable to the one administered by the CFTC (trading on a non-U.S. exchange that may be sufficient to demonstrate that a market for the commodity in financially settled contracts exists, that the commodity is fungible, and that it has a reasonably liquid market). Within this order, the Board approved the FHC's request to take and make physical delivery of nickel, a metal that is traded on the London Metal Exchange. Within the same Board order, the Board recognized that many commodities for which derivatives contracts have not been approved for trading by the CFTC or that are not traded on a non-U.S. exchange but that trade on established alternative trading platforms may also be commodities that have viable markets with financially settled contracts on the commodities and that satisfy fungibility and liquidity concerns. Standards were established to receive Board approval to engage in physical commodity trading in non-CFTC-approved commodities traded on alternative trading platforms in the U.S. or on certain non-U.S. exchanges. The standards are consistent with the Board's existing limited physical commodity trading authority. (See section 3920.0 for more information on Board orders approving limited physical-commodity-trading activities that are complementary to a financial activity.)

Other permissible activities under section 4(k)(4)(E) of the BHC Act are underwriting and dealing in or making a market in securities without any limitation on revenues that can be derived from bank-ineligible securities. These activities must be conducted in accordance with applicable restrictions and limitations found in the BHC Act and any regulations or supervisory guidance adopted by the Board. The Board adopted a rule pertaining to these activities.[9] It imposed two restrictions on FHCs engaged in securities underwriting, dealing, or market-making activities. All intraday extensions of credit by a bank, thrift, or U.S. branch or agency of a foreign bank to an affiliated company engaged in these activities under section 4(k)(4)(E) must be on market terms consistent with section 23B of the Federal Reserve Act (FRA). In addition, a foreign bank that is an FHC must ensure that its U.S. branch or agency making a loan to, or purchasing securities as a principal or fiduciary from, such an affiliated company complies with sections 23A and 23B of the FRA as if the branch or agency were a member bank.

Section 4(k)(5) of the BHC Act requires the Board and the Secretary of the Treasury to define three categories of activities as financial in nature, as well as the extent to which these activities are financial in nature or incidental to a financial activity. These three categories encompass a wide range of activities:

1. lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities
2. providing any device or other instrumentality for transferring money or other financial assets
3. arranging, effecting, or facilitating financial transactions for the account of third parties

The above categories include activities in which FHCs and national banks and their financial subsidiaries are already permitted to engage. For example, the categories include safe deposit services, electronic funds transfer activities, credit and stored-value card activities, securities brokerage, and finder activities. The categories are intended to allow FHCs and financial subsidiaries to engage in activities that were not otherwise permitted for these companies. The procedure below allows an FHC or financial subsidiary to obtain a determination from the Board and the Secretary of the Treasury that an activity is financial in nature or incidental to a financial activity pursuant to section 4(k)(5).

An FHC's request for the Board to determine whether an activity falls within one of the three categories listed above must be in writing. The request must—

1. identify and define the activity for which the

9. See section 225.4(g) of Regulation Y.

determination is sought, specifically describing what the activity would be and how the activity would be conducted, and
2. provide information that supports the requested determination, including information on how the proposed activity falls into one of the three categories, as well as any other information the Board requires concerning the proposed activity.

In making its determination, the Board will take into account the same factors that it must consider when determining whether an activity is financial in nature or incidental to a financial activity. These factors include, among other things, changes in the marketplaces in which FHCs and banks compete, changes in technology for delivering financial services, and whether the activity is necessary or appropriate to allow FHCs and their affiliates, or banks and their subsidiaries, to compete effectively with any company seeking to provide financial services in the United States.

If an activity is listed in more than one provision of section 4 of the BHC Act, the FHC may choose to conduct the activity under any applicable provision. The FHC is subject only to the procedures and limitations that the chosen source of authority imposes on the activity.

3905.0.2 ACTIVITIES THAT ARE PERMISSIBLE FOR FHCs UNDER SECTION 225.86(a) OF REGULATION Y

Activities That Are Financial in Nature or That Are Incidental to a Financial Activity	*Manual Section 3600.*
1. Nonbanking activities listed in section 225.28(b) of Regulation Y that have been determined to be so closely related to banking as to be a proper incident thereto (see section 3000.0.2).	
2. Any nonbanking activity that the Board has determined by order (those in effect on November 12, 1999) to be so closely related to banking as to be a proper incident thereto. The activities are—	
a. providing administrative and other services to mutual funds;	27
b. owning shares of a securities exchange;	6
c. acting as a certification authority for digital signatures, and authenticating the identity of persons conducting financial and nonfinancial transactions (includes transactions abroad);	7
d. providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business;	29
e. check-cashing and wire-transmission services;[1]	
f. in connection with offering banking services, providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle-registration services, and selling public-transportation tickets and tokens; and	25
g. real estate title abstracting.	30

1. See 1990 FRB 860 and 1995 FRB 1130.

An FHC or other interested party may request that the Board, in consultation with the Secretary of the Treasury, determine that an additional activity is financial in nature or incidental to a financial activity. The written request should (1) identify and define the activity, specifically describing what the activity would involve and how the activity would be conducted; (2) explain in detail why the activity should be considered financial in nature or incidental to a financial activity; and (3) provide information supporting the request and any other information the Board requests concerning the proposed activity. (See section 225.88(b) of Regulation Y.)

An FHC may request an advisory opinion from the Board on whether a proposed specific activity falls within the scope of an activity already determined to be a financial activity and listed in section 225.86 of Regulation Y. The request must be in writing and provide (1) a detailed description of the activity, product, or service about which the company proposes to engage in or provide; (2) an explanation supporting an interpretation on the scope of the permissible financial activity; and (3) any other information the Board requests. (See section 225.88(e) of Regulation Y.)

An FHC may request approval to engage in an activity that is complementary to a financial activity. The written request must (1) identify the proposed complementary activity, specifically describing what the activity would involve and how it would be conducted; (2) identify the financial activity for which the proposed activity would be complementary and provide information to support a finding that the proposed activity should be considered complementary to the identified financial activity; (3) describe the scope and relative size of the proposed activity, as a percentage of projected FHC revenues and on the basis of assets associated with conducting the activity; (4) discuss the risks that conducting the proposed activity pose to the subsidiary depository institutions of the FHC and the financial system in general; (5) describe the potential adverse effects of conducting the activity and explain the proposed measures the FHC would take to address these potential effects; and (6) provide any other information the Board requests. (See section 225.89(a) of Regulation Y.)

3905.0.3 SECURITIES UNDERWRITING, DEALING, AND MARKET-MAKING ACTIVITIES

The GLB Act also authorizes securities underwriting, dealing, and market making without regard to whether such securities may be sold by a bank. This activity includes underwriting or distributing shares of open-end investment companies commonly referred to as mutual funds.

Securities underwriting activities conducted under section 4(k)(4)(E) of the BHC Act may be conducted without regard to the 25 percent revenue limitation that is applicable to section 20 nonbank subsidiaries of BHCs engaged in securities underwriting and dealing, as authorized by Board order under section 4(c)(8). In addition, dealing may be done without regard to the 5 percent limitation on ownership of voting securities.

The operating standards applicable to section 20 companies do not apply to FHCs that engage in securities underwriting, dealing, and market making under section 4(k)(4)(E) of the BHC Act, with two exceptions. First, intraday extensions of credit to a securities firm from an affiliated bank or thrift or U.S. branch or agency of a foreign bank must be on market terms consistent with section 23B of the FRA. Second, foreign banks that are FHCs or that are treated as FHCs are required to comply with the restrictions of sections 23A and 23B of the FRA with respect to lending and securities-purchase transactions between the U.S. branch or agency of a foreign bank and a U.S. securities affiliate. The operating standards and revenue limit continue to apply to BHCs that are not FHCs and to FHCs that continue to conduct securities activities pursuant to section 4(c)(8) of the BHC Act.

3905.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1843			
Activities permissible for an FHC		225.86	4-056.5	
Notice requirement for FHCs engaging in a financial activity		225.87	4-056.6	
Requests for Board to determine whether an activity is financial in nature or incidental to a financial activity		225.88	4-056.7	
Request to engage in an activity that is complementary to the financial activity of engaging as principal in BHC-permissible commodity derivatives		225.89	4-056.8	2003 FRB 508 2004 FRB 215 2004 FRB 511
Physical commodity trading in energy-related commodities (natural gas, crude oil, electricity, and emissions allowances) as a complement to a financial activity	1843(k)(1)(B)			2006 FRB C54 2006 FRB C57 2006 FRB C113
Disease management and mail-order pharmacy activities are complementary to the financial activity of underwriting and selling health insurance	1843(k)(1)(B)			2007 FRB C133
Providing energy management services is complementary to the financial activities of engaging as principal in commodity derivatives and providing derivatives investment advisory services	1843(k)(1)(B)			2008 FRB C20

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Providing energy tolling services as a complement to the financial activity of engaging in commodity derivatives activities	1843(k)(1)(B)			2008 FRB C60
Trading in commodities not approved by the CFTC for trading on a U.S. futures exchange (e.g., nickel on London Metal Exchange) or on certain non-U.S. exchanges				2008 FRB C60

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

In 2007, the Federal Deposit Insurance Corporation (FDIC) requested the Board to determine whether the disease management and mail-order pharmacy activities are permissible for a financial holding company (FHC) under the Bank Holding Company Act (BHC Act), as amended by the Gramm-Leach-Bliley Act (GLB Act). WP had filed an application with the FDIC to obtain deposit insurance for AFB, a proposed U.S.-based de novo industrial loan company (ILC).[1]

Section 4(k) (see 12 U.S.C. 1843(k)(4)) of the BHC Act permits a bank holding company (BHC) that qualifies to be an FHC to engage in a broad range of activities that are defined by statute to be financial in nature. The FDIC requested that the Board determine the permissibility of WP's disease management and mail-order pharmacy activities under the BHC Act, as amended by the GLB Act, in connection with the FDIC's moratorium then in place on actions on ILC applications by companies engaged in any nonbanking activity *not* permissible for an FHC.

WP is principally engaged in underwriting and selling health insurance and related activities. Underwriting and selling health insurance as principal, agent, or broker are activities deemed by Congress in the GLB Act to be financial in nature.[2] WP, through its regulated insurance company subsidiaries, provides health insurance. WP's insurance offerings include preferred provider, health maintenance, point of service, Medicare and Medicaid health plans; vision, dental, pharmacy benefit, life, disability, and long-term care insurance products; and consumer-directed, high-deductible, and limited-service health insurance products. WP also engages in a variety of related activities, including claims processing.

WP also provides disease management and mail-order pharmacy services through subsidiaries to persons who obtain health insurance from WP or another insurance company. Through its disease management services, WP provides insurance plan members with access to a variety of tools and resources designed to help them maintain healthy lifestyles and properly manage their medical conditions. These disease management services typically are provided by, or under the direction of, licensed health-care professionals (including doctors and nurses) employed by WP. WP's subsidiaries engage in providing mail-order pharmacy services, fill prescriptions for customers who have pharmacy benefit insurance coverage from WP or another insurance company, provide drug-related information to customers, and track potential issues with customer prescriptions, such as drug interactions. WP's mail-order pharmacy subsidiaries are state-licensed and employ state-licensed pharmacists.

WP's disease management and mail-order pharmacy activities are not within the scope of activities that the Board previously determined to be financial in nature, incidental to a financial activity, or complementary to a financial activity under the provisions of the BHC Act. The activities do not themselves involve providing insurance, are not regulated as insurance by state insurance authorities, and are not provided by an affiliate that is licensed as an insurance company or as an insurance agent or broker. Both activities involve the provision of health-care services that, while related to insurance underwriting activities, are themselves nonfinancial activities. The Board concluded, however, for the reasons set forth below, that there is a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLB Act.

WP's disease management and mail-order pharmacy services help employers that obtain health insurance from an insurance company to manage and reduce the risks and costs of providing health insurance to employees. In its submissions to the Board, WP provided data demonstrating that many of the largest health insurers in the U.S. provide these services to their own customers and those of other health insurance companies and that employer-customers of heath insurance companies often demand such services.

Based on the foregoing, the information provided by WP, and other facts of record, the Board concluded that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance. Section 4(k)(1)(B) of the BHC Act requires that the Board determine that any proposed complementary activity does not pose a substantial risk to the safety or soundness of depository institutions or the financial system

1. Under section 4(c)(2)(H) of the BHC Act, an exemption is provided from the definition of "bank" for ILCs. A BHC may own, control, or operate an ILC, provided that it is not a bank. Under section 225.28(b)(4) of the Board's Regulation Y, a BHC may acquire or retain an industrial bank to the extent authorized by state law.

2. See section 4(k)(4)(B) of the BHC Act (12 U.S.C. 1843(k)(4)(B)).

generally.[3] Moreover, the Board previously has stated that complementary activities should be limited in size and scope relative to the financial activities that they complement.[4] As a condition of its determination that the proposed activities are complementary to a financial activity, the Board required that these activities in the aggregate not account for more than 2 percent of WP's consolidated total assets or 5 percent of its consolidated total annual revenues. In addition, the total assets of WP's subsidiaries engaged in disease management or mail-order pharmacy activities in the aggregate could not exceed 5 percent of the total capital (calculated in accordance with applicable statutory accounting principles) of all regulated insurance company subsidiaries and health plans of WP. The Board also considered how WP managed and addressed the risks posed by the activities through insurance training and other measures. The Board also stated that any future extensions of credit by AFB to, or other covered transactions by AFB with, these or other affiliates, including any covered transaction with an unaffiliated person the proceeds of which are transferred to or used for the benefit of an affiliate, must comply with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.[5] For these reasons, the Board concluded that the proposed activities would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The Board approved the order on September 7, 2007 (The previous discussion is only a summary. See the full text of the Board order at 2007 FRB C133).

3. See section 4(k)(1)(B) of the BHC Act (12 U.S.C. 1843(k)(1)(B))

4. See 68 Federal Register 68493, 68497 (December 9, 2003).

5. See the Federal Reserve Act, sections 371c and 371c-1 (12 U.S.C. 371c, 371c-1) and 12 C.F.R. Part 223.

3907.0.1 MERCHANT BANKING INVESTMENT AUTHORITY

The Gramm-Leach-Bliley Act (GLB Act) and the Board's Regulation Y permit financial holding companies (FHCs) (but not bank holding companies (BHCs) generally) to make investments as part of a bona fide securities underwriting or merchant or investment banking activity.[1] These investments may be made in any type of ownership interest in any type of nonfinancial entity (portfolio company), and they may include any amount up to all of the ownership interests in the company. The investments that may be made are substantially broader in scope than the investment activities that are otherwise permissible for BHCs.

The authority section 4(k)(4)(H) of the Bank Holding Company Act (BHC Act) grants to FHCs to make merchant banking investments (MBIs) is an alternative to any other authority that the FHC may have to make investments in nonfinancial companies under other provisions of the BHC Act, except as specifically noted in the rule. For example, the rule's provisions do not apply to investments acquired as part of securities underwriting, dealing, or market-making activities conducted under section 4(k)(4)(E) of the BHC Act; investments made by insurance underwriting subsidiaries of an FHC in accordance with section 4(k)(4)(I) of the BHC Act; investments made under section 4(c)(6) or (7) of the BHC Act; or investments made overseas under the Board's Regulation K (12 C.F.R. 211).[2] As described below, the BHC Act allows an FHC to make MBIs if it controls a securities affiliate or controls both an insurance underwriter and a registered investment adviser. The GLB Act does contain certain limitations on MBIs made by FHCs, and it provides a framework for MBIs that is designed to help maintain the separation between banking and commerce to ensure the safety and soundness of depository institutions. All MBIs made by an FHC under section 4(k)(4)(H) must comply with the Board's rule.

1. Unless stated otherwise in this section, the ''merchant banking statutory provisions'' refer to section 4(k)(4)(H) of the Bank Holding Company Act, and references to the ''rule'' or ''regulatory provisions'' pertain to Regulation Y and are found in sections 225.170 through 225.177.

2. Although the rule does not apply to investments held under section 4(c)(6) or (7) of the BHC Act or the Board's Regulation K, those authorities are only available if the FHC's aggregate investment in the relevant company under a combination of authorities, including any investment made under the merchant banking authority, is within the applicable investment limitations and restrictions set forth in section 4(c)(6) or (7) or Regulation K.

3907.0.2 PERMITTED INVESTMENTS

Under section 4(k)(4)(H) of the BHC Act and the Board's rule, an FHC may acquire or control *any* amount of shares, assets, or a full range of ownership interests in a company or other entity that is engaged in an activity that is *not* financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4 of the BHC Act. The interests an FHC may acquire include securities, warrants, partnership interests, trust certificates, other instruments representing an ownership interest in a company, and instruments convertible into a security or other ownership interest whether the interest is voting or nonvoting. An FHC can acquire *any amount* of ownership interests in the company or other entity, whether or not that amount results in control for purposes of the BHC Act. An FHC must file a notice with the Board under section 4(k)(6) of the BHC Act and section 225.87 of Regulation Y (12 C.F.R. 225.87) within 30 days after commencing MBI activities or acquiring any company that makes MBIs.[3]

An FHC also can acquire and control ''assets'' other than debt or equity securities or other ownership interests of a company. For example, assets acquired as an MBI may include real estate or the assets of a division of an operating company. To be permissible, the assets must be acquired through or promptly transferred to a portfolio company that has and maintains a separate corporate existence, management, and operations to the extent required by the rule. (See section 225.170(e)(3) of Regulation Y.)

3907.0.2.1 Securities Affiliate

A BHC may make MBIs only if it becomes an FHC.[4] The FHC must either (1) control or be a ''securities affiliate'' or (2) control both an insurance underwriter affiliate and an invest-

3. See section 4(k)(6)(A) of the BHC Act (12 U.S.C. 1843(k)(6)(A)) and section 225.87(a) of Regulation Y (12 C.F.R. 225.87(a)).

4. The Board's Regulation Y sets forth the procedures and qualification criteria applicable to BHCs that seek to elect to become an FHC. See section 225.81 et seq. of Regulation Y (12 C.F.R. 225.81 et seq.).

ment adviser affiliate registered under the Investment Advisers Act of 1940 that provides investment advice to an insurance company. The GLB Act and the rule, however, do *not* require that the FHC make its MBIs *through* such a securities, insurance underwriting, or investment adviser affiliate. Instead, an FHC may make MBIs directly or through any affiliate other than a depository institution or a subsidiary of a depository institution.

The rule defines a "securities affiliate" to include any broker or dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). The definition also includes an SEC-registered municipal securities dealer, including a separately identifiable division or department of a bank that is registered as a municipal securities dealer under the Exchange Act. An FHC may make MBIs if the holding company is itself a registered securities broker or dealer.

3907.0.2.2 Investments in Companies Engaged in Nonfinancial Activities

An FHC is authorized under section 4(k)(4)(H) of the BHC Act to acquire or control a company or entity "engaged in any activity not authorized pursuant to [section 4 of the BHC Act]." An FHC may not make MBIs in financial companies under section 4(k)(4)(H) or the rule. FHCs have separate authority under other provisions of the BHC Act to make investments in companies engaged in financial activities. However, a company held as an MBI may be engaged in both nonfinancial and financial activities, and an FHC may retain an MBI in a nonfinancial company even if the company subsequently commences a financial activity. An FHC also is not prohibited from using a combination of authorities to invest, through the same subsidiary or fund, in ownership interests of both nonfinancial and financial companies.

Investments in financial companies are not authorized in section 4(k)(4)(H) of the BHC Act. The rule's restrictions, such as those for holding periods and cross-marketing, therefore do not apply to FHC investments in financial companies that are made under other provisions of the BHC Act and the Board's Regulation Y—even if such investments are made for strategic reasons or for reselling the investment. An FHC may not, however, use the merchant banking authority to evade restrictions, such as consent or approval requirements or restrictions that address conflicts of interest or that govern the acquisition of financial companies.[5] In addition, nothing in section 4(k)(4)(H) or the rule overrides the prior-approval requirements of section 3 of the BHC Act, which governs the acquisition of shares of a bank or BHC, or the provisions of section 4(k)(6) and (j) of the BHC Act, which governs the acquisition of shares of a savings association or a company that controls a savings association.

3907.0.2.3 Bona Fide Underwriting or Merchant Banking or Investment Activity

An FHC may only make MBIs as part of a bona fide underwriting or merchant banking or investment banking activity.[6] An FHC is not authorized to make an investment in a nonfinancial company for the purpose of engaging in the activities of the nonfinancial company, such as real estate investment or development or other activities that have not been found to be financial in nature. This "bona fide" requirement thus preserves the financial nature of MBI activities and the separation of banking from commerce.

The bona fide requirement does not prohibit an FHC from specializing in making MBIs in particular industries or from making its first MBI in a company engaged in real estate investment or development. However, such investments should be made only for investment as part of an ongoing underwriting or investment or merchant banking activity, and they should be held in accordance with the Board's rules.[7]

3907.0.2.3.1 Investments Made Directly or Through Funds

An FHC may acquire or control MBIs directly or through any subsidiary *other than* a depository institution or subsidiary of a depository institution. An FHC also may *not* acquire or control MBIs on behalf of a depository institution or subsidiary of a depository institution. A

5. See section 4(*l*)(2) of the BHC Act (12 U.S.C. 1843(*l*)(2)) and section 225.84 of Regulation Y (12 C.F.R. 225.84).

6. See section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)).

7. Concentration in particular industries or in individual investments may present supervisory concerns. The Board expects all FHCs that engage in MBI activities to establish policies governing portfolio diversification and to maintain capital that is adequate, considering the FHC's investment portfolio. See section 3900.0 of this manual and SR-00-9.

U.S. branch or agency of a foreign bank is considered a "depository institution" for purposes of the merchant banking rule and its related restrictions. Accordingly, a U.S. branch or agency of a foreign bank may not acquire or control MBIs, and MBIs may *not* be acquired or controlled on behalf of a U.S. branch or agency of a foreign bank.

An FHC is allowed to make MBIs through a private equity fund or other investment fund that, in turn, invests in nonfinancial companies. When an FHC makes such an investment, the holding company's investment in the fund is considered an MBI that must comply with the rule. Certain benefits for investments in or held through a qualifying private equity fund are provided, including an extended holding period and certain relief from the rule's cross-marketing restrictions. Investments in funds that do not qualify as private equity funds are treated as any other type of MBI.

3907.0.2.3.2 Definition of Portfolio Company and Financial Holding Company

Some of the rule's requirements—such as the restrictions on routine management and operation—apply only to portfolio companies. A "portfolio company" means any company or entity that is directly or indirectly held, owned, or controlled by an FHC that is using the merchant banking authority, and the company or entity is engaged in an activity that is not authorized for the FHC under section 4 of the BHC Act. (See section 225.177 of Regulation Y.)

The term "financial holding company," as used in the rule, refers to the FHC and any direct or indirect subsidiary of the holding company (including a private equity fund or other fund controlled by the FHC). The term does not include—

1. a portfolio company that is controlled by the FHC or
2. any depository institution controlled by the FHC or any subsidiary of such a depository institution, unless otherwise provided in the rule.

3907.0.3 LIMITS ON MANAGING OR OPERATING A PORTFOLIO COMPANY HELD AS A MERCHANT BANKING INVESTMENT

The GLB Act prohibits an FHC from routinely managing or operating a portfolio company, except as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. (See section 225.171 of Regulation Y.)

3907.0.3.1 Relationships That Involve Routine Management or Operation

An FHC routinely manages or operates a portfolio company if any director, officer, or employee of the FHC serves as or has the responsibilities of an executive officer of the portfolio company. The term "executive officer" has the same meaning as used in the Board's Regulation O. This definition includes any person who participates or has the authority to participate (other than in the capacity of a director) in major policymaking functions of the portfolio company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation.[8] (See section 225.177(d) of Regulation Y and 12 C.F.R. 215.2(e)(1).) An FHC is also considered to routinely manage or operate a portfolio company if an executive officer of the parent FHC or certain of its major subsidiaries serves as (or has the responsibilities of) an officer or employee of the portfolio company. For the purposes of these restrictions, an FHC's major subsidiaries include any subsidiary that is (1) a depository institution, (2) an SEC-registered broker-dealer, (3) engaged in MBI activities or insurance company investment activities under section 4(k)(4)(H) or (I) of the BHC Act, (4) a small business investment company, or (5) engaged in significant equity investment activities that are subject to a special capital charge under the Board's capital guidelines (for example, a company engaged in investment activities under section 4(c)(6) or (7) of the BHC Act). An FHC also is considered to routinely manage or operate a portfolio company if

8. An executive officer does not include a person who may exercise a certain measure of discretion in the performance of his or her duties, including the discretion to make decisions in the ordinary course of business, but who does not participate in the determination of major policies of the company and whose decisions are limited by policy standards fixed by senior management. In addition, the term does not include any person who is excluded from participating (other than in the capacity of a director) in major policymaking functions of the company by resolution of the board of directors or by the bylaws of the company, provided the person does not in fact participate in such policymaking functions.

it restricts, by covenants, agreements, or otherwise, the portfolio company's ability to make routine business decisions. Covenants or agreements that involve routine business decisions include covenants that restrict the portfolio company's ability to enter into transactions in the ordinary course of business or to hire nonexecutive officers or employees. As described below, an FHC may have covenants and agreements that restrict actions that are outside the ordinary course of business.

In addition, an FHC is presumed to be involved in the day-to-day management or operations of a portfolio company if a director, officer, or employee of the FHC serves as a nonexecutive officer or employee of the portfolio company or if an officer or employee of the portfolio company is supervised by or reports to an officer or employee of the FHC. An FHC may rebut this presumption by presenting specific facts demonstrating that the junior-officer or employee interlock with the portfolio company would not involve the investing FHC in the routine management and operating of the company.[9] Any request to rebut a presumption must be made to the Board and should fully describe all the facts and circumstances related to the FHC's investment in and relationships with the portfolio company.

3907.0.3.2 Relationships That Do Not Constitute Routine Management or Operation

The rule identifies several relationships that an FHC may have with a portfolio company that would *not* involve the FHC in routinely managing or operating the portfolio company.[10] The following relationships allow the FHC to monitor and provide strategic and financial advice to a portfolio company without becoming involved in the day-to-day management or operations of the company:

1. *Director interlocks.* An FHC may have one or more representatives on the board of directors of a portfolio company. The Board considers the selection of the partners (including the general partner) of a partnership to be the equivalent of selecting the directors of a company. An FHC representative who serves as a director of a portfolio company may participate fully in those matters that are typically presented to directors of a company, whether the director participates in these matters at a meeting of the board, at meetings of committees of the board, through written votes, through meetings with officers or employees of the portfolio company, or in other ways. The FHC's director representatives, however, may not participate in the day-to-day operations of the portfolio company or in management decisions that are made in the ordinary course of business and that are not customarily presented to the directors of a company. The portfolio company also must have officers and employees that routinely manage and operate the company, and the FHC must not have other arrangements or relationships with the portfolio company that would involve the FHC in the routine management or operation of the portfolio company.
2. *Covenants concerning actions outside the ordinary course of business.* An FHC may restrict, by covenant or otherwise, the ability of a portfolio company to take actions that are outside the ordinary course of business. Some examples of actions that are outside the ordinary course of business and that may be subject to these types of covenants or agreements are—
   a. the acquisition of significant assets or control of another company by the portfolio company or any of its subsidiaries;
   b. the removal or selection of the portfolio company's independent accountant or investment banker;
   c. significant changes to the portfolio company's business plan or accounting methods or policies;
   d. the removal or replacement of any or all of the executive officers of the portfolio company;
   e. the redemption, authorization, or issuance of any equity or debt securities of the portfolio company;
   f. any borrowing by the portfolio company that is outside the ordinary course of business;
   g. the amendment of the portfolio company's articles of incorporation, bylaws, or similar governing documents; and
   h. the sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution, or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

9. See section 225.171(c) of Regulation Y (12 C.F.R. 225.171(c)).
10. See section 225.171(d) of Regulation Y (12 C.F.R. 225.171(d)).

3. *Providing advisory and underwriting services to and consulting with a portfolio company.* An FHC also may provide financial, investment, or management consulting advisory services to the portfolio company in accordance with applicable limitations under Regulation Y.[11] Any management consulting services provided to a portfolio company must remain solely advisory, and the FHC may not assume responsibility for decision making or for the day-to-day management or operations of the portfolio company.[12] An FHC may also underwrite or act as placement agent for the securities of a portfolio company and provide assistance to the portfolio company in connection with the underwriting or placement of its securities without being considered to be involved in routinely managing or operating the company. An FHC also may have regular or periodic meetings with the officers or employees of a portfolio company to monitor and provide advice regarding the portfolio company's performance or activities, so long as the FHC, through such meetings or otherwise, does not routinely manage or operate the portfolio company.

3907.0.3.2.1 Other Permissible Covenants Not Involving the FHC in Routinely Managing and Operating a Portfolio Company

Listed below are some additional examples of covenants that an FHC may have with a portfolio company without routinely managing or operating the portfolio company.[12a] In particular, an FHC may, consistent with the GLB Act and section 225.171(d) of Regulation Y, have covenants with a portfolio company that restrict the ability of the portfolio company to—

1. alter its capital structure through the issuance, redemption, authorization, or sale of any equity or debt securities of the portfolio company;[12b]
2. establish the general purpose for funds sought to be raised through the issuance or sale of any equity or debt securities of the portfolio company (for example, retirement of existing debt, acquisition of another company, or general corporate use);
3. amend the terms of any equity or debt securities issued by the company;
4. declare a dividend on any class of securities of the portfolio company or change the dividend-payment rate on any class of securities of the portfolio company;
5. engage in a public offering of securities of the portfolio company;
6. register a class of securities of the portfolio company under federal or state securities laws;
7. list (or de-list) any securities of the portfolio company on a securities exchange;
8. create, incur, assume, guarantee, refinance, or prepay any indebtedness outside the ordinary course of business of the portfolio company;
9. voluntarily file for bankruptcy, or consent to the appointment of a receiver, liquidator, assignee, custodian, or trustee of the portfolio company for purposes of winding up its affairs;
10. significantly alter the regulatory, tax, or liability status of the portfolio company (examples of actions that would significantly alter the regulatory, tax, or liability status of the portfolio company include the registration of the portfolio company as an investment company under the Investment Company Act of 1940, or the conversion of the portfolio company from a corporation to a partnership or limited-liability company);
11. make, or commit to make, any capital expenditure that is outside the ordinary course of business of the portfolio company, such as the purchase or lease of a significant manufacturing facility, an office building, an asset, or another company;
12. engage in, or commit to engage in, any purchase, sale, lease, transfer, or other transaction outside the ordinary course of business of the portfolio company, which may include for example—
    a. entering into a contractual arrangement (including a property lease or consulting agreement) that imposes significant financial obligations on the portfolio company;
    b. the sale of a significant asset of the portfolio company (for example, a signifi-

11. See sections 225.28(b)(6) and 225.86(b)(1) of Regulation Y (12 C.F.R. 225.28(b)(6) and 12 C.F.R. 225.86(b)(1)).

12. See sections 225.28(b)(9) and 225.86(b)(1) of Regulation Y (12 C.F.R. 225.28(b)(9) and 12 C.F.R. 225.86(b)(1)).

12a. See letter from Virgil Mattingly, the Federal Reserve Board's general counsel, to Peter T. Grauer, Credit Suisse First Boston, dated December 21, 2001.

12b. For these purposes, the phrase "equity and debt securities" includes options, warrants, obligations, or other instruments that give the holder the right to acquire securities of the portfolio company.

cant patent, manufacturing facility, or parcel of real estate);
   c. the establishment of a significant new subsidiary by the portfolio company;
   d. the transfer by the portfolio company of significant assets to a subsidiary or to a person affiliated with the portfolio company; or
   e. the establishment by the portfolio company of a significant new joint venture with a third party;
13. hire, remove, or replace any or all of the executive officers of the portfolio company;[12c]
14. establish, accept, or modify the terms of an employment agreement with an executive officer of the portfolio company, including the terms setting forth the executive officer's salary, compensation, and severance;
15. adopt or significantly modify the portfolio company's policies or budget concerning the salary, compensation, or employment of the officers or employees of the portfolio company generally;
16. adopt or significantly modify any benefit plan covering officers or employees of the portfolio company, including defined benefit and defined contribution retirement plans, stock option plans, profit sharing, employee stock ownership plans, or stock appreciation rights plans;
17. alter significantly the business strategy or operations of the portfolio company, for example, by entering or discontinuing a significant line of business or by altering significantly the tax, cash-management, dividend, or hedging policies of the portfolio company; or
18. establish, dissolve, or materially alter the duties of a committee of the board of directors of the portfolio company.

Some of the above actions by their very nature are outside the ordinary course of business of a portfolio company and, thus, may be subject to a covenant with the portfolio company. For example, covenants restricting the ability of a portfolio company to issue or redeem its equity or debt securities or hire or fire its executive officers are unusual actions that typically are taken only by or in consultation with the company's board of directors.

12c. The term "executive officer" is defined in section 225.171 of Regulation Y.

Covenants concerning other types of actions may, or may not, involve the FHC in routine business decisions of the portfolio company, depending on the specific scope of actions covered by the covenant and the size and characteristics of the portfolio company. To provide FHCs maximum flexibility in structuring their relationships with portfolio companies to the extent permitted by the GLB Act, several of the examples included above permit an FHC to restrict the ability of a portfolio company to take certain actions whenever the actions are significant.

The measure of "significant" in this context would depend on the size, capital, condition, business, and other characteristics of the portfolio company. In determining what is significant for a particular portfolio company, one rule of thumb is that any action that would, under ordinary business practices, be presented to the board of directors of the portfolio company for approval or consideration may also be subject to a covenant that requires review and approval of the action by the financial holding company investor. In this way, the rule permits a financial holding company investor to exercise the same type of review and approval rights through a covenant that the FHC could exercise directly through representation on the board of directors of the portfolio company. As with a director representative, however, an FHC may not use a covenant as a means to become involved in routine business decisions made in the ordinary course of the portfolio company's day-to-day business activities.

There also may be situations in which a covenant is permissible even though the actions involved are ones that, under ordinary business practices, would not be considered by the board of directors of the portfolio company. It is expected that these situations would be unusual and the permissibility of such a covenant would likely depend on the particular facts and circumstances involved in the case.

3907.0.3.2.2 FHC May Routinely Manage or Operate a Portfolio Company in Special Circumstances

An FHC may routinely manage or operate a portfolio company only when such action is "necessary or required to obtain a reasonable return on [the] investment upon resale or disposition." Examples of situations in which intervention may be needed would be when the portfolio company experiences a significant operating loss or when there is a loss of senior management. Once the FHC has taken appropriate action to obtain a reasonable return on the resale or disposition of the investment, the GLB Act requires the FHC to cease routinely managing or operating the portfolio company. The FHC may routinely manage or operate a portfolio company only for the period of time that may be necessary to address the cause of the holding company's involvement in the routine management or operations of the portfolio company, to obtain suitable management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return on the resale or disposition of the investment. The determination of whether and how long FHC intervention is necessary or required will depend on the facts and circumstances of the particular investment.

Two requirements in the rule assist the Federal Reserve in monitoring the interventions of FHCs in the routine management or operations of portfolio companies. These requirements ensure that such actions are consistent with the GLB Act's limitations. First, FHCs are required to maintain and make available to the Board on request a written record describing the company's involvement in routinely managing or operating any portfolio company.[13] Second, an FHC is required to provide the Board with written notice if the company routinely manages or operates a portfolio company for more than nine months.[14] The notice may be in the form of a letter and should identify the portfolio company, the date on which the FHC first became involved in the routine management or operations of the portfolio company, the reasons for the involvement, and the actions that the FHC has taken to address the circumstances giving rise to the intervention, as well as provide an estimate of when the FHC anticipates it will cease routinely managing or operating the portfolio company.

3907.0.3.3 Depository Institutions Prohibited from Managing or Operating Portfolio Companies

A depository institution or a subsidiary of a depository institution may not routinely manage or operate a portfolio company held by an FHC. As noted above, U.S. branches and agencies of foreign banks are considered depository institutions for purposes of the rule. A director, officer, or employee of a depository institution or its subsidiary, as well as a U.S. branch or agency, however, is not prohibited from serving as a director of a portfolio company to the same extent as would be permitted for a director, officer, or employee of an FHC. Such director, officer, or employee is also not prohibited from taking other actions that the rule does not define to be routine management or operation. In addition, a depository institution is not prevented from having covenants or from taking actions pursuant to covenants that are typically found in credit agreements to ensure repayment of extensions of credit in the ordinary course of business, provided the covenant or action is not an attempt to evade the rule's restrictions.

The rule also does not apply the prohibition on a depository institution routinely managing or operating a portfolio company to a financial subsidiary of a bank that is held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act (FDI Act). The prohibition also does not apply to a small business investment company subsidiary of a bank held in accordance with the Small Business Investment Act of 1958. These subsidiaries may, however, exercise routine management or operation only in accordance with the limitations that apply to FHCs.

3907.0.4 HOLDING PERIODS FOR MERCHANT BANKING INVESTMENTS

The GLB Act requires that any shares, assets, and ownership interests acquired as an MBI be held only for a period of time that enables the sale or disposition of the interest on a reasonable basis, consistent with the financial viability of the FHC's merchant banking activity. The rule permits an FHC to hold any MBI for a period of up to 10 years. In addition, the rule allows an FHC to own or control an MBI in or through a private equity fund (as defined below) for the life of the fund, up to 15 years.[15]

An FHC may hold an MBI beyond the rule's specified time periods only with the Board's prior approval. A request by an FHC for an extension of the applicable holding period must be filed at least 90 days before the expiration of the holding period. An extension request must provide the reasons for the request (including

13. See section 225.171(e)(4) of Regulation Y (12 C.F.R. 225.171(e)(4)).

14. See section 225.171(e)(3) of Regulation Y (12 C.F.R. 225.171(e)(3)).

15. See section 225.172 of Regulation Y (12 C.F.R. 225.172).

the factors listed below), explain the FHC's plan for divesting the investment, and discuss the factors that the Board may consider in reviewing the request. Factors to be included in the extension request are the cost to the FHC of disposing of the investment within the applicable time period, the total exposure of the FHC to the portfolio company and the risks that disposing of the investment without an extension may pose to the FHC, market conditions, the nature of the portfolio company's business, the extent and history of the FHC's involvement in the management and operations of the portfolio company, and the average holding period of the FHC's MBIs. The Board may also consider any other relevant information related to the investment.

If an FHC receives permission to hold an MBI beyond the applicable holding period, a special capital charge applies to the investment. The Board must set this charge at a rate that is above the highest marginal tier 1 capital charge applicable under the Board's capital guidelines for MBIs held by that FHC, but the rate may not be below 25 percent of the adjusted carrying value of the investment as reflected on the FHC's balance sheet. The Board may also impose other restrictions it determines to be appropriate in connection with granting the extension request.

3907.0.4.1 Holding-Period Tacking Provisions

The rule includes special "tacking" provisions to prevent an FHC from circumventing the holding periods on MBIs by transferring an MBI from one company or fund to another.[16] The rule also provides that, for purposes of calculating compliance with the merchant banking holding periods, an investment the FHC acquires under another authority that imposes a restriction on the amount of time that the FHC may hold the investment is considered to have been acquired on the original acquisition date.

3907.0.5 PRIVATE EQUITY FUNDS

As noted above, the rule permits an FHC to make MBIs directly or through funds that pool the firm's capital with capital provided by third-party investors, such as investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors who have a high net worth. Frequently, these pooled investment vehicles have characteristics (such as limited terms, manager-compensation arrangements, and the presence of third-party investors that monitor investments) that encourage the fund to dispose of its investments in a relatively short period of time. Considering such characteristics, and to

16. See section 225.172(b)(2) and (3) of Regulation Y (12 C.F.R. 225.172(b)(2) and (3)).

accommodate industry practice on investment funds, the rule includes several special provisions for MBI activities conducted through a qualifying "private equity fund." The provisions include a longer holding period for private equity fund investments, a higher aggregate investment threshold for review of an organization that makes investments in or through private equity funds, and streamlined reporting and recordkeeping provisions for investments in or held through private equity funds.

3907.0.5.1 Definition of Private Equity Fund

To qualify as a "private equity fund" under the rule, the fund must have a fixed duration of not more than 15 years including all potential extensions, and the FHC (including its officers, directors, employees, and principal shareholders) may not own more than 25 percent of the total equity of the fund. There are no limits on advisory fees or on the various types of incentive compensation that the FHC may receive for services rendered to the fund, provided such fees do not increase the FHC's equity stake in the fund above the 25 percent threshold.

A private equity fund also may not be an operating company and must be engaged exclusively in the business of investing in financial and nonfinancial companies for resale or other disposition. In addition, the fund may not be established or operated for the purpose of making investments that are inconsistent with section 4(k)(4)(H) of the BHC Act or evading the limitations of the GLB Act or the rule.

A private equity fund can be organized in any form, including a partnership, corporation, or limited-liability company. In addition, the fund may, but need not be, registered as an investment company under the federal securities laws.

3907.0.5.2 Permissible Holding Period for Private Equity Fund Investments

As noted above, an FHC, without Board approval, may own or control an investment in a private equity fund that makes MBIs for the duration of the fund, which may be up to 15 years. A qualifying private equity fund may therefore hold investments in portfolio companies for up to 15 years, and it is not required to dispose of its investments within the 10-year period applicable to other types of MBIs. In special circumstances, an FHC may seek the Board's approval to retain an investment in a qualifying private equity fund or to extend the duration of a private equity fund for a period longer than 15 years.[17] (See section 3907.0.5 of this manual for a discussion of how an FHC may request an extension of this holding period.)

3907.0.5.3 Routine Management and Operation Restrictions for Private Equity Funds

The GLB Act and the rule generally prohibit an FHC from routinely managing or operating any portfolio company—that is, any company engaged in nonfinancial activities.[18] These restrictions apply regardless of whether the FHC owns or controls its interest in the portfolio company directly or through a private equity fund. Accordingly, an FHC may not routinely manage or operate a portfolio company that is owned or controlled by a private equity fund in which the FHC owns or controls any ownership interest, except in the limited circumstances permitted by the rule.[19] In addition, if an FHC controls a private equity fund, the private equity fund is a subsidiary of the FHC and the *private equity fund* must abide by the rule's limits on routine management and operation of portfolio companies. An FHC, however, is not prohibited from routinely managing or operating the private equity fund itself.

An FHC is considered to control a private equity fund for the purpose of the rule if the FHC or any director, officer, employee or principal shareholder of the company (1) serves as a general partner, managing member, or trustee of the private equity fund; (2) owns or controls in the aggregate 25 percent or more of any class of voting shares or similar interests in the fund; (3) selects, controls, or constitutes a majority of the directors, trustees, or management of the fund; or (4) owns or controls more than 5 percent of any class of voting shares or similar ownership interests in the fund and serves as the fund's investment adviser.

17. The holding-period tacking rules in section 225.172(b)(2) and (3) of Regulation Y must be applied when a private equity fund investment has been held longer than the permitted time.

18. See sections 225.177(c) and 225.171(a) of Regulation Y (12 C.F.R. 225.177(c) and 225.171(a)).

19. See section 225.171(e) of Regulation Y (12 C.F.R. 225.171(e)).

3907.0.5.4 Other Matters Related to Private Equity Funds

When an FHC has a passive (that is, noncontrolling) investment in a private equity fund that is advised and controlled by an unaffiliated entity, any shares owned by the fund generally are not considered to be owned or controlled by the passive FHC investor.[20] Therefore, the rule's cross-marketing restrictions on the products or services of a portfolio company, the limitations of sections 23A and 23B of the FRA, and the rule's reporting and recordkeeping requirements *do not apply* to investments in portfolio companies that are held by a private equity fund and that are not controlled by the FHC. These restrictions and requirements (other than the cross-marketing restrictions) would, however, apply to the FHC's investment in the private equity fund and would govern the relationship of the FHC with the private equity fund.

3907.0.5.4.1 Funds That Are Not Qualifying Private Equity Funds

An FHC is permitted to invest in and control a fund that does not meet the private equity fund definition. If the FHC controls the nonqualifying fund, then the provisions of the rule, including the holding-period provisions for portfolio companies, the routine-management restrictions, the risk-management and recordkeeping requirements, the cross-marketing provisions, and the section 23A provisions, apply to investments made by the nonqualifying fund in the same manner as those provisions would apply if the investment in the portfolio company were held directly by the FHC. If the FHC owns a noncontrolling interest in the fund, then the fund is itself considered to be a portfolio company.

An FHC may thus own more than 25 percent of the equity of a fund that has an unlimited life (and, consequently, is not a qualifying private equity fund), so long as the fund does not hold investments in portfolio companies for more than 10 years, and the FHC and the fund comply with the routine management and other restrictions of the rule. Similarly, an FHC may invest in a fund that, in addition to making MBIs, engages in other businesses (and, consequently, is not a qualifying private equity fund), so long as the FHC does not control the fund, divests its interest in the fund within 10 years, and complies with the other provisions of the rule that apply to investments in a portfolio company.

20. See section 2(g)(1) of the BHC Act (12 U.S.C. 1841(g)(1)) and section 225.2(e)(2)(i) of Regulation Y (12 C.F.R. 225.2(e)(2)(i)).

3907.0.6 TEMPORARY AGGREGATE INVESTMENT THRESHOLDS FOR MBIs

To allow the Federal Reserve to review the risk-management policies, procedures, and systems of an FHC that seeks to devote a significant portion of its capital to MBIs, temporary investment thresholds on MBIs are included in the rule. An FHC may not, without the Board's prior approval, make additional MBIs if the aggregate carrying value of its existing MBIs exceeds either of the two thresholds. The first threshold prevents an FHC from making additional MBIs (including making additional capital contributions to a company held under the rule) if the aggregate carrying value of the FHC's MBIs exceeds 30 percent of the FHC's tier 1 capital. A second threshold applies if the aggregate carrying value of the FHC's MBIs, *excluding* investments in private equity funds, exceeds 20 percent of the FHC's tier 1 capital. An FHC may exceed either threshold with the prior approval of the Board.

The investment thresholds were adopted as sunset provisions until the Board adopts a final rule specifically addressing the regulatory capital treatment for MBIs and that rule becomes effective. In February 2001, the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation jointly requested comment on proposed rules that would establish special capital requirements for MBIs and similar equity investments held by BHCs and banks. (See 66 *Federal Register* 10, 212 (February 14, 2001).)

The investment thresholds discussed above apply only to MBIs made by FHCs under section 4(k)(4)(H) of the BHC Act and under the rule. They do not apply to or restrict investments made by BHCs or FHCs under other authorities, such as investments made through small business investment companies (SBICs), investments made in less than 5 percent of the voting shares of a company under section 4(c)(6) or (7) of the BHC Act, or investments made overseas under Regulation K.

3907.0.7 RISK-MANAGEMENT, REPORTING, AND RECORDKEEPING POLICIES

3907.0.7.1 Policies, Procedures, Systems, and Reports

An FHC must maintain policies, procedures, and systems that are reasonably designed to manage the risks associated with making MBIs and to monitor compliance with the statutory and regulatory provisions governing such investments. The rule identifies the major areas that must be addressed by the internal policies and controls of an FHC engaged in making MBIs. In particular, an FHC engaged in merchant banking activities must have policies, procedures, records, and systems that are reasonably designed to—

1. monitor and assess the carrying value, market value, and performance of MBIs and of the company's aggregate MBI portfolio;
2. identify and manage the market, credit, concentration, and other risks associated with MBIs;
3. identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or contingent interests) with each company in which the FHC has an MBI;
4. ensure the maintenance of corporate separateness between the FHC and each company in which the FHC holds an interest under the rule, and protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any such company; and
5. ensure compliance with the rule, including the rule's holding-period, routine management and operation, and cross-marketing restrictions, as well as with any other applicable provisions of law governing transactions and relationships with companies in which the FHC holds an interest under the rule, such as fiduciary principles and sections 23A and 23B of the FRA.

This list of policies, procedures, records, and systems identifies only some of the most important elements of a sound approach to monitoring MBI activities. The Board has issued supervisory guidance (see SR-00-9) that provides additional detail concerning the internal controls, policies, and systems that any BHC engaged in equity investment activities is expected to have and maintain to engage in such activities in a safe and sound manner. (See section 3900.0 of this manual for more detail on this guidance.)

If the FHC controls a private equity fund or other fund that makes MBIs, the FHC must ensure that the fund has the types of policies, procedures, and systems for making and monitoring MBIs that are required for FHCs. The FHC may satisfy these requirements by ensuring that the private equity fund or other fund is subject to the FHC's merchant banking policies, procedures, and systems. If an FHC does not control the fund, then the fund is not subject to the recordkeeping and risk-management provisions of the rule. Nevertheless, an FHC must apply its merchant banking policies, procedures, and systems to any investment made by the company in any fund that is controlled by an unaffiliated entity.

It is anticipated that FHCs will be able to satisfy the rule's recordkeeping requirements by using the internal reports and records it prepares in the ordinary course of making an MBI or controlling a private equity fund. Similarly, if an FHC makes a noncontrolling investment in a private equity fund, the FHC should be able to use information provided by the fund's adviser or sponsor to satisfy the rule's recordkeeping requirements.

3907.0.7.2 Notice of Commencement of Merchant Banking Activities

An FHC must notify the Board within 30 days of commencing merchant banking activities under section 4(k)(4)(H) of the BHC Act. (See section 225.87(a) of Regulation Y.) For a domestic FHC, this notice should be provided on the Federal Reserve's reporting form, the FR Y-6A (which is expected to be replaced by the FR Y-10). For qualifying foreign banking organizations, the notice should be provided on the FR Y-7 (which is expected to be replaced by the FR Y-10F).

The appropriate Reserve Bank, in coordination with Board staff, should schedule a review of the investment and risk-management policies, procedures, and systems of an FHC that files a notification indicating that it has commenced merchant banking activities. The review may be conducted either off- or on-site, depending on the expected level and complexity of the FHC's MBIs and the company's previous experience in making equity investments under other legal authorities. This review may be deferred until the next regularly scheduled inspection or examination, if the FHC has significant experience in making equity investments under preexisting authorities and if the Federal Reserve has recently reviewed the company's policies, procedures, and systems for managing and controlling the risks associated with equity investment activities.

3907.0.7.3 Quarterly and Annual Reporting Requirements

The Federal Reserve has instituted two periodic reporting requirements relating to MBIs. The first is a quarterly report (FR Y-12) that seeks aggregate information on the cost and carrying values of an FHC's MBIs. This report also collects information on nonfinancial equity investments made by BHCs and their subsidiaries under other legal authorities, including investments made through SBICs and investments made in less than 5 percent of the voting shares of a company under section 4(c)(6) or (7) of the BHC Act. This quarterly report assists the Federal Reserve in monitoring the exposure of BHCs to MBIs and similar types of equity investments. The second report is an annual report, the FR Y-12A, that will collect basic information on MBIs held by an FHC for an extended time period. The FR Y-12A annual report collects information on MBIs that are approaching the end of their applicable holding period.

3907.0.7.4 Notice of Large Merchant Banking Acquisitions

After an FHC has provided notice to the Federal Reserve that it has commenced merchant banking activities, the FHC generally is *not* required to file a notice after acquiring the shares of a company under its merchant banking investment authority. However, an FHC must file a post-transaction notice with the Federal Reserve within 30 days after making an MBI in a company if (1) the investment represents more than 5 percent of the voting shares, assets, or ownership interests of the company, and (2) the total cost of the investment to the FHC exceeds the lesser of 5 percent of the tier 1 capital of the FHC or $200 million. This notice must be provided on the forms discussed above.

3907.0.8 CROSS-MARKETING RESTRICTIONS

The GLB Act prohibits a depository institution subsidiary of an FHC from marketing or offering any product or service of a company in which the FHC has an MBI. Similarly, the GLB Act prohibits a company held by an FHC as an MBI from marketing or offering any product or service of a depository institution subsidiary of the FHC. U.S. branches and agencies of a foreign bank that conduct BHC activities in the United States or through a U.S. company are considered depository institutions under the rule. Thus, a U.S. branch or agency of a foreign bank may not cross-market the products or services of a company that is owned or controlled by the foreign bank or an affiliate of the foreign bank under section 4(k)(4)(H) of the BHC Act. In addition, the cross-marketing restrictions generally apply to any *subsidiary* of a depository institution controlled by an FHC.

The cross-marketing restrictions, however, do not apply to certain subsidiaries of a depository institution that Congress has expressly authorized the parent institution to own or control. In particular, the cross-marketing restrictions do *not* apply to (1) a financial subsidiary of a depository institution held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the FDI Act, (2) any company held by an Edge Act or agreement subsidiary of the depository institution that is controlled pursuant to section 25 or 25A of the FRA, or (3) any company held by an SBIC subsidiary of the depository institution that is controlled in accordance with the Small Business Investment Act.

The cross-marketing restrictions of the GLB Act and the rule also do *not* apply to nondepository affiliates of FHCs. Accordingly, a nondepository holding company affiliate of an FHC may engage in cross-marketing activities with a portfolio company held by the FHC under section 4(k)(4)(H) of the BHC Act. In addition, these restrictions do not apply to (1) portfolio companies in which the FHC, either directly or indirectly, owns less than 5 percent of the voting shares or ownership interests; (2) portfolio companies that are held by a private equity fund the FHC does not control; and (3) interests in a private equity fund (whether or not the FHC controls the fund). Accordingly, a depository institution subsidiary of an FHC may engage in cross-marketing activities with such a company, or it may market the shares of a private equity fund.

3907.0.8.1 Marketing Products or Services Involving a Portfolio Company

As noted above, the GLB Act prohibits any depository institution controlled by an FHC from (1) marketing or offering any product or service of a portfolio company held by the FHC under section 4(k)(4)(H) of the BHC Act or (2) allowing any product or service of the depository institution to be offered or marketed by or through any portfolio company held by the FHC under that section. A depository institution or subsidiary of a depository institution is *not* prohibited from marketing its own products or services—such as deposit, lending, and advisory products or services—to a portfolio company so long as the portfolio company does not then market those products or services to its customers or others. A depository institution subsidiary of an FHC also may purchase the products or services of a portfolio company—such as data processing hardware, software, or services to support the depository institution's own operations—provided that the institution does not, directly, indirectly, or through any arrangement, market the portfolio company's products or services to the institution's customers or others. Likewise, the cross-marketing restrictions would not prohibit a depository institution controlled by an FHC from engaging in cross-marketing activities with a company that is a co-investor with the FHC in a portfolio company, so long as those activities do not involve products or services of the portfolio company.

3907.0.9 PRESUMPTION OF CONTROL UNDER SECTIONS 23A AND 23B OF THE FRA

Sections 23A and 23B of the FRA impose specific quantitative, qualitative, and collateral requirements on certain types of transactions between an insured depository institution and its affiliates, that is, companies that are under common control with the insured depository institution. Typically, a company owned by an FHC is considered to be an affiliate of the FHC's subsidiary insured depository institution for the purposes of sections 23A and 23B, if the FHC owns or controls 25 percent or more of any class of the company's voting securities. The GLB Act, however, includes a presumption that an FHC controls a company for purposes of sections 23A and 23B if the FHC directly or indirectly, or acting through one or more other persons, owns or controls 15 percent or more of the equity capital of the company under the merchant banking authority of section 4(k)(4)(H) of the BHC Act.[21] Thus, a company is presumed to be a section 23A affiliate of a subsidiary insured depository institution of an FHC if the FHC owns or controls more than 15 percent of the total equity of the company under section 4(k)(4)(H).

An FHC can rebut the presumption by providing information to the Board demonstrating that the FHC does not control the company.[22] In the three situations identified below, the presumption of control under the GLB Act will be considered rebutted. In each situation, the FHC is assumed to own more than 15 percent of the total equity of the portfolio company under section 4(k)(4)(H) of the BHC Act (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the portfolio company (thereby not meeting the statutory definition of control). In particular, absent evidence to the contrary, an FHC will *not* be presumed to control a portfolio company if—

1. no officer, director, or employee of the FHC serves as a director, trustee, or general partner (or as an individual exercising similar functions) of the portfolio company;
2. a person that is not affiliated or associated with the FHC owns or controls a greater percentage of the equity capital of the portfolio company than the FHC, and no more than one officer or employee of the holding company serves as a director or trustee (or as an individual exercising similar functions) of the portfolio company; or
3. a person that is not affiliated or associated with the FHC owns or controls more than 50 percent of the voting shares of the portfolio company, and officers and employees of the FHC do not constitute a majority of the directors or trustees (or of individuals exercising similar functions) of the portfolio company.

21. Equity capital includes voting and nonvoting shares, warrants, options, and other instruments convertible into equity capital.

22. The presumption applies only when an FHC owns or controls 15 percent or more of the total equity of a portfolio company under section 4(k)(4)(H) of the BHC Act and the rule. Under existing Board precedents, an FHC may not own any shares of a company in reliance on section 4(c)(6) or (7) of the BHC Act when the company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

These safe harbors do not require Board review or approval under the provisions allowing rebuttal of the presumptions. An FHC also may request the Board's approval to rebut a presumption of control under other circumstances.

The rule's presumption of control is independent from the general definition of control in section 23A of the FRA.[23] A portfolio company, under the statute, is per se a section 23A affiliate of any insured depository institution subsidiary of an FHC if the FHC owns 25 percent or more of a class of voting securities of the portfolio company, even if the FHC owns or controls less than 15 percent of the portfolio company's *total equity* or is within one of the rule's safe harbors.

For the purpose of applying the presumption of control, an FHC that has an investment in a private equity fund will not be considered to indirectly own the equity capital of a portfolio company held by the fund *unless* the FHC controls the private equity fund. For example, if an FHC has a noncontrolling investment in a private equity fund that, in turn, owns 20 percent of the total equity of a portfolio company, the portfolio company is not presumed to be an affiliate of the insured depository institution subsidiaries of the FHC. On the other hand, if an FHC acts as general partner of a private equity fund and thus controls the fund, and if the private equity fund owns or controls more than 15 percent of the total equity of any portfolio company, the portfolio company is presumed to be an affiliate of the insured depository institution subsidiaries of the FHC.

To ensure competitive equity, the Board's rule applies sections 23A and 23B of the FRA to covered transactions between a U.S. branch or agency of a foreign bank and (1) any portfolio company controlled by the foreign bank or an affiliate of the foreign bank under the merchant banking authority of section 4(k)(4)(H) of the BHC Act, and (2) any company controlled by the foreign bank or an affiliate if the company is engaged in making MBIs under section 4(k)(4)(H) and the proceeds of the covered transaction are used for the purpose of funding the company's merchant banking activities. In determining if a portfolio company is controlled by a foreign bank or an affiliate of a foreign bank for these purposes, the rebuttable presumption of control and the three safe harbors discussed above apply to the foreign bank and affiliate in the same manner that the presumption and safe harbors apply to domestic FHCs. The rule does not restrict lending by a foreign bank's U.S. branches and agencies to parent companies or other affiliated companies unless the proceeds of such lending would be used by these companies to make or fund the making of MBIs.

23. See 12 U.S.C. 371c(3)(A).

3907.0.10 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Merchant banking investment activities	1843(k)(7)(A)			
Permitted investments		225.170	4-058	
Limitations on managing or operating a portfolio company held as an MBI		225.171	4-058.2	
MBI holding periods		225.172	4-058.3	
Investments in private equity fund		225.173	4-058.4	
Aggregate limits on MBIs		225.174	4-058.5	
Risk-management, reporting, and recordkeeping policies for MBIs		225.175	4-058.6	
Cross-marketing and FRA section 23A and 23B limitations for MBIs		225.176	4-058.7	
Definitions		225.177	4-058.8	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Investments in the equity of nonfinancial companies as well as lending to private-equity-financed companies are sources for earnings and business relationships for supervised financial institutions.[1] These equity investments in nonfinancial companies, however, can entail significant market, liquidity, and other risks to an institution. Equity investments can also give rise to increased volatility of an institution's earnings and capital. Accordingly, sound investment and risk-management practices and strong capital positions are critical when an institution engages in these activities.

In supervisory guidance issued in 2000, the Board addresses sound practices that a firm should consider in its equity investment activities. Federal Reserve-supervised institutions (i.e., financial holding companies (FHCs), bank holding companies (BHCs), state member banks, and their affiliates, regardless of the authority under which the investments are made) should consider this guidance in establishing their risk-management practices for equity investment activities.[2] This manual section is based on this 2000 guidance. Therefore, for a more complete discussion, see SR-00-9, "Supervisory Guidance on Equity Investment and Merchant Banking Activities."

3909.0.1 LEGAL AND REGULATORY AUTHORITY FOR EQUITY INVESTMENTS

FHCs, BHCs, and depository institutions (hereafter referred to as "firms" or a "firm") are able to make equity investments under several statutory and regulatory authorities. Under section 4(c)(6) and (7) of the Bank Holding Company Act (BHC Act), BHCs may make passive investments in up to 5 percent of the outstanding voting shares of any company and up to 25 percent of the total equity of the company. Under this authority, there is no aggregate limit on the total dollar amount of equity investments that a BHC may hold.

Firms can make equity investments through a small business investment corporation (SBIC), which can be a subsidiary of a bank or holding company. Investments made by SBIC subsidiaries are allowed up to a total of 50 percent of a portfolio company's outstanding shares, but can only be made in companies defined as a small business according to SBIC rules issued by the Small Business Administration. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus. In the case of BHCs, the aggregate investment is limited to 5 percent of the BHC's proportionate interest in the capital and surplus of its subsidiary banks.

Under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act (FRA) and section 4(c)(13) of the BHC Act, a firm may, with Board approval, make portfolio investments in foreign companies that in the aggregate do not exceed 25 percent of the firm's tier 1 capital. In addition, individual investments must be less than 20 percent of a portfolio company's voting shares and must not exceed 40 percent of the portfolio company's total equity.[3]

FHCs are also permitted to acquire any amount of the shares, assets, or ownership interests of a nonfinancial company under the merchant banking investment authority of section 4(k)(4)(H) of the BHC Act, as amended by the Gram-Leach-Bliley Act (GLB Act). The GLB Act places certain limits on the holding period of merchant banking investments and on the ability of an FHC to routinely manage or operate a portfolio company held as a merchant banking investment. Subpart J of the Board's Regulation Y (12 CFR 225.170–225.177) implements these and other restrictions applicable to merchant banking investments.

1. Nonfinancial companies include companies that engage in activities other than financial activities that a financial holding company may conduct pursuant to section 4 of the Bank Holding Company Act (12 U.S.C. 1843), as amended by the Gramm-Leach-Bliley Act, and the regulations and interpretations thereunder. Equity investments include merchant banking investments made by financial holding companies under the regulations adopted by the Board of Governors (12 CFR part 225, subpart J, sections 225.170 through 225.177) and the Treasury Department (12 CFR part 1500, sections 1500.1 through 1500.8). The term "private equity" refers to shared-risk investments outside of publicly quoted securities and also activities such as venture capital, leveraged buyouts, mezzanine financing, and holdings of publicly quoted securities obtained through these activities.

2. The 2000 supervisory guidance on various sound practices related to the equity investment activities also applies to savings and loan holding companies (SLHCs). See SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

3. Also included in calculating a firm's investment are shares of the corporation held in trading or dealing accounts or under any other authority. The 25 percent of tier 1 capital limitation increases to 100 percent of tier 1 capital for certain non-BHC investors. See Regulation K for more detailed information.

Equity investments made under any of the authorities described above may be in publicly traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company, or it may be made indirectly through a pooled investment vehicle, such as a private equity fund. In general, private equity funds are investment companies, typically organized as limited partnerships, that pool capital from third-party investors to invest in shares, assets, and ownership interests in companies for resale or other disposition.[4] Private equity fund investments may provide seed or early-stage investment funds to start-up companies, or they may finance changes in ownership, middle-market business expansions, and mergers and acquisitions.

The supervisory guidance applies to all equity investments a BHC, SLHC, or FHC holds in nonfinancial companies, public or private, regardless of the authority under which such investments are made. A firm is expected to control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries and affiliates. Also, the basic principles set forth in this guidance should be incorporated into the U.S. operations of foreign banking organizations, with appropriate adaptations to reflect the fact that (1) those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis, and (2) the foreign bank is subject to overall supervision by its home authorities.

3909.0.2 SOUND PRACTICES FOR EQUITY INVESTMENTS

High returns in both equity investments and lending to private-equity-financed companies can spur an increased flow of funds into this market segment. As in other rapidly expanding and highly profitable business lines, business and competitive pressures can lead to compromises in due diligence, the use of overly optimistic assumptions, and breakdowns in internal controls. Sound investment and risk-management practices are crucial to the success of equity investment activities. As with any financial activity, sound management practices for these activities involve—

1. active involvement by senior management;
2. appropriate policies, limits, procedures, and management information systems that govern all elements of the investment decision-making and management process; and
3. adequate internal controls.

As with all financial activities, supervised institutions should ensure that they have sufficient capital for conducting equity investment activities. Supervised institutions that are conducting material equity investment activities are expected to have an internal capital-allocation system that meaningfully links the identification, monitoring, and evaluation of the risks of the institution's equity investment activities to the determination of its needs for economic capital.[5] A review of these systems should be an important part of a firm's investment-management process. When a firm is engaged in this activity, examiners should monitor the risk of this business line to a firm and perform a supervisory review based on this risk assessment.

Supervisory approach. Examiners and supervisory staff should review each of the three areas listed above to identify any management deficiencies. The supervisory efforts should be targeted appropriately in accordance with Federal Reserve policies on risk-focused supervision, taking into account both (1) the findings of internal audit and other independent reviews and (2) the materiality of equity investment activities to the institution. Consistent with the Federal Reserve's role as umbrella supervisor, reviews of a firm's merchant banking activities and the equity investment activities should focus on the potential exposure these activities may pose to insured depository affiliates and should, where appropriate and available, use the findings of primary bank supervisors and functional regulators of holding company affiliates. At the same time, supervisory and examination staff should conduct sufficient and targeted transaction testing across legal-entity lines if necessary to fully assess the adequacy of business-line risk management. Transaction testing should be consistent with the risk profile of the institution and the materiality of the activity to the institution's financial condition.

3909.0.2.1 Role of Senior Management

Senior management should establish portfolio objectives, overall investment strategies, and

4. For a detailed definition of "private equity funds," see the merchant banking rule (12 CFR 225.170 et seq.).

5. For more information on the assignment of risk weights for equity exposures, see Regulation Q (12 CFR part 217).

general investment policies that are consistent with the institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment-management oversight. These objectives, strategies, policies, and procedures should be documented and clearly communicated to all the personnel involved in their implementation. Senior management should actively monitor the performance and risk profile of equity investment business lines in light of the established objectives, strategies, and policies.

Senior management should ensure that there are adequate policies, procedures, and management information systems for managing equity investment activities on a day-to-day and longer-term basis. Senior management should also ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments. Senior management should implement policies that specify lines of authority and responsibility for both acquisitions and sales of investments and ensure that an institution's equity investment activities are conducted by competent staff whose technical knowledge and experience is consistent with the scope of the institution's activities. Senior management should also adopt limits on aggregate investment and exposure amounts, the types of investments (for example, direct and indirect, mezzanine financing, startups, or seed financing) and appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

3909.0.2.2 Management of the Investment Process

Institutions engaging in equity investment activities should have a sound process for executing all elements of investment management, including initial due diligence, periodic reviews of holdings, investment valuation, and realization of returns. This process requires appropriate policies, procedures, and management information systems, the formality of which should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. A sound investment process should be applied to all equity investment activities, regardless of the legal entity in which investments are booked.

Supervisory approach. Any supervisory reviews of equity investment activities should be risk-focused. The review should consider the institution's stated tolerance for risk, the ability of senior management to govern these activities effectively, the materiality of activities in light of the institution's risk profile, and its capital position.

3909.0.2.2.1 Equity Investment Policies and Limits

Effective policies for institutions engaging in equity investment —

1. govern the types and amounts of investments that may be made,
2. provide guidelines on appropriate holding periods for different types of investments, and
3. establish parameters for portfolio diversification.

Investment strategies and permissible types of investments should be clearly identified. Portfolio-diversification policies should identify factors pertinent to the risk profile of the investments being made, such as industry, sector, geographic, and market factors. Policies establishing expected holding periods should specify the general criteria for liquidation of investments, as well as guidelines for the divestiture of underperforming investments. Decisions to liquidate underperforming investments are necessarily made on a case-by-case basis, considering all relevant factors. However, policies and procedures that stipulate more frequent review and analysis are generally used to address investments that are performing poorly or that have been in portfolio for a considerable length of time.

Policies should identify the aggregate exposure that the institution is willing to accept by the type and nature of investment (for example, direct or indirect, in an industry or sector). When adhering to those limits, institutions should consider unfunded and funded commitments. Where hedging activities are conducted, formal and clearly articulated hedging policies and strategies should identify limits on hedged exposures and permissible hedging instruments.

Management and staff compensation play a critical role in providing incentives and controlling risks within a private equity business line.

Clear policies should govern compensation arrangements, including co-investment structures and sales of portfolio company interests by an institution's employees.

3909.0.2.2.2 Equity Investment Procedures

As they do with investment policies, many institutions have different procedures for assessing, approving, and reviewing investments based on their size, nature, and risk profile. Often, procedures used for direct investments are different than those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior management approvals may be required. The management infrastructures that have been constructed for conducting these activities should ensure that operating procedures and internal controls appropriately reflect the diversity of investments.

Supervisory approach. Supervisors should recognize the potential diversity of practice when conducting reviews of the equity investment process. They should focus on the appropriateness of the process employed relative to the risk of the investments made and the materiality of this business line to an institution's overall soundness and the potential impact on affiliated depository institutions.

3909.0.2.2.2.1 Investment Analysis and Approvals

Well-founded analytical assessments of investment opportunities and formal processes for approving investments are critical in conducting equity investment activities. While analyses and approval processes may differ by individual investments and across institutions, the methods and types of analyses conducted should be appropriately structured to adequately assess the specific risk profile, industry dynamics, management, and specific terms and conditions of the investment opportunity, as well as other relevant factors. All elements of the analytical and approval processes, from initial review through the formal investment decision, should be documented and clearly understood by the staff who are conducting these activities. An institution's evaluation of potential investments in private equity funds, as well as its reviews of existing fund investments, should assess the adequacy of a fund's structure, with due consideration given to the following:

1. management fees
2. carried interest[6] and its computation on an aggregate portfolio basis
3. the sufficiency of the general partners' capital commitments in providing management incentives
4. contingent liabilities of the general partner
5. distribution policies and wind-down provisions
6. performance benchmarks and return calculation methodologies

3909.0.2.2.2.2 Investment-Risk Ratings

It is a sound practice to establish a system of internal risk-ratings for equity investments. The system should assign each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors. Different rating factors may be appropriate for indirect investments and direct investments. For example, rating factors for investments in private equity funds could include an assessment of the fund's diversification, management experience, liquidity, and actual and expected performance. An institution's rating systems can cover an assessment of both new investment opportunities and existing portfolio investments.

3909.0.2.2.2.3 Periodic Reviews

Senior management should ensure the periodic and timely review of the institution's equity investments. Reviews should be conducted at both individual investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, where appropriate, include factors such as—

1. the history of the investment, including the total funds approved;
2. commitment amounts, principal-cash investment amounts, cost basis, carrying value, major-investment cash flows, and supporting information, including valuation rationales and methodologies;

6. The carried interest is the share of a partnership's return that is received by general partners or investment advisers.

3. the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
4. a summary of recent events and current outlook;
5. the recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;
6. internal investment-risk ratings and rating-change triggers;
7. exit strategies, both primary and contingent, and expected internal rates of return on exit; and
8. other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

Portfolio reviews should include an aggregation of individual investment-risk and performance ratings, as well as an analysis of appropriate industry, sector, geographic, and other pertinent concentrations, and total portfolio valuations. Portfolio reports containing the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

Given the inherent uncertainties in equity investment activities, institutions should include in their periodic review consideration of best case, worst case, and probable case assessments of investment performance. The reviews should evaluate changes in market conditions and alternative assumptions used to value investments—including expected and contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. The assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses. The formality and sophistication of investment reviews should be appropriate for the overall level of a firm’s risk from this business line.

3909.0.2.2.2.4 Valuation and Accounting

Valuation and accounting policies and procedures can have a significant impact on the earnings of institutions engaged in equity investment activities. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or require the skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding-period restrictions, or when the institution holds a significant block of a company’s shares. Accordingly, clearly articulated policies and procedures on the accounting and valuation methodologies used for equity investments are of paramount importance.

Several methods are used in accounting for equity investments. Under generally accepted accounting principles (GAAP), equity investments held by investment companies, held by broker-dealers, or maintained in the trading account[7] are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments not held in investment companies, by broker-dealers, or in the trading account and that have a readily determinable fair value (quoted market price) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in GAAP-defined “comprehensive income,” but not earnings. Appreciation or depreciation flows to equity but, for regulatory capital purposes only, depreciation is included in tier 1 capital.[8] Equity investments without readily determinable fair values generally are held at cost, subject to write-downs due to impairments in the value of the asset. As is the case with all assets, impairments in value should be promptly addressed. Institutions should ensure that they have taken write-downs in a timely manner and in an appropriate amount.

In determining fair value, the valuation methodology is critical. Clearly articulated methods for valuing investments are critical to the effective management of equity investments. Formal

7. Equity investments in nonfinancial companies held under the authorities discussed previously would not normally be held in the trading account, as they are not intended to be traded actively.

8. For a Board-regulated institution that makes an accumulated other comprehensive income opt-out election, tier 2 capital may include up to 45 percent of pretax net unrealized gains on AFS preferred stock classified as an equity security under GAAP and AFS equity exposures. See 12 CFR 217.20(d)(5).

valuation and accounting policies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate, other types of investments with special characteristics. In establishing valuation policies, institutions should consider market conditions, taking into account the lockout provisions, the restrictions of Securities and Exchange Commission Rule 144, liquidity features, the dilutive effects of warrants and options, and industry characteristics and dynamics.

For institutions acting as general partners of private equity funds, "clawback," or "lookback," provisions of partnership agreements can pose additional challenges when accounting for and valuing the distributions received from funds managed by the institution. Clawback provisions are promises general partners make to repay limited partners at the end of the term of a fund, if the general partner has received more than its contractually defined compensation or "carried interest" over the life of the fund. Clawback provisions can come into play when the liquidation and associated disposition of both limited-partner and general-partner returns on well-performing investments in a fund occur before the liquidation of poorer-performing investments. Often, escrow accounts are established to hold a portion of the general partners' carried interest during the life of the fund. When applicable, institutions should appropriately recognize the estimated impact of these provisions in accounting for and valuing general-partner activities, including the earnings derived from those activities.

The accounting and valuation of equity investments should be subject to regular periodic reviews. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. These reviews should assess the consistency of the methodologies used to estimate fair value.

Accounting and valuation treatments should be assessed in light of their potential for abuse through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at "fair value." On the other hand, inappropriately understated valuations can be vehicles for "smoothing earnings" by recognizing gains on profitable investments when an institution's earnings are otherwise under stress. While reasonable people may disagree on the valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Given the uncertainties in valuation methodologies and the relatively high volatility of the equity market, equity investments that are reported at fair value can contribute to earnings volatility in the institutions where they play a major role. As equity investments contribute to a firm's earnings, the potential impact of these investments on the composition, quality, and sustainability of an institution's overall earnings should be appropriately assessed by both a firm's senior management and supervisors.

3909.0.2.2.2.5 Exit Strategies

Returns and reported earnings on equity investments are highly affected by assumed and actual exit strategies. The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution's assumptions regarding exit strategies can significantly affect the valuation of the investment. The importance of reasonable and comprehensive primary and contingent take-out strategies for equity investments should be emphasized. Senior management should periodically review investment exit strategies, particularly focusing on larger or less liquid investments.

3909.0.2.2.2.6 Disposition of Investments

An institution should have policies and procedures to govern the sale, exchange, transfer, or other disposition of the institution's investments. These policies and procedures should state clearly the levels of approval required for the disposition of investments. In the case of investments held under the merchant banking provisions of the GLB Act, such policies and procedures should take into account and comply with the time limits for holding merchant banking investments.[9]

3909.0.2.2.2.7 Capital

Given the potential volatility of returns on equity investments, the risks associated with private equity investment and merchant banking business lines can exceed those of many more tradi-

10. See 12 CFR 225.172.

tional banking activities. Supervised institutions that are conducting material equity investment activities should have internal methods for allocating economic capital based on the risk inherent in those activities. These methods should identify all material risks and their potential impact on the safety and soundness of the institution. The amount and percentage of capital that is dedicated to this business line should be appropriate to the size, complexity, and financial condition of the supervised institutions. Institutions substantially engaged in equity investment and merchant banking activities should have strong capital positions supporting their equity investments, and they should allocate economic capital to these investments that is well in excess of the current regulatory minimums applied to lending activities.

Supervisory approach. Assessments of capital adequacy by supervisors should include not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but also its methodologies for internally allocating economic capital to this business line.

3909.0.2.3 Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting equity investment activities effectively. Appropriate internal controls should address all of the elements of the investment-management process, and they should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. An institution's policies and procedures should address a departure from policy, documentation of the reason for the departure, and the review by senior management.

Assessments of an institution's compliance with both written and implied policies and procedures should be conducted by institution employees who are independent of line decision-making functions to the fullest extent possible. Large complex banking institutions with material equity investment activities should have internal auditors or independent outside parties conduct periodic independent reviews of their investment process and valuation methodologies. In smaller, less complex institutions, where limited resources may preclude independent review, alternative checks and balances should be established. These checks and balances may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

3909.0.2.3.1 Documentation of the Investment Process

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal-control system. Accordingly, institutions should appropriately document their policies, procedures, and investment activities.

Institutions should be aware that the statutory and regulatory authority under which some equity investment activities are conducted may impose specific documentation and recordkeeping requirements. For example, merchant banking regulations require an FHC to maintain a written record any time it becomes involved in the routine management or operation of a portfolio company and to notify the Board if it routinely manages or operates a portfolio company for more than nine months.

Supervisory approach. Review internal controls policies over the key elements of the equity investment process. If senior management has authorized and reviewed any departures from policies and procedures, examiners should review the firm's justifications for those departures.

3909.0.2.3.2 Legal Compliance

Compliance with all federal statutes and regulations that are applicable to the institution's investment activities should be addressed in an institution's system of internal controls. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

Private equity and merchant banking activities are subject to different statutes and regulations, depending on the authority under which the activities are conducted. For example, the merchant banking investments of an FHC are subject to holding period limits and restrictions on the FHC's involvement in the routine management or operation of the portfolio company. Accordingly, management should have a system in place, consistent with applicable statutes and regulations, to ensure that impermissible control is not exercised over portfolio companies held under this authority and that merchant banking investments are disposed of within the time periods required by the rule. Limiting a supervised institution's involvement in the portfolio company's day-to-day management and operation is also important to protect the institution from lender-liability claims.

Likewise, certain cross-marketing restrictions apply to subsidiary depository institutions of FHCs and to portfolio companies controlled by the FHC under statutory merchant banking authority. Management should ensure that these limits are observed. When a banking organization owns or controls a significant percentage of a company's voting securities, the company may be an affiliate of the organization's depository institution subsidiaries for the purposes of the affiliate transaction limits of sections 23A and 23B of the Federal Reserve Act, as well as the Federal Reserve's Regulation W (12 CFR part 223). Also, the section 23A and 23B limitations on transactions between a depository institution and its affiliates are presumed by the GLB Act to apply to certain transactions between a depository institution subsidiary of an FHC and any portfolio company in which the FHC owns at least a 15 percent equity interest under the merchant banking authority. This ownership threshold is lower than the ordinary definition of an affiliate for section 23A purposes, which is typically 25 percent.

Moreover, to ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A restricted list of securities for which the institution has inside information is one widely used mechanism for controlling the risk of insider trading. In addition, the institution should have control procedures in place to ensure that appropriate reports are filed with functional regulators.

3909.0.2.3.3 Compensation

Often, key employees in the private equity investment units of a supervised institution may co-invest in the direct or fund investments made by the unit. The return on this co-investment, which the FHC may underwrite, may constitute a significant portion of the compensation of these employees. These co-investment arrangements can be an important incentive mechanism and risk-control technique and can help to attract and retain qualified management. However, "cherry picking," or selecting only certain investments for employee participation while excluding others, should be discouraged.

In many cases, the employees' co-investment may be funded through loans from affiliates of the supervised institution, which, in turn, hold a lien against the employees' interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and sales of participants' interests before the release of the lien.

3909.0.3 DISCLOSURE OF EQUITY INVESTMENT ACTIVITIES

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose the information necessary for the markets to assess the institution's risk profiles and performance in the equity investment business line. Indeed, it is in the institution's interest, as well as that of its creditors and shareholders, to disclose publicly information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. The following topics are relevant for public disclosure, though disclosures of each of these topics may not be appropriate, relevant, or sufficient in every case:

1. the size of the portfolio
2. the types and nature of investments (for example, direct or indirect, domestic or international, public or private, equity or debt with conversion rights)
3. the initial cost, carrying value, and fair value of investments, and, where applicable, comparisons to publicly quoted share values of portfolio companies
4. the accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
5. the realized gains (or losses) arising from sales and unrealized gains (or losses)
6. insights regarding the potential performance of equity investments under alternative market conditions

Supervisory approach. Supervisors should fully use the disclosures in public filings, as well as the periodic regulatory reports filed by publicly held institutions, as part of the information that they review routinely. Supervisors should encourage supervised institutions to make adequate disclosures or to improve their public disclosures of equity investment and merchant banking activities (these disclosures should include the items listed above).

3909.0.4 INSTITUTIONS LENDING TO OR ENGAGING IN OTHER TRANSACTIONS WITH PORTFOLIO COMPANIES

Additional risk-management issues may arise when a bank or an affiliate lends to or has other business relationships with (1) a company in which the supervised institution or an affiliate has invested (that is, a portfolio company); (2) the general partner or manager of a private equity fund that has also invested in a portfolio company; or (3) a private-equity-financed company in which the supervised institution does not hold a direct or indirect ownership interest, but which is an investment or portfolio company of a general partner or fund manager with which the institution has other investments. Given the potentially higher than normal risk attributes of these lending relationships, institutions should devote special attention to ensuring that the terms and conditions of these relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners.

Lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate must be negotiated on an arm's length basis, in accordance with section 23B of the Federal Reserve Act. The holding company also should have systems and policies in place to monitor transactions between the holding company, or a nondepository institution subsidiary of the holding company, and a portfolio company. (These transactions are not typically governed by section 23B.) A holding company should ensure that the risks of these transactions, including exposures of the holding company on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms. Special attention should be paid to transactions that are not on market terms.

A supervised institution may lend to a private-equity-financed company in which it has no equity interest. When the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity-related relationships, the extension of credit should be conducted on reasonable terms. In some cases, supervisors have found that lenders may wrongly assume that the general partners or another third party implicitly guarantees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on an institution's own assessment of the borrower and the borrower's ability to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit-risk rating of the borrower company or to prevent the classification or special mention of a loan. Any tendency to relax this requirement when the general partners or sponsors of private-equity- financed companies have significant business dealings with the supervised institution should be strictly avoided.

When an institution lends to a portfolio company in which it has a direct or indirect interest, implications arise under sections 23A and 23B of the Federal Reserve Act, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company when the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The Gramm-Leach-Bliley (GLB Act) extended this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution subsidiary of an FHC if the FHC uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the total equity of the company. Institutions should obtain the assistance of counsel to determine whether such issues exist or would exist if loans were extended to a portfolio company, general partner, or manager.

In addition to limiting and monitoring the exposure to portfolio companies that arises from traditional banking transactions, a supervised institution should adopt policies and practices that limit their legal liability, and that of their affiliates, for the financial obligations and liabilities of portfolio companies. These policies and practices include, for example, the use of limited-liability corporations or special-purpose vehicles to hold certain types of investments, the insertion of corporations that insulate liability between the supervised institution and a partnership controlled by the institution, and contractual limits on liability. Supervised institutions that extend credit to companies in which the institution has made an equity investment should also be aware of the potential for equitable subordination of the lending arrangements.

Supervisory approach. Supervisors should assess whether the institution has conducted a proper review of section 23A and 23B compliance issues to avoid violations of law or regulations. Supervisors should also ascertain that internal controls limit and monitor the exposures to portfolio companies in which the institution has a direct or indirect interest. Further, supervisors should determine whether the supervised institution has adopted policies and practices that limit its legal liability and that of its affiliates for the financial obligations and liabilities of the portfolio companies.

A finder brings together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate. National banks and state banks have been permitted to act and have acted as a finder in nonfinancial transactions for many years. Banking organizations have served as a finder by providing enclosures (or "statement stuffers") and other marketing materials from sellers of various products and services. Banking organizations have also helped to identify service providers as an accommodation to their customers. Financial holding companies (FHCs) have argued that acting as a finder, particularly in an electronic form, offers them increased opportunities to cross-sell financial products and services or to enhance the attractiveness of their electronic web site to customers. BHCs and foreign banks that qualify as FHCs may engage in finder activities (as authorized by section 225.86(d)(1) of Regulation Y) by providing the post-transaction notice stipulated in section 225.87(a) of Regulation Y.

An FHC may act as a finder for financial and nonfinancial products or services.[1] A finder includes providing any or all of the following services:

1. identifying potential parties, making inquiries as to their interest, introducing and referring potential parties to each other, and arranging contacts between and meetings of interested parties
2. conveying between interested parties expressions of interest, bids, offers, orders, and confirmations relating to a transaction
3. transmitting information concerning products and services to potential parties in connection with the activities described in this section

Some examples of finder services that may be provided by a finder, in accordance with section 225.86(d) of the rule, include—

1. hosting an electronic marketplace on the FHC's Internet web site by providing hypertext or similar links to the web sites of third-party buyers or sellers;
2. hosting, on the FHC's servers, the Internet web site of—
   - a buyer (or seller) that provides information concerning the buyer (or seller) and the products or services it seeks to buy (or sell) and allows sellers (or buyers) to submit expressions of interest, bids, offers, orders, and confirmations relating to those products or services; or
   - a government or government agency that provides information concerning its services or benefits, assists persons in completing applications to receive such government or agency services or benefits, and allows persons to transmit their applications for services or benefits to the government or agency;
3. operating an Internet web site that allows multiple buyers and sellers to (1) exchange information concerning the products and services that they are willing to purchase or sell, (2) locate potential counterparties for transactions, (3) aggregate orders for goods or services with those made by other parties, and (4) enter into transactions between themselves; or
4. operating a telephone call center that provides permissible finder services.

An FHC that acts as a finder for a buyer or seller may also provide the buyer or seller with any combination of other services that are permissible under Regulation Y, so long as the finder and other services are provided in accordance with any applicable limitations under the finder provisions of Regulation Y. For example, a finder for a merchant may, in addition to acting as a finder, make, acquire, broker, or service loans or other extensions of credit to or for the merchant or merchant's customers; provide the merchant with check-verification, check-guaranty, collection agency, and credit bureau services; provide financial investment advice to the merchant or its customers (within the parameters of Regulation Y); act as a certification authority for digital signatures and thereby authenticate the identity of persons conducting business with the merchant over electronic networks; and process and transmit financial, economic, and banking data on behalf of the merchant, such as processing the merchant's accounts receivable and debit and credit card transactions. The FHC may also provide the merchant

1. An FHC is permitted to act as a finder for financial products and services as part of other permissible financial activities. For example, an FHC may act as a finder (1) in the purchase and sale of securities under authority to act as a securities broker under section 225.86(a) of Regulation Y or (2) in the purchase or sale of insurance products as an insurance agent under section 225.86(c) of Regulation Y.

with bill-payment and billing services, as well as processing order, distribution, accounting, settlement, collection, and payment information for the merchant's transactions.

Furthermore, an FHC may market and provide its own financial products and services in conjunction with acting as a finder for buyers and sellers of nonfinancial products and services. For example, an FHC may use its finder services to promote a company's products and services and, in connection with that activity, may negotiate on its own behalf and bind itself to transactions.

3910.0.1 LIMITATIONS ON AN FHC THAT ACTS AS A FINDER

A finder cannot serve as a principal in the underlying transaction. A finder may act only as an intermediary between a buyer and a seller. A finder may not negotiate for or bind any buyer or seller to the terms of a specific transaction or negotiate the terms of a specific transaction on behalf of a buyer or seller. However, a finder may—

1. arrange for buyers to receive preferred terms from sellers so long as the terms are not negotiated as part of any individual transaction, are provided generally to customers or broad categories of customers, and are made available by the seller (and not by the FHC), and
2. establish rules of general applicability governing the use and operation of the finder service, including rules that—
   - govern the submission of bids and offers by buyers and sellers that use the finder service and the circumstances under which the finder service will match bids and offers submitted by buyers and sellers, and
   - govern the manner in which buyers and sellers may bind themselves to the terms of a specific transaction.

A finder may not (1) take title to or acquire or hold an ownership interest in any product or service offered or sold through the finder service; (2) provide distribution services for physical products or services offered or sold through the finder service; (3) own or operate any real or personal property that is used for the purpose of manufacturing, storing, transporting, or assembling physical products offered or sold by third parties; or (4) own or operate any real or personal property that serves as a physical location for the physical purchase, sale, or distribution of products or services offered or sold by third parties. Further, a finder cannot engage in any activity that would require the company to register or obtain a license as a real estate agent or broker under applicable law.

3910.0.2 REQUIRED DISCLOSURES

A finder is required to distinguish the products and services offered by the FHC from those offered by a third party through the finder service. Because an FHC may act as a finder for third parties through varied technological means and in a wide variety of circumstances, FHCs are not required to provide specific disclosures. The Board expects FHCs to provide disclosures that, given the medium employed and type of buyers and sellers using the service (for example, consumers or corporations), are reasonably designed to ensure that users are not led to believe that the FHC is providing the products or services offered or sold by third parties through the finder service. An FHC could provide such notice by identifying those products or services that are offered or sold by the FHC (with a corresponding notice that all other products or services are provided by third parties), or by identifying those products or services that are offered and sold by third parties and not by the FHC.

A financial holding company (FHC), a bank holding company (BHC) that meets the requirements of 4(l)(1) of the Bank Holding Company Act (the BHC Act),[1] proposed to acquire, manage, and operate in the United Kingdom defined benefit pension plans established and maintained by unaffiliated third parties (third-party UK pension plans). The activities would be conducted by or through a nonbank subsidiary of the FHC. The FHC would acquire third-party UK pension plans in standalone transactions and not as part of the acquisition of all or part of the ongoing business operations of the third parties.

Section 4 of the BHC Act generally prohibits a BHC, including an FHC, from directly or indirectly engaging in, or acquiring the shares of a company engaged in, any nonbanking activity unless the activity is otherwise permissible under the act. Section 4(k) of the BHC Act, as amended by the Gramm-Leach-Bliley Act (the GLB Act), permits a BHC that qualifies to be an FHC to engage in, and acquire and retain shares of any company engaged in, a broad range of activities that are defined by statute to be financial in nature.[2] The BHC Act also permits an FHC to engage in, and acquire and retain shares of any company engaged in, any activity that the Board determines, by order or regulation and in consultation with the Secretary of the Treasury, to be financial in nature or incidental to a financial activity.[3]

A defined benefit pension plan generally is a plan established by or on behalf of an employer (the plan "sponsor"). The plan provides for the payment of benefits to employees, typically beginning on their retirement or other termination of service, in an amount that is specified in and determinable under the plan, typically through a formula that takes into account the employee's pay, years of employment, age at retirement, and other factors.[4] The terms of the plan itself also typically specify (1) the circumstances under which benefits will be paid under the plan to an employee, a former employee, or a related person (such as a spouse) (collectively, a beneficiary) and (2) the length of time such payments will be made to a beneficiary. The benefits payable under a plan typically take the form of a specified stream of payments that begin on retirement or, at the employee's option, a lump sum payable at retirement; plan rules may also provide for other ancillary benefits, such as spousal or survivor benefits.[5] The nonbank subsidiary of the FHC that directly acquires a third-party UK pension plan would assume the responsibilities of the plan's sponsor under applicable UK law. In the United Kingdom, defined benefit pension plans are regulated by the UK Pensions Regulator under the Pensions Act of 1995, the Pensions Act of 2004, and the general law of trusts. These laws provide that pension plans must be managed and administered by a trustee that is independent of the plan sponsor. Plan sponsors must also provide sufficient assets to a pension plan to pay all benefits under the plan,[6] consult with the trustees for the pension plan concerning the investment strategy of the plan, and agree with the plan trustees on a statement of funding principles that sets out the plan's funding target, methods, and assumptions. In addition, trustees and plan sponsors must agree on amendments to any part of the plan.

As proposed, the FHC would acquire a third-party UK pension plan only if no additional beneficiaries may be added to the plan and existing beneficiaries may not accrue additional benefits under the plan (a hard-frozen plan). In addition, the FHC would acquire a third-party UK pension plan only if the plan, at the time of its acquisition, is fully funded by the selling sponsor, based on the plan's assets and projected liabilities (using appropriate actuarial assumptions).[7] The FHC indicated that, as part of its due-diligence process for each transaction,

1. 12 U.S.C. 1841 et seq.
2. See 12 U.S.C.1843(k)(4).
3. 12 U.S.C. 1843(k)(1)(A) and (2). In addition, the BHC Act permits an FHC to engage in any activity that the Board (in its sole discretion) determines, by regulation or order, is "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally" (12 U.S.C. 1843(k)(1)(B)).
4. A defined contribution plan is a benefit plan under which an individual account is established for each participant and the benefits payable to each participant are based on the amount contributed to the participant's account, plus or minus income, gains, expenses, and losses allocated to that account.
5. "Defined benefit pension plan" does not include a plan that provides health insurance to employees or that guarantees or indemnifies employees for health care costs.
6. The sponsor may recover assets contributed to or held on behalf of a plan after all of the plan's obligations to beneficiaries have been satisfied and the plan is closed out.
7. The term "fully funded" means that, at the time of acquisition, the current value of the plan's assets is at least equal to the present value of the plan's projected liabilities. The selling sponsor may issue debt to the plan or the FHC to fully fund the plan at acquisition. In some situations, the requirement that a plan be fully funded may require funding

it would employ qualified actuaries to review and analyze the present value of benefits owed to plan beneficiaries to ensure that all pension plans acquired are fully funded by the selling sponsor.

The activity of acquiring, operating, and managing third-party pension plans had not been previously determined to be financial in nature or incidental to a financial activity for purposes of the BHC Act. The activity proposed is broader than the pension plan activities that FHCs are currently permitted to conduct for third parties. For example, as discussed above, a nonbank subsidiary of the FHC would assume the rights and obligations of the sponsor of an acquired third-party UK pension plan and would do so in transactions that do not represent the acquisition of a going concern or ongoing business operations by the FHC. In addition, the assets and liabilities of an acquired third-party UK pension plan (unlike assets held by an FHC as trustee for third parties or assets held by the pension plans maintained for the FHC's own employees) would be fully consolidated with the assets and liabilities of the FHC on its balance sheet.[8]

The Board concluded, for the reasons set forth below, that there is a reasonable basis for determining that the acquisition, management, and operation by the FHC of hard-frozen, fully funded third-party UK pension plans is an activity that is financial in nature within the meaning of the BHC Act. The activity involves, at its core, the types of investment advisory and investment management skills that are routinely exercised by banking organizations and also involves the types of operational and investment risks that banking organizations routinely incur and manage.

FHCs are currently permitted by the BHC Act to engage in activities that are related or operationally and functionally similar to the proposed activity and that involve similar risks. For example, an FHC is already permitted to provide a wide variety of services to third-party pension plans, including acting as trustee, custodian, or investment adviser (with or without investment discretion) for a third-party benefit plan, as well as designing, assisting in the implementation of, providing administrative services to, and developing employee communication programs for third-party benefit plans.[9] FHCs engaged in these activities have gained substantial expertise with the laws, regulations, and fiduciary obligations associated with providing fiduciary, custodial, and administrative services to pension plans. Moreover, FHCs engaged in these plan-related activities have developed risk-management systems and internal controls to monitor, manage, and address the legal, operational, and reputational risks associated with managing the investments of and administering third-party pension plans.

The proposed activity also bore a strong functional resemblance to the issuance of a group annuity contract. The BHC Act, as amended by the GLB Act, expressly states that providing and issuing annuities is an activity that is financial in nature.[10] A company that issues a fixed annuity becomes obligated to make periodic payments to the annuitant during his or her lifetime and to pay any death or survivor benefits in accordance with the terms of the annuity contract. The company that issues a fixed annuity assumes responsibility for investing and managing the funds received from the annuitant and bears the risk that such funds and the returns earned on the funds will not be sufficient to pay out the full amount of benefits promised under the annuity contract. The company also assumes responsibility for administering the annuity contract both before and during its payout period.

In connection with these activities, the issuer of fixed annuities is exposed to certain types of risks, which are part of the activity determined to be financial in the GLB Act. These risks include the risk that (1) the life expectancy of annuitants, on average, will exceed the actuarial estimates used in establishing the terms of and funding for the annuities; (2) the inflation rate and other assumptions used to determine the expected obligations under the annuity contracts underestimate these obligations; and (3) payments from the annuitant and the return obtained through the investment of such payments will fall short of estimates.

The FHC would perform essentially the same financial functions and assume essentially the same financial obligations and risks through the

in excess of the statutory funding requirements of the relevant jurisdiction.

8. Since the FHC would acquire each third-party UK pension plan in a standalone transaction, and not as part of a business combination involving it and the selling sponsor, the FHC stated that it will fully reflect the assets and liabilities of an acquired plan as assets and liabilities of the FHC on its balance sheet. This treatment differs from the manner in which the assets and liabilities of an internal pension plan of an employer typically are accounted for on the balance sheet of the employer under U.S. generally accepted accounting principles. See Statement of Financial Accounting Standards No. 158 (FAS 158), "Accounting for Defined Benefit Pension and Other Post Retirement Plans."

9. See 12 C.F.R. 225.28(b)(5), (6), and (9)(ii).

10. 12 See 12 U.S.C. 1843(k)(4)(B).

acquisition of a third-party UK pension plan as an insurance company would perform and assume in connection with the issuance of fixed annuities. The functional similarity between a plan sponsor's obligations under a defined benefit pension plan and an insurance company's obligations under an annuity contract is especially close when the pension plan is both fully funded and hard-frozen, as it is in the FHC's proposed activity. When a pension plan's obligations to plan beneficiaries are hard-frozen and the plan is fully funded, one method commonly used by a plan sponsor to close out a plan is to purchase a terminal funding group annuity contract from an insurance company. Through such an annuity contract, the provider of the annuity becomes obligated to satisfy the responsibility to pay the benefits promised under the plan to the plan's beneficiaries. The FHC's proposed activities would be specifically permitted under the BHC Act if they were provided through an annuity contract or other form of insurance.

When evaluating this proposal, the Board considered that, under UK law, the nonbank subsidiary established by the FHC to acquire a third-party UK pension plan will generally bear sole responsibility for making additional contributions to the plan if the plan assets are not sufficient to meet the plan's expected or actual liabilities. However, UK law also permits the UK Pensions Regulator in certain circumstances to commence proceedings to hold an affiliate of a plan sponsor (including a depository institution affiliate) responsible for the sponsor's obligations to the plan.[11]

Generally, the Board has taken the position that, when a depository institution is secondarily liable for a financial obligation of an affiliate, even if the depository institution's liability is created by statute or regulatory action, the institution has issued a guarantee on behalf of an affiliate for purposes of section 23A of the Federal Reserve Act and the Board's Regulation W. Section 23A and Regulation W impose quantitative and qualitative limits on covered transactions between a depository institution and its affiliates.[12] The limitations in section 23A and Regulation W provide important protections against a depository institution suffering losses due to covered transactions with its affiliates and also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net.

To address the potential section 23A and Regulation W issues presented by its initial proposed transaction, and in accordance with UK law,[13] the FHC obtained written assurances from the UK Pensions Regulator that it will not seek to hold any of the FHC's depository institution subsidiaries that are subject to section 23A responsible for any shortfalls that may occur in the pension plan proposed to be acquired by the FHC in this initial transaction. As a condition of this order, the FHC must obtain similar written assurances from the UK Pensions Regulator before acquiring any additional third-party UK pension plan.[14]

Based on the foregoing and other facts of record, the Board concluded that the acquisition, management, and operation by the FHC of hard-frozen, fully funded third-party UK pension plans, when conducted in accordance with the conditions and limitations set forth in the order, is an activity that is financial in nature within the meaning of section 4(k) of the BHC Act. Any investment made by a third-party UK pension plan acquired by the FHC must otherwise be permissible for an FHC under the BHC Act and the Board's Regulation Y.[15] The authorization and determination granted by the Board's order is limited to the acquisition, management,

11. See the UK Pensions Act of 2004, section 38 (contribution notices) and section 43 (financial support directives). The UK Pensions Regulator may issue a contribution notice or financial support directive to an affiliate of a sponsor only if, among other things, the Pensions Regulator determines that it is reasonable to impose the proposed financial obligations on the affiliate.

12. See 12 U.S.C. 371c(b)(7) and 12 C.F.R. 223.3(h).

13. The Pensions Act of 2004 expressly authorizes the UK Pensions Regulator, on application by a plan or other person, to issue a "clearance statement" that determines that it would be unreasonable to issue a contribution notice or financial support directive to the plan or person under the circumstances described in the application. See Pensions Act of 2004, sections 42 and 46. The FHC received such a clearance statement with respect to its initial proposed acquisition of a third-party pension plan in the United Kingdom.

14. The FHC has indicated that the written assurances provided by the UK Pensions Regulator are subject to review and renewal by the regulator no later than five years after issuance. Before the expiration of any written assurances provided by the UK Pensions Regulator in connection with the acquisition by the FHC of a third-party UK pension plan, the FHC must either ensure that its activities conform with those permitted under section 23A and Regulation W or obtain an exemption from the Board from the limitations of section 23A and Regulation W with respect to the plan. The Board has not determined that section 23A applies to the contingent liabilities that may arise under applicable pension law from the establishment or operation by an affiliate of a depository institution of employee benefit plans in the ordinary course of its other business to provide benefits to the employees or former employees of the affiliate.

15. See, for example, 12 U.S.C. 1843(c)(5), (c)(6), and (k)(4)(H).

and operation by the FHC of third-party pension plans in the United Kingdom.[16]

Under the BHC Act, the Board may not determine, by regulation or order, that an activity is financial in nature or incidental to a financial activity if the Secretary of the Treasury (the Secretary) notifies the Board in writing that the Secretary believes the activity is not financial in nature, incidental to a financial activity, or otherwise permissible under section 4 of the BHC Act.[17] The Board provided the Secretary of the Treasury with notice of the FHC's proposal in accordance with the BHC Act, and the Secretary informed the Board in writing that the Secretary did not intend to prevent the Board from authorizing the FHC to engage in the proposed UK pension activities, subject to the conditions and limitations in the Board's order.

16. Other FHCs may seek approval to engage in similar activities by requesting a determination with respect to their own proposed activities under section 4(k)(2)(A) of the BHC Act and section 225.88 of the Board's Regulation Y (12 C.F.R. 225.88).

17. See 12 U.S.C. 1843(k)(2)(A).

The Board's determination and approval is subject to all the conditions set forth in Regulation Y, including those in section 225.7,[18] and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to ensure compliance with, or to prevent evasion of, the provisions and purposes of the BHC Act and the Board's regulations and orders. The Board's decision is specifically conditioned on compliance with all the commitments made to the Board in connection with the request, including the commitments and conditions discussed in the order. The Board's order was approved and effective on October 12, 2007.[18]

18. 12 C.F.R. 225.7.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, a brief discussion of a Board order in which the Board considered under section 4(k) of the Bank Holding Company (BHC) Act, and approved, a financial holding company (FHC)'s limited trading in certain physical commodities that are not approved by the Commodities Futures and Trading Commission (CFTC) for trading in the U.S. or on non-U.S. futures exchanges. To trade in such commodities, the FHC must be able to demonstrate that the derivative contracts on the commodity satisfy the specified standards that are stated in the order. The section also discusses the Board's approval of the same FHC's request to make and take delivery in nickel, a metal that is traded on the London Metal Exchange (LME)—a CFTC-comparable regulatory entity. Members of the LME can conduct brokerage activities for U.S. customers without being registered with the FTC as a futures commission merchant.

An FHC's Board-approved request to permit the refining, blending, or altering of approved commodities by a third party is reviewed within the section along with the use of recognized alternate trading platforms. The same Board order includes the Board's approval of the FHC's request to engage in limited physically settled energy tolling by entering into tolling agreements with power plant owners. The Board determined that the activity is complementary to the financial activity of engaging as principal in commodity derivatives transactions. The FHC nonbank activity had not *been previously approved by the Board. (See 2008 FRB C60.)*

For another Board order, the section discusses the Board's approval of an FHC's request to engage in providing Energy Management Services (EMS) to owners of power generation facilities. The EMS are to be provided under energy management agreements as a complement to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivative transactions. (See 2008 FRB C20.)

3920.0.1 ENGAGING IN LIMITED FHC COMMODITY-TRADING ACTIVITIES INVOLVING A PARTICULAR COMMODITY AS A COMPLEMENT TO THE BHC-PERMISSIBLE FINANCIAL ACTIVITY OF ENGAGING REGULARLY IN COMMODITY DERIVATIVES BASED ON THAT COMMODITY

An FHC requested the Board's approval under section 4(k) of the Bank Holding Company Act (the BHC Act) to retain all of the shares of a company that engaged in a variety of commodity-related activities in the United States, including trading in physical commodities, an activity not previously approved under the BHC Act.

Regulation Y authorizes bank holding companies (BHCs) to engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on a rate, price, financial asset, nonfinancial asset, or group of assets (other than a bank-ineligible security) (commodity derivatives). A BHC may conduct commodity-derivatives activities under Regulation Y subject to certain restrictions that are designed to limit the BHC's activity to trading and investing in financial instruments rather than dealing directly in physical nonfinancial commodities. Under these restrictions, a BHC may take and make delivery of physically settled derivatives involving commodities that a state member bank is permitted to own.[1] For all other types of physically settled derivatives,[2] a BHC must make reasonable efforts to avoid delivery on such derivatives or must take and make delivery only on an instantaneous, pass-through basis. (See section 3260.0.4.6.) Other than in the limited circumstances described above in connection with commodity derivatives, Regulation Y generally does not permit BHCs to take or make delivery of nonfinancial commodities underlying commodity derivatives. In addition, BHCs are generally not permitted to purchase or sell nonfinancial commodities in the spot market.

1. State member banks may own, for example, investment-grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals.

2. These derivative contracts would include instruments based on, for example, energy-related and agricultural commodities.

The FHC requested that the Board expand the authority of FHCs to purchase and sell commodities in the spot market and to take and make delivery of physical commodities to settle commodity derivatives (commodity-trading activities), by determining that these activities are ‘‘incidental’’ to a financial activity (pursuant to section 4(k) of the BHC Act). Commodity-trading activities typically involve the commercial activities of physically owning and disposing of assets such as oil, natural gas, agricultural products, and other nonfinancial commodities. Moreover, the risks associated with conducting these activities are commercial risks not traditionally incurred or managed to a material extent by banking organizations. Accordingly, the Board did not believe that commodity-trading activities could be construed as incidental to a financial activity within the meaning of the Gramm-Leach-Bliley Act (the GLB Act) or the BHC Act. The Board concluded, however, for the reasons set forth below, that there was a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLB Act or the BHC Act.

Section 4(k)(1)(B) of the BHC Act permits FHCs to seek Board approval to engage in any activity the Board determines (1) to be complementary to a financial activity and (2) not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. FHCs must submit a written request for the Board's approval to engage in a complementary activity through the filing of a notice under section 4 of the BHC Act. The Board considers each request on a case-by-case basis. (Subsection 3905.0.1 provides a list of the information that needs to be included with such a request.)

A number of considerations supported a Board determination that commodity trading activities are complementary to a financial activity. (See 2003 FRB 508.) Commodity-trading activities can flow from the existing financial activities of FHCs. In particular, commodity-trading activities provide FHCs with an alternative method of fulfilling their obligations under otherwise BHC-permissible commodity derivatives. For example, if warranted by market conditions, an FHC would be able to use commodity-trading-activity authority to take a commodity derivative to physical settlement rather than terminating, assigning, offsetting, or otherwise cash-settling the contract.

The Board also noted that the applicant contended that the existing restrictions of Regulation Y place FHCs at a significant bargaining disadvantage when operating in physically settled over-the-counter (OTC) derivatives markets. According to the applicant, counterparties to FHCs in these markets are aware of the regulatory impediments that inhibit BHCs and FHCs from taking derivative contracts to physical settlement. As a consequence, BHCs and FHCs that participate in these markets can be forced to terminate or offset their derivative contracts on uneconomic terms. Allowing BHCs and FHCs to engage in commodity-trading activities would permit FHCs to compete in physically settled OTC derivatives markets more economically.

The Board concluded that commodity trading activities involving a particular commodity complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity.[3] In order to authorize FHCs to engage in commodity-trading activities as a complementary activity under the GLB Act, the Board must also determine that those activities do not pose a substantial risk to the safety or soundness of depository institutions or the U.S. financial system generally.[4] To limit the potential safety-and-soundness risks of commodity-trading activities, the applicant proposed to engage in only a limited amount of commodity-trading activities. As a condition of the Board's order, the market value of commodities held by the applicant as a result of commodity-trading activities must not exceed 5 percent of the applicant's consolidated tier 1 capital.[5] The applicant also must notify its designated supervising Federal Reserve Bank if the market value of commodities held by the applicant as a result of its commodity-trading activities exceeds 4 percent of its tier 1 capital.

In addition, the Board's order permitted the applicant to take and make delivery of only physical commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (CFTC) (unless specifically excluded by the Board) or that have been specifically approved by the Board.[6] This

3. For example, commodity-trading activities involving all types of crude oil would be complementary to engaging regularly as principal in BHC-permissible commodity derivatives based on Brent crude oil.

4. 12 U.S.C. 1843(k)(1)(B).

5. The applicant is required to include in this 5 percent limit the market value of any commodities it holds as a result of a failure of its reasonable efforts to avoid taking delivery under section 225.28(b)(8)(ii)(B) of Regulation Y.

6. The particular commodity-derivative contract that the applicant takes to physical settlement need not be exchange-traded, but (in the absence of specific Board approval) futures

requirement is designed to prevent the applicant from becoming involved in dealing in finished goods and other items, such as real estate, that lack the fungibility and liquidity of exchange-traded commodities.

The Board concluded that permitting the applicant to buy and sell commodities in the spot market or physically settle commodity derivatives would not appear to increase significantly the organization's potential exposure to commodity-price risk.

The Board's order acknowledged that adding commodity-trading activities would expose the applicant to additional risks, including, but not limited to, storage risk, transportation risk, and legal and environmental risks. To minimize these risks, the applicant was not authorized to (1) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities or (2) process, refine, or otherwise alter commodities. In conducting its commodity-trading activities, the applicant was expected to use appropriate storage and transportation facilities owned and operated by third parties.[7]

The applicant indicated that it will mandate that the commodity-storage facilities it uses have all required governmental permits and provide the applicant with a certificate to that effect. The applicant further stated that all commodity-storage facilities will be inspected by or on its behalf before use and that it will physically inspect any commodity in storage every six months.

The applicant also stated that it would adopt additional standards for commodity-trading activities that involve environmentally sensitive products, such as oil or natural gas. For example, the applicant will require that the owner of every vessel that carries oil on its behalf be a member of a protection and indemnity club and carry the maximum insurance for oil pollution available from the club. Every such vessel will be required to carry substantial amounts of additional oil-pollution insurance from creditworthy insurance companies. The applicant will place age limitations on vessels and will require vessels to be approved by a major international oil company and have appropriate response plans and equipment for oil spills. The applicant will also have a comprehensive backup plan in the event any vessel owner fails to respond adequately to an oil spill and will hire inspectors to monitor the loading and discharging of vessels.

The applicant also represented that it will have in place specific policies and procedures for the storage of oil. In addition, the applicant will require all oil-storage facilities it uses to carry a significant amount of oil-pollution insurance from a creditworthy insurance company and to have appropriate spill-response plans and equipment. The applicant will also follow a comprehensive backup plan in the event the storage facility owner fails to respond adequately to an oil spill.

The Board determined that the applicant had the managerial expertise and internal control framework to manage the risks of taking and making delivery of physical commodities. It also concluded that the applicant had the expertise and internal controls to integrate effectively the risk management of commodity-trading activities into its overall risk-management framework, which includes managing on a consolidated basis the overall exposure arising from the applicant's commodity-related activities.

For these reasons, and based on the applicant's policies and procedures for monitoring and controlling the risks of commodity-trading activities, the Board concluded that consummation of the proposal did not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and could reasonably be expected to produce benefits to the public that outweighed any potential adverse effects. (See 2003 FRB 508.)

In another Board order (2004 FRB 215), a foreign bank (the FB) that is treated as a financial holding company (FHC) for purposes of the Bank Holding Company Act (the BHC Act), requested the Board's approval under section 4 of the BHC Act (12 U.S.C. 1843) and the Board's Regulation Y (12 C.F.R. 225) to retain all the voting shares of FB Energy, LLC, located in Connecticut (FB Energy) and to continue engaging in physical-commodity trading in the United States. The FB conducts physical-

or options on futures on the commodity underlying the derivative contract must have been approved for exchange trading by the CFTC. The CFTC publishes annually a list of the CFTC-approved commodity contracts. See, for example, Commodity Futures Trading Commission, *FY 2002 Annual Report to Congress* 124 and *FY 2003 Annual Report to Congress* 109.

With respect to granularity, the Board intends this requirement to permit commodity-trading activities involving all types of a listed commodity. For example, commodity-trading activities involving any type of coal or coal-derivative contract would be permitted, even though the CFTC list specifically approves only Central Appalachian coal.

7. The Board's approval of commodity-trading activities as a complementary activity, subject to the limits and conditions, did not restrict the existing authority of the applicant to deal in foreign exchange, precious metals, or any other bank-eligible commodity.

commodity trading in the United States pursuant to temporary grandfather authority provided by the BHC Act and Regulation Y.[8]

The FB requested that the Board permit it to purchase and sell physical commodities in the spot market and to take and make delivery of physical commodities to settle commodity derivatives (commodity-trading activities). As noted in the 2003 Board order (2003 FRB 508), the Board had previously determined that commodity-trading activities involving a particular commodity complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity. The FB regularly engages as principal in BHC-permissible commodities derivatives based on a variety of commodities, including natural gas and electricity. The Board determined that the commodity-trading activities are complementary to the commodity-derivatives activities of the FB.

The FB has established and maintained policies for monitoring, measuring, and controlling the credit, market, settlement, reputational, legal, and operational risks involved in its commodity-trading activities. These policies address key areas such as counterparty credit risk, value-at-risk methodology and internal limits with respect to commodity trading, new-business and new-product approvals, and identification of transactions that require higher levels of internal approval. The policies also describe critical internal control elements, such as reporting lines, and the frequency and scope of internal audit of commodity-trading activities.

The FB is subject to the same commitments and restrictions set forth in the previously discussed Board order (2003 FRB 508). The FB and its commodity-trading activities also remain subject to the general securities, commodities, and energy laws and to the rules and regulations (including the anti-fraud and anti-manipulation rules and regulations) of the Securities and Exchange Commission, the CFTC, and the Federal Energy Regulatory Commission.

The Board concluded that permitting the FB to engage in the limited amount and types of commodity-trading activities described previously, on the terms described in the order, would not appear to pose a substantial risk to the FB, depository institutions, or the U.S. financial system generally. Because of its existing authority to engage in commodity derivatives, the FB could already incur the price risk associated with commodities. Therefore, permitting the FB to buy and sell commodities in the spot market or to physically settle commodity derivatives did not appear to increase significantly the organization's potential exposure to commodity-price risk.

Based on the reasons stated in the Board's order, and based on the FB's policies and procedures for monitoring and controlling the risks of commodity-trading activities, the Board concluded that consummation of the proposal did not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and that it could reasonably be expected to produce benefits to the public that outweigh any potential adverse effects.

Based on all the facts of record, including the representations and commitments made by the FB in connection with the notice, and subject to the terms and conditions set forth in the order, the Board approved the notice on January 27, 2004. (See 2004 FRB 215 and the notice approved by the Board at 2004 FRB 511; both FHCs were approved by the Board to engage in limited physical-commodity trading involving such commodities as natural gas and electricity.) Also see the approvals for FHCs to engage in limited commodities trading that included certain energy-related commodities, such as natural gas, crude oil, electricity, and emissions allowances.[9] These Board orders were approved on November 18, 2005 (2006 FRB C57), December 19, 2005 (2006 FRB C54), and March 15, 2006 (2006 FRB C113). Subsequently, the Board delegated its authority to approve notices by FHCs to engage in physical-commodity trading as a complementary activity to the director of the Division of Banking Supervision and Regulation, with the concurrence of the General Counsel, when the proposal meets the conditions imposed by the Board in approving previous requests and when the specific proposal raises no significant legal, policy, or supervisory issues.

8. The FB's grandfather rights were scheduled to expire on February 8, 2004. The FB conducts its U.S. energy trading business through FB Energy and FB's London branch.

9. An emission allowance is an intangible right to emit certain pollutants during a given year or any year thereafter that is granted by the U.S. Environmental Protection Agency or comparable foreign regulatory authority to an entity—such as a power plant or other industrial concern—affected by environmental regulation aimed at reducing emission of pollutants. An allowance can be bought, sold, or exchanged by individuals, brokers, corporations, or government entities that establish an account at the relevant governmental authority.

Emissions allowances are stored and tracked in the records of the relevant government authority. Accordingly, there is no transportation, environmental, storage, or insurance risk associated with ownership of emissions allowances.

3920.0.2 TRADING IN CERTAIN PHYSICAL COMMODITIES NOT APPROVED BY THE CFTC FOR TRADING ON A FUTURES EXCHANGE

The Board had previously conditioned its notice approvals to engage in physical commodity trading (PCT) based on commitments made by the FHCs to trade only in commodities for which derivative contracts had been approved for trading on a futures exchange by the CFTC, unless the commodity was specifically excluded or approved by the Board (Approved Commodities Commitment). This commitment provided a means to ensure that the PCT remained complementary to the financial activity of commodity derivatives activities (CDAs) because it helped demonstrate that there was a derivatives market for the underlying commodity. This commitment also was intended to prevent FHCs from dealing in finished goods and other items, such as real estate or industrial products that lacked the fungibility and liquidity of exchange-traded commodities.

In another request, a foreign-domiciled FHC, RB, requested the Board's approval under section 4 of the BHC Act, and the Board's Regulation Y, to engage in limited PCT. That request led to the Board's decisions with regard to trading of certain physical commodities, which are *not* CFTC-approved for trading on a futures exchange. The Board determined that, subject to certain requirements, an FHC may take delivery of certain commodities that have *not* been approved by the CFTC, if those commodities are similarly fungible and liquid, and do not expose the FHC to significant additional risk.

3920.0.2.1 Commodities Approved for Trading on Non-U.S. Exchanges.

The Board has previously used CFTC-approval of a commodity for trading on a U.S. futures exchange as a test to determine whether a derivative or the underlying commodity is liquid and fungible. For some liquid and fungible commodities, however, no market-maker had sought CFTC approval because of the presence of an established foreign trading market, which could deter a U.S. exchange from listing a similar product. The absence of CFTC approval, in those cases, generally would *not* indicate that taking and making physical delivery of the commodity would entail substantially greater risks than taking and making delivery of a CFTC-approved commodity. A derivatives contract that is based on a commodity that trades on a non-U.S. exchange may be subject to a regulatory structure comparable to the one administered by the CFTC. Such a structure generally should be sufficient to demonstrate that (1) there is a market in financially settled contracts on the commodities, (2) the commodity is fungible, and (3) a reasonably liquid market for the commodity exists.

3920.0.2.1.1 Take and Make Delivery of Nickel

RB specifically requested the Board's approval to take and make physical delivery of nickel, which is a metal that is widely and actively traded on the London Metal Exchange (LME). The LME offers futures and options contracts for aluminum, copper, nickel, tin, zinc, and certain aluminum alloy contracts. The CFTC has determined that the LME is subject to a regulatory structure comparable to that administered by the CFTC under the Commodity Exchange Act. As a result, members of the LME may conduct brokerage activities for U.S. customers without having to register with the CFTC as a futures commission merchant or otherwise comply with certain of the CFTC's consumer protection rules.[10] Given the nature of the LME trading market and the CFTC's determination that LME members are subject to comparable regulatory oversight, the Board determined that FHCs that receive approval to engage in PCT may take and make delivery of nickel. The Board determined that other FHCs that had already received approval to engage in PCT could also make and take delivery of nickel, consistent with the Approved Commodities Commitment, as a commodity that has been specifically approved by the Board.

3920.0.2.2 Commodities That Are Not Approved for Trading in the U.S. or on Certain Non-U.S. Exchanges

Many commodities for which derivatives con-

10. The CFTC's Rule 30.10 permits a person affected by the requirements contained in Part 30 of the CFTC's rules, which relate to registration as a futures commission merchant, to petition the CFTC for an exemption from the requirements based on the person's substituted compliance with a foreign regulatory structure found comparable to that administered by the CFTC under the Commodities Exchange Act.

tracts have not been approved for trading by the CFTC or that are not traded on a non-U.S. exchange may also be commodities that have viable markets with financially settled contracts on the commodities and that satisfy fungibility and liquidity concerns. In many cases, the existence of an established over-the-counter market obviates the need to seek CFTC approval for listing on a futures exchange. In addition, the particular commodity may be similar to a CFTC-approved commodity, such as a product that is derived from a CFTC- approved commodity. In which case, the separate listing may be excessive because market participants can use derivatives contracts on the CFTC-approved commodity to hedge their positions in the non-CFTC-approved derivative product.

The Board believes that taking and making physical delivery of non-CFTC-approved commodities may be consistent with the PCT authority if an FHC can demonstrate that (1) there is a market in financially settled contracts on those commodities in addition to the physically settled contracts, (2) the particular commodity is fungible, and (3) the market for the commodity is sufficiently liquid. In addition, the FHC must demonstrate that it has established trading limits in place that address both concentration risk and overall exposure to the commodity to ensure that the FHC could physically trade in these commodities without incurring significant additional risk.

RB requested the Board's approval to trade in certain natural gas liquids, oil products, and petrochemicals. The natural gas liquids consisted of butane, ethane, and natural gasoline; the proposed oil products were asphalt, condensate, boiler cutter, residual fuel oil no. 6, kerosene, straight run, marine diesel, and naphtha; and the proposed petrochemicals were ethylene, paraxylene, styrene, propylene, and toluene (collectively, PCs). Contracts on those PCs are not approved by the CFTC for trading on a U.S. futures exchange or on a major non-U.S. exchange. Nonetheless, the following considerations provided the Board support for making a determination that trading in the PCs should be permitted as part of the PCT authority.

3920.0.2.2.1 Market in Financially Settled Contracts

Many commodities trade on established alternative trading platform(s) or ATPs that are used by a wide variety of market participants, rather than on a futures exchange. If derivatives contracts on a commodity trade on a recognized ATP, that activity could serve as sufficient evidence that a market in financially settled contracts on the particular commodity exists. Financially and physically settled contracts for all the PCs trade on recognized ATPs.

The natural gas liquids are traded on the Intercontinental Exchange ("ICE") and on the New York Mercantile Exchange ("NYMEX") electronic trading platforms; the distillate and residual oil products trade on ICE and NYMEX; and the petrochemicals are traded on the Chemconnect electronic trading platform. These ATPs are major platforms that are widely used by a variety of producers, consumers, and traders of the PCs.

3920.0.2.2.2 Fungibility

To ensure that a commodity is fungible, an FHC must demonstrate that no specification of exact product or lot would be included for contracts on the commodity. The physical asset that may be delivered to satisfy a contract would be, by nature or usage of trade, the equivalent of any other unit of the asset. The PCs, which trade on ICE, NYMEX, and Chemconnect, are fungible because market participants contract for specific quantities of the commodity but cannot specify the particular product they will receive.

3920.0.2.2.3 Liquidity

To ensure that the market for a particular commodity is sufficiently liquid, an FHC must demonstrate that an active trading market in the commodity exists that would allow the institution to limit its position in the commodity relative to the volume that trades in the market generally. The following factors indicate that a reasonably liquid market exists: (1) reliable trading volume in the commodity or production statistics exist that demonstrate the size of the market in the commodity; (2) daily or intraday price data on the commodity are published; and (3) a number of market makers in the commodity stand ready to buy or sell the commodity each day at published bid and offer quotations. Each of the PCs is derived from CFTC-approved commodities (natural gas and oil) and is used, similar to CFTC approved commodities, as fuel or as inputs for finished products. The PCs are traded widely through brokers on the previously discussed ATPs and are physically traded at various hubs in the U.S. and abroad.[11] The ATPs post daily prices for both the buy and sell offers on which the PCs trade.

3920.0.2.2.4 Trading Limits

An FHC that proposes to trade in a new commodity must demonstrate that it has established appropriate limits on its trading in the commodity and has a risk-management program in place to monitor compliance with those limits, which must include both concentration limits and overall exposure limits. RB represented that as part of its risk-management program relating to the PCs, it would impose appropriate concentration and overall exposure limits for each of the PCs.

In light of the characteristics of the PCs and based on all the facts of record, the Board has determined that taking physical delivery of the PCs is consistent with the complementary nature of PCT and does not present undue safety and soundness concerns for RB.[12]

3920.0.2.2.5 Altering Commodities.

Previously, the Board approved PCT, on a limited basis, subject to a number of commitments, including that the FHC not process, refine, or otherwise alter a commodity. RB intends to engage third parties to refine, blend, or otherwise alter commodities for which it is permitted to take and make physical delivery.

A number of considerations supported the Board's determination that engaging a third party to alter a commodity is consistent with the existing PCT authority. Permitting RB to engage a third party to alter a commodity would not significantly increase the risks to the institution from PCT. Under this authority, an FHC may already engage a third party to store commodities, which exposes an FHC to substantially the same types of risks as engaging a third party to alter a commodity. Also, an FHC could sell a commodity to a refinery and buy back the refined commodity if both the commodity sold to and bought from the refinery were permissible commodities. Permitting an FHC to engage third parties to alter commodities also would enhance an FHC's ability to meet its customers' needs.

To ensure that the activity remains consistent with the scope of PCT, RB made the following commitments: (1) RB will not alter commodities itself; (2) both the commodity input and the resulting altered commodity will be permissible commodities under the Board's decisions; and (3) RB will not have exclusive rights to use the alteration facility. Requiring that both the commodity input and the altered commodity be permissible commodities under the Board's decisions helps ensure that RB would not assume the risk of taking and making physical delivery of commodities that the Board has not yet evaluated. In addition, preventing RB from having the exclusive right to use an alteration facility should reduce RB's exposure to the potential risks associated with operating commodity-altering facilities.

3920.0.2.2.6 Risks of Proposed Physical Commodity Trading Activities.

Permitting RB to engage in the limited amount and types of PCT described above would not appear to pose a substantial risk to RB, depository institutions, or the U.S. financial system generally. RB made commitments relating to its PCT that are designed to address the risks involved in the proposed activities. In addition to the commitments discussed previously, RB provided substantially the same commitments and agreed to the same limitations as those provided by other FHCs in connection with the Board's approvals of their proposals to engage in PCT. With regard to RB and its Board order, see also subsection 3920.0.4.

3920.0.3 ENERGY MANAGEMENT SERVICES AS A COMPLEMENT TO A FINANCIAL ACTIVITY

A foreign-owned FHC, for the purposes of the BHC Act, a directly owned foreign bank, and its other directly owned foreign companies (all collectively referred to as "F"), requested the Board's approval under section 4 of the BHC Act (12 U.S.C. 1843) and the Board's Regulation Y to provide energy management services (EMS) to owners of power generation facilities

11. Natural gas liquids are physically traded in the U.S. at hubs in Texas and Kansas; the distillate and residual oil products are physically traded at various points in the United States as well as the Caribbean, Africa, Europe, and Singapore; and the petrochemicals are physically traded at various points in the U.S., South Korea, and Thailand.

12. Because trading of the proposed commodities might require that an FHC adapt a particular risk-management program beyond what would be required to trade in the commodities that are currently permissible, the Board's order does not grant authority to take and make delivery of the proposed commodities to all FHCS with PCT authority.

under energy management agreements (EMAs); an activity that is complementary to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivatives transactions.[13] Providing EMS generally involves acting as a financial intermediary for a power plant owner to facilitate transactions relating to the acquisition of fuel and the power plant owner's sale of power. Such services may also consist of providing advice to assist the owner in developing its risk-management plan.

3920.0.3.1 Provision of Energy Management Services

Under its EMAs, EMT, as energy manager, assists power plant owners by providing transactional and advisory services. The transactional services consisted primarily of EMT acting as a financial intermediary, substituting its credit and liquidity for those of the owner to facilitate the owner's purchase of fuel and sale of power. EMT's advisory services include providing market information to assist the owner in developing and refining a risk-management plan for the plant.

When providing EMS, EMT will provide services under an EMA based on a strategic framework that will be established by the owner. The owner, in consultation with EMT, establishes an energy management plan and risk-management policy to govern how the generation facility should be operated. The energy management plan establishes the amount of power the plant should generate and determines how the plant will meet its reliability obligations to the power transmission grid. The plant owner must approve all commodity contracts, including all contracts for the purchase of fuel or the sale of electricity. The authority to enter into power or fuel contracts, in some cases, may be delegated to EMT, if the contracts satisfy specific criteria that are established by the owner; other contracts must be approved by the owner. The owner also maintains the right, subject to EMT's right of first refusal, to market and sell power directly to third parties. The owner ultimately retains all decision-making authority, including decisions relating to the facility's generation output and, in particular, whether the facility should be shut down for any period of time.

An EMA's compensation structure includes this allocation of responsibilities. When the facility is in operation, EMT is typically compensated on a monthly basis at the greater of a monthly fixed fee or a stated percentage of the spread between delivered fuel prices and the realized power revenues (adjusted to reflect certain fees and costs). When the facility is not in operation, EMT is not responsible for the fixed costs of the facility and is not entitled to revenues or other compensation, apart from the monthly fees.

EMT is not involved in providing day-to-day operational services to the facility. Those tasks are generally performed by the owner or by an operator who is hired directly by the owner and is not affiliated with EMT. The operator manages and maintains the facility on a daily basis, which typically includes providing labor and support services. The operator is to provide EMT with information on the operating status of the facility, maintenance issues that might affect the availability of the facility to generate power, and scheduled outage and maintenance periods.

EMT may buy fuel for the facility from third parties and enter into a mirror transaction for the fuel with the owner. The owner may then sell the power generated by the facility to EMT, and then EMT generally resells the power in the market. EMT would thus be acting as the financial intermediary for the owner, providing credit and liquidity support, including posting any required collateral for transactions. Because EMT is able to substitute its name and credit rating for the owner's, the terms of the transactions may be generally more favorable than what the owner could negotiate on its own.

EMT assumes responsibility for administrative tasks related to the fuel and power transactions so that the owner does not have to maintain an administrative infrastructure to support its transactions with third parties. The services include (1) arranging for third parties to provide fuel transportation or power transmission services, (2) scheduling those services, and resolving any resulting imbalances; (3) ensuring that fuel deliveries and power sales are properly coordinated; (4) negotiating contracts with, and monitoring the credit support and collateral requirements of, the owner's counterparties; (5) assisting in complying with power tariffs; and (6) paying fuel suppliers. EMT also may enter into transactions with third parties as nec-

13. In connection with an acquisition of a marketing and trading entity, F received approval to engage in the U.S. in limited PCT activities, as an activity that is complementary to a financial activity of engaging in CDAs. The marketing and trading entity, now EMT, also served as an energy manager under EMAs with several power generators.

essary to ensure that the owner meets its power generation obligations to the power grid in accordance with the energy-management plan.

Risk-management and hedging services may also be provided by EMT to the owner in connection with both the purchase of fuel and the sale of power. These transactions may be entered into with third parties back to back (with EMT in the middle) or may consist of direct hedging transactions between the owner and EMT. EMT would retain the risk that the owner is hedging. For the first type of transaction, the owner would inform EMT of its intention to hedge the price of fuel or power for a specified term, and EMT would then solicit bids or offers. After reviewing the competing bids or offers, the owner would make a selection and direct EMT to enter into the transaction with that counterparty. EMT and the owner then would enter into a mirror transaction so that EMT would not retain any risk exposure on the overall transaction. For the second type of transaction, EMT would submit the offer for a hedging transaction to the owner, who can accept or reject the offer. If the owner accepts, EMT may enter into the transaction directly with the owner. All these transactions would be governed by the International Swaps and Derivatives Association's master agreements between the owner and EMT. The owner may also enter into hedging transactions directly with a third party without EMT's involvement.

EMT may generally provide two types of market information services to the owner. First, EMT may provide market and risk information to assist the owner in developing its risk-management plan and strategy. As a direct market participant, EMT has access to information that may help the owner refine its risk-management strategies. Second, EMT may provide the owner with day-to-day market information that the owner, in consultation with the operator of the power facility, may use to determine its short-term dispatch guidelines (that is, the amount of power the facility should generate to meet its contractual requirements and reliability obligations).

3920.0.3.2 Energy Management Services is Complementary

The Board concluded that the provision of EMS is complementary, within the meaning of the GLB Act, to the financial activities of providing commodity derivatives activities (CDAs) and Derivatives Advisory Services (DAS). EMS would add to these financial activities a number of agency and administrative services that would facilitate providing CDAs and DAS on behalf of a plant owner. The combination of services complements and enhances F's CDAs and DAS by allowing F to offer power plant owners an integrated approach to managing the commodity-related aspects of their business. Some non-BHC participants in the energy trading markets, including diversified financial services companies, offer EMS to clients in connection with their commodity derivatives business. Those companies can, and regularly do, provide EMS to owners. The Board's permitting FHCs to provide EMS would enable FHCs to offer the same integrated services that are provided by a number of their competitors. The Board thus concluded that F's EMS complement its CDAs and DAS.

3920.0.3.3 Limitations on Energy Management Services

In order to limit the size, scope, and safety and soundness risks of EMS, F committed that the revenues attributable to EMS would not exceed 5 percent of F's total consolidated operating revenues.[14] In addition, F's authority to provide EMS is subject to several conditions that limit F's responsibilities and potential liabilities it may assume under an EMA. Specifically, F may only act as energy manager if the relevant EMA provides that:

- the owner retains the right to market and sell power directly to third parties, which may be subject to the energy manager's right of first refusal;
- the owner retains the right to determine the level at which the facility will operate (i.e., to dictate the power output of the facility at any given time);
- neither the energy manager nor its affiliates guarantee the financial performance of the facility; and
- neither the energy manager nor its affiliates bear any risk of loss if the facility is not profitable.

The Board determined that permitting F to engage in EMS in the limited amounts and situations described previously would not appear

14. Total operating revenues are defined as net income and all non-interest revenue, net securities gains and losses but excluding extraordinary income.

to pose a substantial risk to F, depository institutions, or the U.S. financial system generally. F, acting as an energy manager, would enter into the same type of commodity derivatives transactions that other FHCs had been permitted to enter into; only it would enter into these transactions to facilitate the business strategies of a third-party owner.

Based on all the facts of record that were presented, including the representations and commitments made by F within its notice to the Board, and those commitments and conditions contained in the order, the Board approved the notice on December 4, 2007. (The previous discussion is only a summary. See the full text of the Board order at 2008 FRB C20.)

3920.0.4 Energy Tolling Services As A Complement To A Financial Activity

A foreign bank, R Bank (RB), a financial holding company (''FHC'') for purposes of the Bank Holding Company Act (''BHC Act''), requested the Board's approval under section 4 of the BHC Act (12 U.S.C. 1843) and the Board's Regulation Y (12 C.F.R. 225) to engage in limited PCT and the providing of EMS for owners of power generation facilities under EMAs. RB has requested the Board's approval to engage in physically settled energy tolling (ET) by entering into tolling agreements (TAs) with power plant owners as an activity that is complementary to the financial activity of engaging as principal in commodity derivatives transactions. The Board previously determined PCT and EMS to be activities that are complementary to the financial activity of engaging as principal in commodity derivative transactions, and in the case of EMS, also complementary to providing financial and investment advisory services for derivative transactions. The Board has not previously considered whether the requested ET is complementary to a financial activity under section 4 of the BHC Act for a FHC. RB intends to engage in such complementary activities through a joint venture company (JV) formed with SE, to be located in the U.S. and to operate as an energy services company. Certain existing TAs would be transferred to the JV.

3920.0.4.1 FHC'S Proposal

RB operates in the U.S. through CFG Corp., a multibank holding company, as well as through U.S. domiciled branches and representative offices.[15] RB also operates U.S. domiciled nonbanking companies in the United States, including a broker-dealer subsidiary, RB-GC.

3920.0.4.2 Physical Commodity Trading

RB intends to expand its commodity-related activities by forming a JV with S Corp. (S). A subsidiary of S, TE Corp. (TE), which engages in commodity derivatives transactions and PCT, would be transferred to the JV.[16] TE acts as principal in commodity transactions in and outside the U.S., taking and making physical delivery of commodities in connection with those transactions. TE also acts as an energy manager and enters into TAs with power plant owners. RB plans to engage in PCT, EMS, and ET under the complementary activity authority of section 4 of the BHC Act so that the ET companies transferred to the JV can continue to conduct those activities.[17] RB engages in CDAs in the U.S. and plans to expand those activities and engage in PCT through the JV. The JV's activities would include taking or making delivery of permissible commodities pursuant to physically settled commodity derivatives; taking inventory positions in natural gas, oil, emissions allowances, and other permissible commodities; and engaging in other spot market trading activities. RB has also indicated that JV might engage in commodity-related financing transactions, including volumetric production payment transactions (VPPs).[18]

15. RB holds a 38 interest in RF, an FHC formed by a group of banking organizations, including F and certain of its affiliates.

16. JV plans to purchase TE and its related energy trading subsidiaries and affiliates (″TE Companies″), which would become JV's subsidiaries.

17. RB committed that within two years of consummation of the transaction, it will conform, including by divestiture if necessary, any activities that are impermissible for an FHC under the BHC Act or that are inconsistent with the activities permitted under this order.

18. RB may engage in VPPs on oil and gas as permissible credit transactions if it agrees to sell the oil or gas it receives under the VPP to third parties before delivery. VPPs are a means of financing oil and gas exploration and production. Under a VPP, the lender or VPP holder provides an up-front payment in exchange for a royalty interest that entitles the VPP holder to receive hydrocarbons on a regular basis during the life of the VPP transaction in quantities that will allow the VPP holder to recover its up-front payment and a specified return. The Board's General Counsel has determined that VPPs generally are considered extensions of credit permis-

The Board had previously determined that PCT is a permissible activity because it complements the financial activity of engaging in CDAs. Most of the transactions in which RB is to engage as part of PCT would not differ from transactions that the Board has previously approved. RB plans to engage, however, in a wider set of transactions under the PCT authority and therefore requested confirmation that those activities are within the scope of that authority. Specifically, RB plans to enter into long-term power supply contracts with large commercial and industrial (C&I) end-users; to engage in PCT for which derivatives contracts have *not* been approved by the CFTC for trading on a U.S. exchange or specifically approved by the Board; and to enter into contracts with third parties to process, refine, or otherwise alter commodities.

3920.0.4.3 Long-Term Electricity Supply Contracts

RB plans, as part of its energy trading business, to enter into long-term electricity supply contracts with large C & I customers. The current PCT authority permits an FHC to take a position in a commodity and does not limit the duration of, or counterparties to, an FHC's contracts. Most commodities in which an FHC may trade under the PCT authority tend by their nature to be limited to the wholesale market. Electricity, however, has a greater potential to be sold not only to end-users generally but also to small retail customers who are unlikely to be participants in the market for energy related derivatives products.

To ensure that RB's activities remain consistent with the general complementary nature of the activities permitted, RB committed to enter into long-term supply contracts only with large C & I customers. The market risk relating to these long-term contracts would be handled using the same methodologies that are used for other electricity trades. RB represented that in all states where the electricity market has been deregulated, state regulations distinguish among types of end-users, generally relying on the customer's typical electricity consumption level. To ensure that RB contracts only with customers who are sufficiently large and sophisticated, RB committed that it will enter into long-term electricity supply contracts only with C & I customers that consume electricity at a rate of at least (1) 800 megawatt-hours/year ("MWHrs/year") or (2) the minimum consumption level for large C & I customers under applicable state law, whichever is greater. This restriction should be sufficient to ensure that RB transacts with financially sophisticated purchasers (and not with retail purchasers) and thus RB would remain essentially a wholesale intermediary.

sible for a BHC under section 225.28(b)(1) of Regulation Y, if the BHC agrees to sell the commodities before delivery.

3920.0.4.4 Energy Tolling Agreements

TE, as toller, pays the plant owner a fixed periodic payment that compensates the owner for its fixed costs ("capacity payments"), usually monthly, in exchange for the right to all or part of the plant's power output. The plant owner, however, retains control over the day-to-day operations of the plant and physical plant assets at all times.[19] The toller provides (or pays for) the fuel needed to produce the power that it directs the owner to produce. The fuel and energy transactions that the toller enters into in these circumstances are generally physically settled.[20] The agreements also generally provide that the owner will receive a marginal payment for each megawatt hour produced by the plant to cover the owner's variable costs plus a profit margin. The toll is similar to a call option on the power produced by the plant with a strike price linked to fuel and power prices. In general, the toller would direct the operator to run the plant (i.e., the toller would exercise its option) when the price of power exceeds the cost of producing that amount of power. Some TAs may also give the toller the right to a plant's excess capacity, which the toller may sell to the market or use to meet reliability obligations to the power grid.

3920.0.4.5 Risks of Energy Tolling

The primary risk to a toller is that the plant proves to be uneconomical to operate, which can occur when the cost of producing power is greater than the power's market price. In those cases, the toller has no ability to recover its

19. RB has indicated that TE's TAs are all medium term (generally two to five years), although some market participants enter into longer-term agreements. TE has not entered into longer-term contracts because it can be difficult to hedge exposure over a longer period of time.

20. Because an FHC would generally take or make physical delivery of fuel and electricity in connection with a TA, an FHC would need approval to engage in PCT to engage in ET.

capacity payments. To limit the potential safety and soundness risks of ET, RB has committed that it will limit the amount of its ET activities. Currently, all PCT activities are limited to a maximum of 5 percent of the FHC's tier 1 capital. RB committed to include the present value of its future committed capacity payments under a TA in calculating the value of commodities held by RB under its Physical Commodity Trading authority to determine compliance with the cap of 5 percent of tier 1 capital. As a result, allowing RB to engage in ET activities would not increase the overall position that it may take in physical commodities. This limit would also ensure that ET remains limited in size and scope relative to RB's financial activities.

3920.0.4.6 Energy Tolling is Complementary

Energy Tolling is an outgrowth of the existing financial activity of a BHC-FHC engaging in CDAs. Energy tolling complements CDAs by allowing an FHC to hedge its own, or assist its clients to hedge, positions in energy. An FHC engaging in authorized energy tolling would also provide an FHC with additional information on the energy markets that would help the FHC manage its own commodity risks. The Board also notes that financial institution competitors of RB that are not FHCs engage in tolling activities as part of their energy trading operations. Based on the foregoing and all other facts of record, the Board concluded that RB's ET activities complement its CDAs.

Based on all the facts of record, including RB's representations and commitments that were made to the Board in connection with its notice, and the terms and conditions set forth in the Board's order, the Board approved the FHC's notice. The Board's determination is also subject to all the conditions set forth in Regulation Y. The Board order was approved on March 27, 2008. (The previous discussion is only a summary. See the full text of the Board order at 2008 FRB C60.)

3920.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Limited commodity-trading activities involving a particular commodity, such as natural gas and electricity, that complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity.	1843(k)(1)(B)	225.89	4-056.8	2003 FRB 508 2004 FRB 215 2004 FRB 511
Limited commodity trading in Energy-related commodities (natural gas, crude oil, electricity, and emmissions allowances) as a complement to a financial activity	1843(k)1)(B)			2006 FRB C54 2006 FRB C57 2006 FRB C113

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Commodities not approved by the CFTC for trading on a U.S. futures exchange (e.g., nickel on London Metal Exchange) or on certain non-U.S. exchanges				2008 FRB C60
Engaging third parties to alter commodities.				2008 FRB C60
Providing energy management services as a complement to financial activities—providing commodity derivatives activities and derivatives advisory services				2008 FRB C20
Providing energy tolling services as a complement to a financial activity				2008 FRB C60

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies were also permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agent to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized bank holding companies that make an effective election to become a financial holding company (FHC) to *underwrite* and *sell* any type of insurance nationwide. In addition, the GLB Act authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities.

To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,[1] independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

3950.0.1 OVERVIEW AND SCOPE

The following guidance pertains to bank holding companies (BHCs) (including FHCs) and state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products as agents. As noted above, the GLB Act amended the BHC Act to allow a BHC or foreign bank that qualifies as an FHC to engage in a broad range of insurance activities, including underwriting or selling (as agent or broker) any type of insurance and issuing and selling annuities, in any state.

BHCs that are not FHCs may sell or underwrite insurance as a principal, agent, or broker only to the limited extent authorized, before the GLB Act, under section 4(c)(8) of the BHC Act and section 225.28(b)(11) of Regulation Y. For example, a BHC that is not an FHC may underwrite and sell insurance (including home mortgage redemption insurance) that is directly related to an extension of credit by the BHC or any of its subsidiaries and that is limited to ensuring repayment of the outstanding balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor. A BHC that is not an FHC can also sell any type of insurance as agent in a town if the town has a population of 5,000 or less and the BHC or a subsidiary has a lending office in the small town. (See section 3170.0.)

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly through a financial subsidiary.[2] A financial subsidiary engaged in insurance sales may be located wherever state law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements. The examination guidance found in this section is limited to insurance and annu-

1. The term "producer" refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. Rules pertaining to state member bank financial subsidiaries are found in the Board's Regulation H (12 C.F.R. 208.71–77).

ity *sales* activities. Because this section focuses only on insurance sales activities, it does *not* address insurance underwriting (that is, as principal) activities of FHCs or the limited insurance-underwriting powers of BHCs or state member banks. Examiner guidance on performing appropriate risk assessments for insurance and annuity sales activities of BHCs (including FHCs) and state member banks is included.[3]

Additionally, guidance is provided for examining a state member bank for compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 C.F.R. 208.81–86), "Consumer Protection in Sales of Insurance" (CPSI). Subpart H, which became effective October 1, 2001, implements the insurance consumer protection requirements of the GLB Act, which are codified at 12 U.S.C. 1831x. (See 65 *Fed. Reg.* 75841 (December 4, 2000)). The regulation applies not only to the sale of insurance products or annuities by the state member bank but also to activities of any person engaged in insurance product or annuity sales on behalf of the state member bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a BHC or state member bank, including determining the risks posed to the BHC or state member bank from the insurance sales activities it conducts, directly or indirectly, and determining the effectiveness of its risk-management systems. The GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities conducted by a BHC or state member bank through a functionally regulated subsidiary.

3. The term "risk assessment" denotes the work product described in SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the banking organization. The scope of the review depends on the significance of the activity to the BHC or state member bank and on the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the BHC's or state member bank's insurance sales activities and on other relevant factors.[4]

3950.0.2 SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

3950.0.2.1 Supervisory Objective

The primary objective of the review is to determine the level and direction of risk to a BHC or state member bank from its insurance sales activities, including insurance sales activities conducted directly, by or in conjunction with a subsidiary or affiliate, or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the BHC or state member bank does not adequately manage these risks, they could have an adverse impact on a BHC's or state member bank's earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the BHC or state member bank by risk category and (2) an assessment of the adequacy of board of directors and management oversight of the activity, including the activity's internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

4. See SR-02-01, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less," and section 1000.1 of the *Commercial Bank Examination Manual* for a discussion of the Federal Reserve's risked-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24.

3950.0.2.2 State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that "no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, provided the Act shall be applicable to the business of insurance to the extent that such business is not regulated by State law" (15 U.S.C. 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer's activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a BHC or bank to prevent it from engaging in authorized insurance activities or (2) otherwise discriminating against BHCs and banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. It should be noted, however, that the GLB Act generally does not prohibit a state from requiring a BHC or bank, or its employees engaged in insurance sales, solicitation, or cross-marketing activities, to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer's market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

State market conduct examinations of *insurance sales practices* are focused at the insurance-underwriter level.[5] The insurance underwriter is generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter's products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.[6] However, in the past, a state insurance regulatory authority has not typically examined a producer unless the insurance underwriter owns the producer.

Generally, market conduct examinations include reviews of insurance underwriters' complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty[7] lines of business guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter's market share or on previous examination findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms "insurance underwriter," "insurer," "insurance carrier," and "insurance company" are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

3950.0.2.3 Functional Regulation

Under the GLB Act, reviews by banking supervisors of insurance or securities activities conducted in a BHC's or bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a BHC or bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a BHC or state member bank or the insurance activities conducted by either of them. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a BHC or state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to those activities.[8]

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a BHC or state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a BHC or state member bank only in the following situations:

1. The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by the responsible Reserve Bank and Board staff.
2. After reviewing relevant information available at the BHC or state member bank level (including information obtained from the appropriate functional regulator), it is determined that an inspection or examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
3. On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the BHC or state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a functionally regulated nonbank subsidiary of a BHC or state member bank. As noted above, these GLB Act limitations do *not* apply to a BHC parent company or state member bank even if the BHC parent company or state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of BHC or state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated BHC or state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a BHC's or state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of BHCs or state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance

8. For example, if a BHC's nonbank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

activities by the appropriate state insurance authorities.

3950.0.2.4 Information Sharing with the Functional Regulator

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.[9] The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable state insurance regulator concerning insurance sales activities conducted by BHCs or state member banks.) The Board's Division of Consumer and Community Affairs' CP Letter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

3950.0.3 STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

3950.0.3.1 Privacy Rule and the Fair Credit Reporting Act

BHCs, state member banks, and the subsidiaries of both (other than subsidiaries that are subject to the privacy rules of another financial regulator such as a broker-dealer or insurance company) that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 U.S.C. 6801–6809), as implemented by the Board's Regulation P (12 C.F.R. 216) (the privacy rule). Functionally regulated BHC and state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

The privacy rule regulates a BHC's or state member bank's treatment of nonpublic personal information about a "consumer," that is, an individual that obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a BHC or bank to provide a notice to each of its customers that describes the privacy policies and practices of the BHC or bank no later than when the BHC or bank establishes a business relationship with the customer. The privacy rule also generally prohibits a BHC or bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the BHC or bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out" of) the disclosure, and the consumer does not opt out. The privacy rule permits a BHC or bank to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a BHC or bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a BHC or bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the BHC or bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

3950.0.3.2 Anti-Tying Prohibitions

Federal law (section 106(b) of the BHC Act Amendments of 1970 (12 U.S.C. 1972(b)) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a state member bank may not require that a customer purchase insurance from the bank or a subsidiary or an affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).[10] The special anti-tying rules in section 106 do not apply to tying arrangements imposed by a BHC or a nonbank affiliate of a BHC.

3950.0.3.3 Policy Statement on Income from Sale of Credit Life Insurance

This Federal Reserve Board policy statement (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. (See section 3170.0.4.1 and the inspection procedure related to this policy statement in section 3170.0.6.)

3950.0.4 RISK-MANAGEMENT PROGRAM

3950.0.4.1 Elements of a Sound Insurance or Annuity Sales Program

A BHC or state member bank engaged in insurance or annuity sales activities should—

1. conduct insurance sales programs in a safe and sound manner;
2. have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
3. obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
4. effectively oversee the sales program activities, including third-party arrangements;
5. have an effective, independent internal audit and compliance program;
6. appropriately train and supervise the employees conducting insurance and annuity sales activities;
7. take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations;
8. ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
9. have controls in place to ensure accurate and timely financial reporting.

Every banking organization conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

3950.0.4.1.1 Sales Practices and Handling of Customer Complaints

Every component of a banking organization that engages in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A BHC's or state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the organization.

3950.0.4.1.2 Third-Party Arrangements

BHCs and state member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A BHC's or state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into

10. See section 3500.0.

any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the BHC or state member bank, which includes compliance with applicable consumer protection laws and regulations.

The BHC's or state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the BHC's or state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the banking organization to have access to third-party records considered necessary to evaluate compliance. A BHC or state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.[11] Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

A BHC or state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the organization is appropriately trained either by the banking organization or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials to monitor the third party's performance on its disclosure and training obligations.

3950.0.4.1.3 Designation, Training, and Supervision of Personnel

A banking organization hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the banking organization should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.[12]

The banking organization should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the organization's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a banking organization or by third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A banking organization also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as a state member bank's compliance with the CPSI regulation, if applicable.

3950.0.4.1.4 Compliance

Banking organizations should have policies and procedures to ensure that insurance or annuity

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of a state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the BHC or state member bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity product sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the banking organization's board of directors or to its designated board committee.

3950.0.5 RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished (1) in the course of conducting a regularly scheduled BHC inspection or state member bank examination or (2) as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the BHC or bank arising from its insurance and annuity sales activity. The risks to banking organizations engaged in insurance sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of "errors and omissions" claims.[13] Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information; a high volume of customer complaints; or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, banking organizations that have recently commenced insurance or annuity sales activities, or that are expanding their insurance sales business, are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by banking organizations, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The banking organization should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

insurance or annuity sales activity. Such information is available in the BHC's Bank Holding Company Performance Report or the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the BHC or state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a BHC or state member bank, examiners should rely, to the fullest extent possible, on information available from the BHC or state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the BHC or state member bank, or from the applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a BHC or state member bank without first obtaining approval from the appropriate Board staff.

3950.0.6 CONSUMER PROTECTION IN SALES OF INSURANCE RULES

3950.0.6.1 Overview of the CPSI Regulation

The CPSI regulation is only applicable to all insured depository institutions, including state member banks.[14] The regulation, however, generally *does not* apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation, issued by the federal banking agencies, are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation. A BHC's board of directors and senior management are responsible for overseeing its depository institution subsidiaries' compliance with the CPSI regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting on behalf of a bank. For purposes of the CPSI regulation, "office" means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

3950.0.6.2 Misrepresentations Prohibited

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

1. that the insurance product or annuity is backed by the federal government or the bank, or is insured by the Federal Deposit Insurance Corporation (FDIC);
2. that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
3. in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the anti-tying provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

3950.0.6.3 Insurance Disclosures

The regulation also requires that a bank or a person selling insurance at an office of, or on behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

1. The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
2. The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
3. The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

3950.0.6.4 Credit Disclosures

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

3950.0.6.5 Consumer Acknowledgment

The bank must obtain written or electronic acknowledgments of the consumer's receipt of the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

3950.0.6.6 Location

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

3950.0.6.7 Referrals

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may not depend on whether a sale results from the referral.

3950.0.6.8 Qualifications

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

3950.0.6.9 Relationship of the CPSI Regulation to State Regulation

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

3950.0.6.10 Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products

When a bank sells insurance products or annuities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of nondeposit investment products (NDIPs).[15] If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

3950.0.6.11 Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertaining to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The state member bank examination procedures described in section 3950.0.10.2 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any other person that is engaged in such activities at an office of the bank, or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

1. The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
2. The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
3. Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

3950.0.7 APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.[16] A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

16. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

3950.0.7.1 Disclosures

3950.0.7.1.1 Credit Disclosures

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank ("a covered person") must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer's loan application is pending. A consumer's application for credit is still "pending" for purposes of the regulation if the depository institution has approved the consumer's loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

3950.0.7.1.2 Disclosures for Sales by Mail and Telephone

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

3950.0.7.1.3 Use of Short-Form Insurance Disclosures

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

3950.0.7.2. Acknowledgment of Disclosures

3950.0.7.2.1 Reasonable Efforts to Obtain Written Acknowledgment

The banking agencies have not prescribed any steps that must be taken for a depository institution's efforts to obtain a written acknowledgment to be deemed "reasonable" in a transaction conducted by telephone. Examples of reasonable efforts, however, include:

1. providing the consumer with a return-addressed envelope or similar means to facilitate the consumer's return of the written acknowledgment,
2. making a follow-up phone call or contact,
3. sending a second mailing, or
4. similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) record his or her efforts to obtain the signed acknowledgment. The "reasonable efforts" policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

3950.0.7.2.2 Appropriate Form or Format for Acknowledgment Provided Electronically

Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

3950.0.7.2.3 Retention of Acknowledgments by an Insurance Company

If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance company may retain the acknowledgment. The depository institution is responsible for ensuring that sales made "on behalf of" the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

3950.0.7.2.4 Form of Written Acknowledgment

There is no prescribed form for the written acknowledgment. The regulation requires, however, that a covered person obtain the consumer's acknowledgment of receipt of the complete insurance and credit disclosures.

3950.0.7.2.5 Timing of Acknowledgment Receipt

A covered person must obtain the consumer's acknowledgment either at the time a consumer receives disclosures *or* at the time of the initial purchase of an insurance product. The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question "Do you acknowledge that you received this disclosure?" is acceptable.

3950.0.7.3 Scope of the CPSI Regulation

3950.0.7.3.1 Applicability to Private Mortgage Insurance

Depending on the nature of a depository institution's involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, then the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

3950.0.7.3.2 Applicability to Federal Crop Insurance

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

3950.0.7.3.3 Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation

Direct-mail solicitations and "take-one" applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed *before* that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

3950.0.7.4 Renewals of Insurance

Renewals of insurance are not subject to the disclosure requirements (see the 3950.0.7.1 sections above), but are subject to other requirements of the CPSI regulation. A "renewal" of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade do not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

3950.0.7.4.1 Disclosures Required with Renewals of Insurance Coverage

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the CPSI regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the CPSI regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

3950.0.7.4.2 "On-Behalf-of" Test and Use of Corporate Name or Logo

Under the CPSI regulation, an affiliate of a bank is not considered to be acting "on behalf of" a bank simply because the affiliate's marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words "First National," an affiliate would not be considered to be engaged in an activity "on behalf of" an affiliated bank simply by using the terms "First National" as part of a corporate logo or identity. The affiliate would, however, be considered to be acting "on behalf of" an affiliated bank if the name of the bank (for example, "First National Bank") appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the "on-behalf-of" test is met.

3950.0.7.5 Compliance

3950.0.7.5.1 Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting standards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer's file would also be adequate. The documentation should be maintained in the consumer's file so that it is accessible to examiners.

3950.0.7.5.2 Setting for Insurance Sales

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution's retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could "clearly delineate and distinguish" insurance areas, signage or other means may be used.

3950.0.8 APPENDIX B—GLOSSARY

See section 4040.1 of the Commercial Bank Examination Manual *for additional definitions of insurance terms.*

Accident and health insurance. A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured becomes disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance*.)

Actuary. A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

Admitted insurer. An insurance company licensed by a state insurance department to underwrite insurance products in that state.

Agency contract (or agreement). An agreement that establishes the contractual relationship between an agent and an insurer.

Agent. A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

1. *Captive or exclusive agent.* An agent who represents a single insurer.
2. *General agents.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. General agents are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.
3. *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent's agent's compensation originates from commissions.

Aggregate excess-of-loss reinsurance. A form of "excess-of-loss" reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as stop-loss reinsurance or excess-of-loss ratio reinsurance.

Allied lines. Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

Annuity. A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

1. *Fixed-annuity contracts* provide for payments to annuitants at fixed, guaranteed minimum rates of interests.
2. *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

Assigned risk. A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

Assignment. The legal transfer of one person's interest in an insurance policy to another person or business.

Bank-owned life insurance (BOLI). Life insurance purchased and owned by a BHC or bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a BHC or bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the BHC's or bank's balance sheet as "other assets"; and is the beneficiary of the policies upon the death of any insured employee or former employee.

Beneficiary. The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

Binder. A written or oral agreement, typically issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and to provide interim coverage pending the insurance company's issuance of a binding policy.

Blanket bond. Coverage for an employer for loss incurred as a result of employee dishonesty.

Boiler and machinery insurance. Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

Broker. A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

Bulk reinsurance. A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

Captive insurer. An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. For example, a BHC or bank may form a captive insurance company to underwrite its own directors' and officers' risks or to underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

Cash surrender value of life insurance. The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

Casualty insurance. Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

Cede. To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

Ceding commission. The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

Ceding company (also cedant, reinsured, reassured). The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

Cession. The amount of insurance risk transferred to the reinsurer by the ceding company.

Churning. The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

Claim. A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

Coinsurance. A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

Combination-plan reinsurance. A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

Commission. The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

Comprehensive personal liability insurance. A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

Contractholder. The person, entity, or group to whom an annuity is issued.

Credit for reinsurance. A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

Credit life insurance. A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common BHC and bank insurance products.

Credit score. A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

Debt-cancellation contract/debt-suspension agreement. A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrower's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

Deductible. The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile accident, or to all claims made during a specified period, as with health insurance.

Directors' and officers' liability insurance. Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

Direct premiums written. Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

Direct writer. An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

Disability income insurance. An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

Endowment insurance. A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

Errors and omissions (E&O) liability insurance. Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

Excess-of-loss reinsurance. A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

Excess-per-risk reinsurance. A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Excess and surplus lines. Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

Exposure. The aggregate of all policyholder limits of liability arising from policies written.

Face amount. The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

Facultative reinsurance. Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

Financial guarantee insurance. Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

Financial strength rating. Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

Fixed annuity. See annuity.

Flood insurance. A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

General liability insurance. A broad commercial policy that covers all business liability exposures, such as product liability, completed operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

Gross premiums written. Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

Group insurance. Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

Health insurance. An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

Incurred but not reported (IBNR). The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term incurred but not enough reported (IBNER) is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

Inland marine insurance. A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

Key person life insurance. Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

Lapse. The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

Liability insurance. Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

Lines. A term used in insurance to denote insurance business lines, as in ''commercial lines'' and ''personal lines.''

Long-term care insurance. Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

Managing general agent. A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

Manuscript policy. A policy written to include specific coverage or conditions not provided in a standard policy.

Morbidity. The incidence and severity of illness and disease in a defined class of insured persons.

Mortality. The rate at which members of a group die in a specified period of time or die from a specific illness.

Mortgage guarantee insurance. A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

Mortgage insurance. Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

Multiperil insurance. An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

Net premiums written. The amount of gross premiums written, after deduction for premiums ceded to reinsurers.

Ninety-day loss rule. A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

Obligatory treaty. A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

Policyholder. The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Premium. The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

Private mortgage insurance (PMI). Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most BHCs and banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

Producer. A person licensed to sell, solicit, or negotiate insurance.

Professional designations and organizations. Three of the most common insurance professional designations are Chartered Life Underwriter (CLU), Chartered Property Casualty Underwriter (CPCU), and Chartered Financial Consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

Property insurance. Coverage for physical damage or destruction of real property (building, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, and vandalism.

Pro rata reinsurance. A generic term describing all forms of "quota-share" and "surplus reinsurance," in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

Protected cell. A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

Quota-share reinsurance. A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

Rebating. Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

Reinsurance. Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

Reinsurance premium. The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

Residual market. Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

Retrocession. A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

Retrospective rating. An insurance plan in which the current year's premium is based on the insured's own loss experience for that same period, subject to a maximum and minimum.

Rider. A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company's standard contract terms.

Self-insured retention (SIR). The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

Separate accounts. Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

Split-dollar life insurance. An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

Subrogation. An insurance carrier may reserve the "right of subrogation" in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

Term life insurance. An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

Title insurance. Insurance that protects BHCs, banks, and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

Treaty reinsurance. A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

Twisting. In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and to take out another policy with another company, when it is not to the insured's benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the ‘‘churning’’ concept in securities sales, and it results in increased commissions for the inducing agent.

Umbrella liability insurance. This type of liability insurance provides excess liability protection over the ‘‘underlying’’ liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

Underwriting. The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

Unearned reinsurance premium. The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

Universal life insurance. A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

Variable annuity. See Annuity.

Variable life insurance. A form of whole life, or universal life, insurance in which the policyholder's cash value is invested in ‘‘separate accounts’’ of the insurer. These accounts are segregated from the insurance carrier's other asset holdings. Such separate account investments are generally not available to a carrier's general creditors in the event of the carrier's insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the National Association of Securities Dealers and registered with the Securities and Exchange Commission.

Vendors' single-interest insurance. A form of force-placed insurance that is typically purchased by the BHC or bank to protect against loss or damage to loan collateral in which the BHC or bank has a security interest. The banking organization passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

Viatical settlement. The cashing in of a life insurance policy at a discount from face amount by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

Whole life insurance. A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.

3950.0.9 INSPECTION OBJECTIVES

1. To understand the volume and complexity of the banking organization's insurance or annuity program and insurance sales strategy.
2. To assess the financial results of the activity compared with planned results.
3. To determine if the insurance and annuity sales activities are effectively integrated into

the banking organization's risk-management, audit, and compliance functions and if the control environment is adequate.
4. To assess the adequacy of the banking organization's controls to ensure compliance with the applicable state and federal laws and regulations.
5. To assess the level and direction of operational, legal, and reputational risks to the consolidated banking organization and the bank from the insurance or annuity sales activity.

The following objectives apply if insurance products or annuities are sold by another person at an office of, or on behalf of, a state member bank subsidiary of the BHC.

6. To assess the adequacy of the BHC's oversight program for ensuring a state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 3950.0.1.)
7. To assess the effectiveness of the BHC's oversight of a state member bank's compliance and audit programs with respect to the CPSI regulation.
8. To assess the BHC's oversight of a state member bank's compliance with the CPSI regulation.
9. To obtain commitments for a BHC's oversight for needed corrective action when a state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

3950.0.10 INSPECTION PROCEDURES

3950.0.10.1 Risk Assessment of Insurance and Annuity Sales Activities

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the BHC that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.
   a. Obtain a general overview of the scope of the BHC's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
   b. Determine the BHC's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the BHC and business generated by insurance producers.
   c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
   d. Determine the volume and type of insurance or annuity products and services sold or solicited.
   e. Determine what other related services the BHC provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.
   f. If the BHC is not an FHC, confirm that any insurance sales activities conducted by the BHC or a nonbank subsidiary are within the limited scope of activities permissible for BHCs that are not FHCs.
2. *Insurance sales products and concentrations.*
   a. Determine the composition of sales—
      - by line of business, such as property/casualty insurance, life insurance including annuities, and health insurance;
      - by the proportion of sales to commercial and retail customers; and
      - by the portion of sales that is credit related, such as credit life and credit health insurance.
   b. Determine any sales concentrations to particular entities, industries, or BHC customers.
   c. Note any concentrations to large commercial accounts.
   d. Determine what insurance services are provided to the BHC, its employees, and BHC or bank affiliates.
3. *Legal-entity and the risk-management structure for insurance or annuity sales.*
   a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
   b. Determine—

- whether the insurance or annuity sales activity is conducted in an affiliated producer, by the BHC itself, through another distribution arrangement, or by a combination of these entities;
- the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed; and
- the locations outside of the United States where insurance or annuities are sold or solicited.

c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).[17] If so, determine —
- the scope of the MGA activities;
- the BHC management's assessment of the risk associated with the MGA activity; and
- what risk controls are in place to protect the BHC from potential loss that may arise from the MGA's activities, such as loss arising from legal liability.

4. *Strategic and financial plans.* Assess management controls over the insurance annuity sales activities.
   a. Ascertain the BHC management's strategic and financial plans and goals for the insurance or annuity sales activity.
   b. Review the BHC's due-diligence process for acquiring and pricing agencies, if applicable.
   c. Review the BHC's financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies, and marketing arrangements, and the rate of actual and expected growth for the activity.
   d. Determine the cause for significant deviations from the plan.
   e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency's revenues are covering the debt servicing associated with the purchase, if applicable.
5. *Review of board and committee records and reports.*
   a. Review the reports of any significant BHC oversight committees, including relevant board of directors' and board committees' minutes and risk-management reports.
   b. Determine if the BHC's board of directors, a board committee, or senior management reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization's plan for the insurance and annuity sales activities.
6. *Policies and procedures.*
   a. Determine—
      - the adequacy of the BHC's policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
      - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting, and
      - if the board of directors or a designated committee of the board has formally approved the policies.
   b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of BHCs and banks are all eligible investments.
   c. Determine the independence of the BHC's audit program applicable to the insurance and annuity sales activity. Ascertain if the audit program's scope, frequency, and resources are commensurate with the insurance and annuity activities conducted.
   d. Determine how the BHC selects insurance underwriters with whom to do business, as well as how the banking organization monitors the continuing performance of the underwriters.
   e. Determine the adequacy of the BHC board of directors' oversight of the insurance management team's qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.

17. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

f. Review the internal controls of the BHC related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance and annuity activities.

7. *Claims, litigation, and functional regulator supervision.* Assess legal and reputational risk.
   a. Identify any significant litigation against the BHC arising from its insurance or annuity sales activity and the likely impact of the litigation on the BHC.
   b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the claim status, and the amount of claim payments.
   c. Review the BHC's policies and procedures for tracking and resolving claims. Determine if the policies and procedures appear adequate and if they are adhered to.
   d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.
8. *Consumer complaints.*
   a. Determine if the BHC's management has policies and procedures in place to assess whether consumer complaints received are likely to expose the BHC to regulatory action, litigation, reputational damage, or other significant risk.
   b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.
9. *Audit and compliance functions.*
   a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.
   b. Determine the adequacy of the BHC's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.[18]
10. *Insurance underwriter oversight of agent/agency activities.*
   a. Determine if the banking organization has adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the BHC.[19]
   b. Determine whether any of the insurance underwriters conducted a periodic review of producers that they engaged to sell insurance.
11. *State supervisory insurance authorities.*
   a. During discussions with the BHC's management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.
   b. Consult with the state insurance regulator (or regulators), as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)
12. *Operational risk assessment.* Ascertain from BHC management whether there are—
   a. any significant operational problems or concerns relating to insurance or annuity sales activities;
   b. policies and procedures in place to ensure accurate and timely reporting to the BHC's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;[20]
   c. appropriate policies and procedures at the BHC to ensure accurate reporting of

18. Enforcement of the privacy provisions of the GLB Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

19. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. These reviews' findings and conclusions should be available to the state member bank's management.

20. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, "Management of Insurable Risks," of the *Commercial Bank Examination Manual*.

insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, BHC and bank call reports, or other applicable reports. If so, seek resolution of the issues); and

d. adequate disaster-recovery plans and procedures to protect the BHC from loss of data related to insurance or annuity sales activities.

3950.0.10.2 Consumer Protection in Sales of Insurance Regulation

These examination procedures apply only to the examination of state member banks. The procedures are provided for the BHC examiner's information only.

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee relies on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas:[21]
   a. disclosures, advertising, and promotional materials
   b. consumer acknowledgments
   c. physical separation from areas of deposit-taking activities
   d. qualifications and licensing for insurance personnel
   e. compliance programs and internal audits
   f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the state member bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
   g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices or on behalf of the state member bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
5. Review the state member bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
6. Obtain and review the record of consumer complaints related to the CPSI regulation. These records are available from the Board's Division of Consumer and Community Affairs' database. (See CP letter 2001-11.)
7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

21. If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

3950.0.11 INTERNAL CONTROL QUESTIONNAIRE

3950.0.11.1 Risk Assessment of Insurance and Annuity Sales Activities

3950.0.11.1.1 Program Management

1. Does the BHC have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the BHC have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has management obtained the approval of the board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for

insurance or annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations?
5. Does the BHC's management effectively oversee the insurance or annuity sales activities, including those involving third parties?
6. Does the BHC have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
7. Does the BHC appropriately train and supervise employees conducting insurance or annuity sales activities?

3950.0.11.1.2 Management Information Systems

8. Does the BHC's insurance program management plan establish the appropriate management information systems (MIS) necessary for the banking organization's board of directors to properly oversee the insurance or annuity sales activities?
9. Does the MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to compliance with the CPSI regulation?
10. Does the MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

3950.0.11.1.3 Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third party's arrangement with the BHC?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
16. Do compliance personnel determine the scope and frequency of the insurance-product review?
17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the BHC's board of directors or a designated committee thereof?

3950.0.11.2 Consumer Protection in Sales of Insurance Regulation

This internal control questionnaire applies only to the examination of state member banks. It is provided for the BHC examiner's information only.

If applicable, review the state member bank's internal controls, policies, practices, and procedures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

3950.0.11.2.1 Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
   a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
   b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
   a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or

annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
b. the consumer is not free to purchase an insurance product or annuity from another source?

3950.0.11.2.2 Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
   a. the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
   b. the insurance product or annuity is not insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
   c. in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
   a. the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
   b. the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
8. If an application for credit is made by telephone, are the disclosures under question 4 above provided by mail to the consumer within three business days?
9. Are the disclosures under questions 3 and 4 above provided through electronic media instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?
12. Are required disclosures presented in a meaningful form and format?

3950.0.11.2.3 Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
    a. has an oral acknowledgment of receipt of the disclosures been obtained and is sufficient documentation maintained to show that the acknowledgment was given?
    b. have reasonable efforts to obtain a written acknowledgment from the consumer been made?

3950.0.11.2.4 Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
    a. keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
    b. identify the areas where insurance product or annuity sales activities occur?
    c. clearly delineate and distinguish insurance and annuity sales areas from the

areas where the bank's retail deposit-taking activities occur?

3950.0.11.2.5 Qualifications and Licensing

16. Does the state member bank permit any person to sell or offer for sale any insurance product or annuity in any part of its office or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

3950.0.11.2.6 Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel or third-party sales personnel conducting sales activities at or on behalf of the state member bank receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

3950.0.11.2.7 Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?

3950.0.11.2.8 Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulations?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?

33. If the bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

3950.0.11.2.9 Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the bank?

3980.0.1 ADDITIONAL BOARD AUTHORITY FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING COMPANIES

3980.0.1.1 Establishment of an Intermediate Holding Company

3980.0.1.1.1 Action the Board May Require

Pursuant to 12 U.S.C. 5667, if a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (Board) conducts activities other than those that are determined to be financial in nature or incidental thereto under section 4(k) of the BHC Act (12 U.S.C. 1843 (k)), the Board is authorized to require the company to establish and conduct all or a portion of such activities that are determined to be financial in nature or incidental thereto in or through an intermediate holding company. The intermediate holding company must be established in accordance with the Board's regulation no later than 90 days (or other longer appropriate time), after the date on which the Board notifies the nonbank financial company of the determination.

3980.0.1.1.2 Required Board Actions

The Board must require a nonbank financial company to establish an intermediate holding company, if it makes a determination that the establishment of such an intermediate holding company is necessary to

- appropriately supervise activities that are determined to be financial in nature or incidental thereto or
- ensure that supervision by the Board does not extend to the commercial activities of the nonbank financial company.

3980.0.2 Internal Financial Activities

Activities that are determined to be financial in nature or incidental thereto under section 4(k) of the BHC Act do not include internal financial activities, including internal treasury, investment, and employee benefit functions. If an internal financial activity was engaged in for the company or an affiliate and a non-affiliate of such company during the year prior to July 21, 2010, the company (or an affiliate of an intermediate holding company or subsidiary of an intermediate holding company) may continue to engage in such activity, provided that not less than 2/3 of the assets or 2/3 of the revenues generated from the activity are from or attributable to the company or an affiliate. These prior-engaged activities are subject to the Board's determination of whether engaging in such an activity presents undue risk to the company or to the financial stability of the United States.

3980.0.3 Source of Strength

A company that directly or indirectly controls an intermediate holding company shall serve as a source of strength to its subsidiary intermediate holding companies.

3980.0.4 Parent Company Reports

The Board is authorized to require reports under oath from a company that controls an intermediate company and from its appropriate officers or directors, solely for the purpose of ensuring compliance with the provisions of section 12 U.S.C. 5667, including assessing the ability of the company to (1) serve as a source of strength to its subsidiary intermediate holding company and (2) enforce compliance.

3980.0.5 Limited Parent Company Enforcement

The Board may enforce compliance with the provisions of 12 U.S.C. 5667 that are applicable to any company that controls an intermediate holding company under section 8 of the Federal Deposit Insurance Act (FDI Act) (see 12 U.S.C. 1818), and the company will be subject to each such section in the same manner and to the same extent as if the company were a bank holding company.

3980.0.5.1 Application of Other Act

Any violation of 12 U.S.C. 5667 by any company that controls and intermediate holding company also may be treated as a violation of the FDI Act.

Financial Factors (Introduction)

Section 4000.0

The analysis of financial factors should be conducted in four primary parts, namely: (1) parent only, (2) banking subsidiary(ies), (3) nonbank subsidiary(ies), and (4) consolidated organization. In view of the fact that all BHCs are not structured in the same organizational and financial manner, it is important that examiners be flexible in their approach and be judicious in their use of ratio analysis and peer group comparisons. There is no substitute for using sound judgment and creativity while performing an analysis, providing all of the pertinent information is available. The summary and conclusions should follow from the information presented in the analysis.

The analysis is intended to determine the financial strengths and weaknesses of an organization and the impact of conditions at the parent company and nonbank subsidiary which could adversely affect the condition of the banking subsidiary. As a regulatory agency, a goal of the Federal Reserve System is to safeguard and protect the soundness of commercial banks. The System oversees holding company banking and nonbanking activities to assure the continued safety and soundness of individual banks and the industry as a whole.

The analysis of financial factors resulting from the inspection of a bank holding company is essentially a finding of facts and an expression of judgment. In conducting an appraisal of a holding company's condition, the financial analysis of the organization, based on a ‘‘building block’’ or ‘‘component’’ approach, should provide the examiner with a solid foundation from which to proceed. In order to complete the analysis it is first necessary to accumulate sufficient information concerning the parent company, bank and nonbanking subsidiary(ies) and the consolidated organization. A final analysis should not be attempted until these integral parts have been thoroughly reviewed.

4010.0.1 INTRODUCTION AND SCOPE OF THE ANALYSIS

The cash flow analysis is *applicable to all bank holding companies with consolidated assets in excess of $1 billion, those that have substantive fixed charges or debt outstanding,* as well as select others at the option of the Reserve Bank. Key parts of the analysis involve the use of:

1. A standardized ''Cash Flow Statement (Parent)'' page (refer to manual sections 5010.23 and 5020.13 for the illustrated pages) which includes computation of the cash earnings coverage ratios and analyses; regarding the results;
2. Earnings cash flow coverage ratios to measure the parent company's ability:
   a. To pay its fixed charges, including interest costs, lease expense, income taxes, retirement of long-term debt (including sinking fund provisions), and preferred stock cash dividends, and
   b. To pay common stock cash dividends.
3. Guidelines for supervisory determination of parent company debt servicing capacity.

The cash flow statement page of the inspection report presents the cash earnings and the cash expenditures of the parent company. Within the statement are the key components to be used in the ''Fixed Charge Coverage Ratio,'' which measures the parent company's ability to meet its fixed obligations, and a ''Common Stock Cash Dividend Coverage Ratio'' which measures the ability of the remaining, or residual, earnings to cover common stock dividends.

4010.0.2 CASH FLOW STATEMENT

The cash flow statement is an effective tool used in understanding how a particular bank holding company operates. Its primary objective is to summarize the financing and investing activities of the holding company, including the extent to which the entity has generated funds (externally and internally) during the period. The cash flow statement is related to both the income statement and the balance sheet and provides information that otherwise can be obtained only partially by interpreting each of those statements.

An analysis of past cash flow statements can supply important information regarding the uses of funds, such as internal asset growth or acquisitions, as well as data on the sources of funds used and the financing needs of management. A projected cash flow statement will focus on the need for future funds, its applications, and the sources from which they are likely to be available.

Specifically, the analysis of the cash flow statement is necessary for a thorough understanding of a bank holding company and the nature of its operations to the extent that it provides information on such areas as:

1. Utilization of funds provided by operations;
2. Use of funds from a new debt issue or sale of stock;
3. Source of funds used for acquisitions or additional capital contributions;
4. Means of payment of a dividend in the face of an operating loss;
5. Means of debt repayment and stock redemption.

While the cash flow statement provides an overall perspective of a holding company's utilization of available funds, it does not, by itself, indicate possible or actual difficulties the parent company may have in meeting its fixed obligations from internally generated funds. Fixed obligations or fixed charges are those recurring expenses which must be paid as they fall due, which includes interest expense, lease expense, sinking fund requirements, scheduled debt repayments and preferred dividends.

One ratio that may be used to calculate the strength of a parent company's earnings to meet its fixed charges or obligations is the *Fixed Charge Coverage Ratio* (FCCR). The components of the ratio are included on the ''Cash Flow Statement (Parent)'' page. The Fixed Charge Coverage Ratio (FCCR) measures the parent company's ability to pay for *fixed* contractual obligations if management is to *retain control of the organization,* thereby satisfying the expectation of creditors and preferred stockholders. Net income *after taxes* is used in the formula. Interest and lease expenses are already deducted to arrive at the net income figure and must be added back to obtain the earnings available to pay such charges. Interest expense is usually the largest component among all ''fixed charges,'' and the ability to pay this expense from earnings cash flow is critical to an assurance of continued refunding of the parent company's debt. It measures not only the extent to which net cash operating earnings covers the debt servicing requirements of the parent company, but the capacity to pay income taxes and preferred stock cash dividends as well, thereby meeting the expectations that creditors and preferred shareholders have for the protection of their respective interests. The need for *better than a 1:1* coverage is therefore critical.

Another important formula, required to be calculated is the *Common Stock Cash Dividend Coverage Ratio* (CSCDCR) which measures the ability of the parent company to pay common stock cash dividends. The CSCDCR will show, in turn, whether the residual cash earnings of the parent company are sufficient to pay the common stock cash dividend and, if not, the amount that must be provided from other sources of cash, such as the liquidation of assets or additional borrowings, to cover the shortfall.

Significant shortfalls in the CSCDCR are to be scrutinized in light of the Board's November 1985 Policy Statement on "Cash Dividends Not Fully Covered by Earnings." According to the statement, a bank holding company should not maintain its existing rate of cash dividends on common stock unless:

1. The holding company's net income available to common stockholders over the past year has been sufficient to fully fund the dividends; *and*

2. The prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

A bank holding company whose cash dividends are inconsistent with the above criteria is to give serious consideration to cutting or eliminating its dividends. The need for *at least a 1:1 coverage* is therefore critical.

The two ratios[1] are calculated as follows:

$$\text{FCCR} = \frac{\text{After tax cash income (1) + interest expense (2) + lease \& rental expense (3)}}{\text{interest expense (2) + lease \& rental expense (3) + contractual long-term debt retired (4) + preferred stock dividend payments (5)}}$$

$$\text{CSCDCR} = \frac{\text{After tax cash income (1)} - [\text{Contractual long-term debt retired (4) + preferred stock dividend payments (5)}]}{\text{Common Stock Dividend Payments (6)}}$$

Note that the Cash Flow Statement (Parent) page presents only cash items included in the parent's income and therefore the analyst can use its income figures without any need to adjust for noncash items.

Both the Fixed Charge Coverage and the Common Stock Cash Dividends Coverage ratios are considered inadequate at less than 1:1. If a holding company is generating funds which provide at least dollar-for-dollar coverage, no criticism need be made. However, the examiner should be aware that these ratios, as well as others, are merely guidelines and good judgment must prevail. A ratio of 1.02:1 may pass the test, but it is only barely adequate. No criticism may necessarily be warranted for the period covered by the 1.02:1 ratio, but it may be indicative of a deteriorating trend over the past few years. Accordingly, an appropriate comment concerning the trend may be warranted.

When reviewing these ratios, it should be kept in mind that certain components in the numerator can to some degree be altered at the discretion of management. For example, by altering the dividends paid by bank subsidiaries, the amount of funds available to the parent to cover fixed charges can be increased or decreased. For this reason, the fixed charge and funds flow ratios should be analyzed in conjunction with a review of the dividend payout ratios of the subsidiary banks. Cash flow ratios that otherwise appear adequate may be a cause for concern if the banks are paying out dividends that are too high in relation to capital or overall condition. Analysts should evaluate the bank dividend payout ratios in light of the bank's capital and financial condition. Only in this way can the analyst gain a better understanding of the quality of the parent's cash flow and its potential effect on bank subsidiaries.

Ratios of less than 1:1 coverage show that internally generated funds are not sufficient to meet a parent company's needs. In many cases, the examiner may find low coverage ratios yet all fixed charges were paid as agreed. Had they not been, the company would have incurred severe financial difficulties long before the start of the inspection. Therefore, when less than adequate ratios appear and obligations are paid

1. The numbered ( ) items correspond to the numbered lines on the "Cash Flow Statement (Parent)" page.

on time, the examiner must determine what other source of funds was utilized to make up the shortfall and to permit the timely payment of obligations.

4010.0.3 SUPERVISORY DETERMINATION AS TO ADEQUACY OF PARENT COMPANY CASH FLOW

A supervisory determination about the adequacy of parent company cash flow, and its use as a measure of parent company debt servicing capacity, requires more information than just the results of the Fixed Charge Coverage and Common Stock Cash Dividend Coverage Ratios. The typical major parent company does not generate an earnings cash flow by conducting banking operations itself, although it nevertheless may incur a heavy external debt on behalf of its operating subsidiaries which are the generators of the actual earnings cash flow. Therefore, the parent company earnings cash flow may not be indicative of the *actual* earnings power of the entire banking organization. For example, the cash earnings of the parent company may be kept low by management to avoid State or local income tax liability and/or to increase leveraged lending volumes at the subsidiary level. Conversely, cash earnings may be forced to the parent company through imprudent levels of upstream cash dividend payments which eventually will endanger the operating subsidiaries and the parent itself.

A supervisory determination about the adequacy of parent company cash flow must take place at *two levels:* (1) by analyzing the results of the two coverage ratios using the net earnings cash flow *realized* by the parent company, *and* (2) by analyzing the effect that upstream cash flow to the parent company has had, and can be expected to have, on the financial condition of the bank subsidiaries and the significant nonbank subsidiaries. The latter focus should be on significant nonbank subsidiaries whose capital and dividend policies are subject to separate regulation—such as thrifts—or subsidiaries with significant external funding, whose creditors presumably monitor capital and dividend policies of the subsidiary.

4010.0.4 SPECIFIC GUIDELINES FOR DEBT SERVICING CAPACITY

The specific guidelines for debt servicing capacity are as follows:

1. The adequacy or inadequacy of parent company cash flow, and thereby the capacity to sustain the parent company's debt, is determined ultimately from the results of the Fixed Charge and Common Stock Cash Dividend Coverage Ratios, and the related analysis of the effects of upstream cash flow on the financial condition of the key subsidiaries.

2. For those parent companies with material amounts of long-term debt, coverage ratios in excess of 1:1 will not necessarily be considered sufficient to sustain the parent company's leverage *unless: first,* the Tier 1 capital positions of the bank subsidiaries are considered adequate; *second,* that the bank holding company's consolidated Tier 1 capital position is considered adequate; and *third,* the parent's liquidity is judged adequate. If that is not the case, then a critical comment on the ''Examiner's Comments'' page should be made regarding the potentially excessive leverage of the parent, as well as that of its subsidiaries. A specific period of time should be established for the management of the bank holding company to submit a capital improvement program acceptable to the System. *Moreover,* where the capital positions, bank and consolidated, are considered adequate but the dividend payout ratios are excessive, it is indicative of a potential future debt servicing problem and should be brought to management's attention. Since the earnings level may not be sustainable, corrective action must be taken within a specified period of time.

3. For coverage ratios of less than 1:1, there is a presumption of a critical comment on the ''Examiner's Comments'' page of the inspection report *unless* the shortfall is prudently planned,[2] insignificant in amount and/or the trend of earnings cash flow and dividend policies clearly point toward a return to sufficient parent company earnings cash flow coverage.

   a. In circumstances where the Tier 1 capital position of *any bank subsidiary* is considered inadequate, a written program of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

   b. In circumstances where the Tier 1 *consolidated* capital position of the holding company is considered inadequate, a written program of corrective action should be required,

2. A planned cash flow shortfall might typically occur when the parent elects to reduce (or not increase) dividends from subsidiaries because it anticipated an excess cash or liquid asset position from certain *external sources* (i.e., stock or debt issuance, dividend reinvestment plans, or tax refunds) sufficient to cover the deficiency.

including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

c. In circumstances where the Tier 1 capital position of *each bank subsidiary* and the consolidated Tier 1 capital position of the bank holding company is considered adequate, but there is a developed trend of inadequate earnings cash flow coverage at the parent company level or excessive dividend payouts from the subsidiaries, a written program of corrective action should be required to reestablish and maintain a positive earnings cash flow at the parent company.

4010.0.5 SOURCES OF FUNDS TO MAKE UP SHORTFALLS

Basically, there are three source categories, other than current earnings, that could be used to make up any deficit: (1) liquidation of assets, (2) proceeds from a stock offering, or (3) borrowed funds. These sources must be thoroughly analyzed to determine the extent they were and could still be utilized. It must be kept in mind that the use of these sources cannot permanently eliminate a shortfall in the flow of funds from current operations. These alternative sources only alleviate temporarily the effects of a shortfall. Nevertheless, a deficit could have been intentionally allowed to occur because the holding company knew of funds coming from these alternate sources. For example, the parent knew of an impending stock sale and cut dividends from subsidiaries significantly. In future years, dividends from subsidiaries could be restored to normal proportions, bringing the ratios up to adequate levels.

At this point, it must be determined what, if any, criticism is necessary when an unplanned shortfall is made up by any of these alternate sources. The necessity of liquidating assets to meet cash needs may warrant a critical comment. The parent's advances to subsidiaries and its investment in marketable securities are considered temporary investments. That is, the holding company may reasonably expect to sell its securities and be repaid on its advances to subsidiaries within a reasonably short period of time. In the case of advances to a problem subsidiary, repayments may not be forthcoming. Nevertheless, if the parent does receive partial payments, such funds are available to meet cash needs. The concern to the examiner is the extent to which such temporary investments can be relied upon before they are fully exhausted. If the continued liquidation of those investments to meet cash needs has fully exhausted the assets or will do so in the near future, then appropriate critical comments are warranted. Such comments should stress that the liquidation of the investment portfolio and the advances to subsidiaries can no longer be considered a reliable source of funds.

Another method which may be used by a holding company to overcome a flow of funds deficiency is the sale of capital stock which is an effective source for generating permanent funds for the parent. However, it must be recognized that the primary reason for the stock offering was something other than covering the shortfall (i.e., debt repayment, capital contributions to subsidiaries, acquisitions). Therefore, it cannot be relied upon as a consistent annual source to supplement internally generated funds from operations. Also, it should be realized that the sale of stock will increase future funding requirements as additional dividends will have to be paid. Consequently, where no significant improvement in internal operations is contemplated in future periods, an appropriate comment is warranted indicating the potential problem.

Holding companies also compensate for inadequate funds flow with borrowed money. Although not a permanent source of funds, long-term debt is a source similar to the sale of stock. Its main purpose, however, was not to cover the shortfall. Long-term debt cannot be considered as a reliable, consistent annual source, and moreover, its existence creates new funding requirements.

Short-term debt is perhaps the most commonly used source to cover a deficit cash flow from operations and its use is of serious concern from a supervisory viewpoint. Unlike long-term debt and equity issues, short-term borrowings (i.e., bank loans, commercial paper) are readily available to holding companies which can and do rely on this source year after year for support. As a consequence, this indebtedness increases fixed charges and where material improvement in earnings does not develop, the shortfall could increase in subsequent periods thereby necessitating even larger borrowing requirements. This practice may jeopardize the parent's liquidity position since short-term liabilities rise without a corresponding increase in liquid assets as the borrowed funds are used to pay expenses. Here, an appropriate comment is warranted indicating the problems.

4010.0.6 REPORTING THE RESULTS

If the coverage ratios are less than 1:1, then appropriate comments are necessary to explain the external source utilized to make up the shortfall. The supporting details may be shown within the comments section of the Cash Flow Statement. More significant comments should be included on the "Analysis of Financial Factors" page or the "Examiner's Comments" page. The examiner may include prior years' results for comparative purposes.

4010.0.7 INSPECTION OBJECTIVES

1. To determine the ability of the parent to manage its cash position and operate within debt service and funding requirements.
2. To measure the parent's ability to meet its fixed obligations and its dependency on borrowed funds to meet its cash needs.
3. To determine if the parent company's dividends to stockholders are covered by residual cash earnings.
4. To analyze any cash flow transaction which may adversely affect the financial stability of the parent.
5. To discuss with parent company management:

   a. Deficit cash flows arising from internal operations;

   b. Steps management has taken, or plans to take, to restore adequate cash earnings coverage for fixed charges and dividend payments and whether such plans should be commensurate with the maintenance of adequate loan loss reserves and Tier 1 capital levels in the bank and major nonbank subsidiaries.

   c. Any parent company borrowings or restructurings needed to sustain dividend payments to shareholders; and

   d. The need to increase cash flow although there may be no deficit in current cash flow coverage.

4010.0.8 INSPECTION PROCEDURES

1. Prepare the "Cash Flow Statement (Parent)" FR 1225.

   a. Analyze each item of the parent company's comparative balance sheet and income statement. Since accrual figures may be used for all accounts except tax and dividend payments, adjustment to the figures may be necessary for the difference between accrual and cash basis accounting.

   b. Examine the underlying nature of period increases or decreases for the balances listed on the financial statements, particularly any material transactions that aided in averting coverage ratio shortfalls.

   c. Note contractual long-term debt retired (net decrease in borrowed funds, including sinking fund provisions) as a memo item on the bottom of the page, where indicated.

   d. Compute the fixed charge and common stock cash dividend coverage ratios as illustrated on the page. *The numbered items in the formula correspond with the numbered items on the "Cash Flow Statement (Parent)" page.*

   e. Answer the six questions on the "Cash Flow Statement (Parent)" page that prompt an analysis.
2. Analyze the Results.

   a. If there is full coverage, no problem should be assumed. However, *the underlying assets and transactions that provided for the coverage should be examined to make certain that "no problem" does, in fact, exist.*

   b. If a shortfall exists, provide guidelines to the parent company's management for developing a workable contingency plan, using your "good examiner judgement", considering the viability of all sources in resolving the shortfall.

   - Review the *sources* for making up shortfalls:
     - — Liquidation or sale of assets, *giving full consideration to external market concerns and losses that may result from the sales.*
     - — Proceeds from stock offerings.
     - — Increase in borrowed funds, including a restructuring of short term debt to long term debt.
     - — Sale of capital stock.
     - — Payments from subsidiaries on advances in the form of amortization or interest.
     - — Short term debt.
3. Report the Results.

   a. *When an "engineered" (planned) shortfall exists,* indicate that one does exist, the reasons therefore, and the degree of severity to which it should be addressed, either as part of the answers to the questions on the "Cash Flow Statement (Parent)", the "Analysis of Financial Factors" page, or the "Examiner's Comments" page. Provide management's assessment as to whether planned short falls will occur in the future.

b. When an *unplanned shortfall exists,* determine the extent of criticism that is to be made when short falls are lessened or corrected by an imprudent use of *alternative sources.* Based on the severity of the situation, determine whether the comments will be provided in the inspection report as answers to the questions on the Cash Flow Statement, or within the content of the ‘‘Analysis of Financial Factors’’ page, or the ‘‘Examiner’s Comments’’ page.

BHC financial leverage is the use of debt to supplement the equity in a company's capital structure. It is anticipated that funds generated through borrowings will be invested and earn a rate of return above their cost so that the net interest margin generated will improve the company's net income, providing a higher rate of return on stockholders' equity which has otherwise remained constant. Since no creditor or lender would be willing to extend credit without the cushion and safety provided by the stockholders' equity, this borrowing process is also referred to as "trading on equity." That is, utilizing the existence of a given amount of equity capital as a borrowing base. Stockholders and management often view leveraging as a favorable financial alternative because if owners have provided only a small portion of total financing, much of the financial risk will be borne by the lenders, alleviating the need of the stockholders to assume the total risk. In addition, by raising funds through long-term debt, the owners gain the benefits of maintaining control of the firm with a limited investment rather than diluting existing ownership via the sale of additional capital stock.

There are, however, some unfavorable aspects in this type of financing. As a holding company substitutes debt for equity, keeping its asset size constant, its leverage ratio will increase. The increase in leverage increases the probability that a company may go into default since a larger portion of the income stream generated by earning assets must then be used to meet increased fixed charges (interest expense). (This assumes that increases in future earnings are not anticipated. While earnings may be sufficient to meet fixed interest expenses at the time the debt is issued, it is possible that future earnings will not be sufficient to meet the increased expenses.) In addition, utilization of leverage reduces management flexibility in making future decisions because lenders impose restrictive covenants that may limit future debt issues, limit dividend payments, or impose constraints on specific operating ratios. However, not all of the effects of increased leverage are unfavorable. Additional long-term debt may have the favorable effect of extending maturities on obligations and may improve liquidity.

Leverage ratios measure the contribution of owners compared with the financing provided by lenders. Companies with low leverage ratios generally have less exposure to loss when the economy is in a recession, but they may also have lower expected returns when the economy booms. Firms with high leverage ratios run the risk of large losses but also have a chance of earning high rates of return on equity and assets. Thus, if a company earns more on the borrowed funds than it pays in interest, the return to the owners is increased. For example, if the company earns 10 percent on assets and debt costs 8 percent, there is a 2 percent differential accruing to the stockholders. However, if the return on assets falls to 7 percent, the differential between that figure and the cost of debt must be made up from total profits.

A bank holding company is composed of at least two tiers, parent and subsidiary, and each tier may issue long-term debt in its own name. Several different types of long-term debt instruments are utilized by holding companies. Corporations make use of instruments such as debentures, convertible debentures, term loans, capital notes and mortgage notes. (See Manual section 2080.0—"Funding"). While most issues are generally sold to the public, in some cases, issues of subsidiaries have been placed directly with another subsidiary, the parent company, or perhaps with an unaffiliated banking institution. Alternatively, issues presently held on the books of the parent may have been originally issued by one of the subsidiaries and later transferred to the parent. These transfers have often occurred at the time of the formation of the holding company when debt of the subsidiaries was assumed by the parent.

The proceeds of parent company long-term debt may be advanced to banking subsidiaries as debt or invested in banking subsidiaries as equity. When parent debt is issued, and the proceeds are advanced to subsidiaries as debt, a condition of "***simple leverage***" exists. When such proceeds are invested in subsidiaries as equity, a condition of "***double leverage***" is said to exist since the increase in the subsidiary bank's capital base will allow the bank to increase its own borrowings.[1] In effect, the

1. Parent company "***total leverage***" may be defined as the relationship between equity at the parent level and the total assets of the parent company. Such assets typically consist of investments in bank and nonbank subsidiaries, advances to affiliates, deposits with bank affiliates and securities. A useful related measure of parent company leverage is "***investment leverage***" which may be defined as the relationship between parent equity and its equity investments in subsidiaries. Since the equity which has been invested in subsidiaries can, and often is, further leveraged by external borrowings of such subsidiaries, this type of parent company investment leverage

parent's capital injection which was funded by debt, provides the bank with greater debt capacity, thereby allowing the bank to borrow additional funds on its own. Therefore, the original borrowing by the parent has, in effect, been compounded when the bank borrows based on its newly injected equity.

If the parent debt is reinvested as equity in a bank, the servicing of interest and principal is usually provided by dividends paid to the parent by the bank subsidiaries. The bank dividends, however, may become restricted based on the bank's earning power which may not provide for sufficient retention of earnings to support its asset growth. Problems may be less severe when parent debt is downstreamed as debt to the bank subsidiary. When the terms and maturities of the indentures match, the obligation of a bank to meet its interest and principal payments to the parent are contractual and represent fixed charges (interest is tax deductible) which will continue up to the maturity of the note. When funds are downstreamed as equity and the bank typically issues dividends to its parent, it is easier to restrict the flow of funds from the bank than if the funds were downstreamed as debt which results in bank payments of interest expense. Bank dividend declarations are subject to limitations imposed by sections 5199(b) (12 U.S.C. 60) and 5204 (12 U.S.C. 56) of the United States Revised Statutes, while interest payments are not subject to such restrictions.

4010.1.1 ACQUISITION DEBT

Some holding companies use debt for the acquisition of subsidiary banks. The Board believes that a high level of acquisition debt can impair the holding company's ability to act as a source of strength to its bank subsidiaries, and thus does not favor the use of a substantial amount of acquisition debt in bank holding company formations. However, the Board recognizes that the use of acquisition debt in the formation of certain holding companies may be necessary, particularly when transferring the ownership of small community banks (approximately $150 million or less), and the maintenance of local ownership in those banks. To this end, and in the interest of maintaining a safe and sound banking system, the Board has adopted a policy for assessing financial factors in the formation of small one-bank holding companies. (see Manual section 2090.2)

4010.1.2 INSPECTION CONSIDERATIONS

Generally, it is not the examiner's responsibility to criticize the method of term financing used by a bank holding company. The examiner, however, should be familiar with the various types of leveraging and the possible ramifications that they may have on a holding company structure. While the use of ratios may show an excessive leverage position, indicating vulnerability, it is primarily the corporation's earning power that dictates the acceptable level of debt. Accordingly, the examiner should compute a holding company's ability to meet its fixed charges (as detailed in the preceding section) to determine the appropriateness of the leverage position. If the company's earnings do not support the present fixed charge requirements, or if a declining trend is noted, appropriate comments are warranted.

can lead to what is referred to as "***double leverage***."

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to incorporate a reference to the ''Liquidity Risk'' sections (3005.1 to 3005.5) of the Federal Reserve System's Trading and Capital-Markets Activities Manual. *These sections provide additional guidance on evaluating a banking organization's liquidity management.*

4010.2.1 INTRODUCTION

Liquidity is generally defined as the ability of a company to meet its short-term obligations, to convert assets into cash or to obtain cash, or to roll over or issue new short-term debt. ''Short-term'' is generally viewed as a time span of up to a year. Since a bank holding company does not have the full range of asset and liability management options available to it that a bank does in managing its liquidity position, a BHC needs to have a sufficient cushion of liquid assets to support maturing liabilities. Certain assets that would not normally be considered current may be readily sold to avert a liquidity squeeze. For example, a holding company may be participating in long-term loans originated by a small business investment company (SBIC) subsidiary. If these loans are of good quality, the parent's share may be sold at little or no discount to that SBIC subsidiary, another subsidiary, or an unaffiliated company to obtain the needed cash. Consequently, the breakdown of assets segregating those that are current would not necessarily be indicative of liquid assets, given the nature of bank holding company investments. Therefore, liquid assets are defined as those assets that are readily available as cash or that can be converted into cash on an arm's-length basis without considerable loss.

Liquidity problems are usually a matter of the degree of severity. A less serious liquidity problem may mean that the company is unable to take advantage of profitable business opportunities. A more serious lack of liquidity may mean that a company is unable to pay its short-term obligations and is in default—this can lead to the forced sale of long-term investments and assets and, in its most severe form, to insolvency and bankruptcy. (See SR-86-17 and SR-85-37.) See also the ''Liquidity Risk'' sections (3005.1 to 3005.5) of the Federal Reserve System's *Trading and Capital-Markets Activities Manual.* These sections provide additional guidance on evaluating a banking organization's liquidity management.

4010.2.2 SUPERVISORY APPROACH TO ANALYZING PARENT COMPANY LIQUIDITY

For bank holding companies with consolidated assets in excess of $1 billion or material amounts of debt outstanding, or others, at the option of the Reserve Bank, the analytical approach to parent company liquidity will include the following key elements:

1. Evaluate parent company liquidity by analyzing the *contractual* maturity structure of assets and liabilities, extending this analysis to consider the underlying liquidity of the parent's intercompany advances and deposits. Any judgment of *adequate* parent company liquidity must be keyed to a finding that the parent has adequate liquid assets, on an underlying basis, to meet its short-term debt obligations.
2. Estimate the underlying liquidity of parent liabilities and assets, giving particular attention to interest-bearing deposits in and advances to subsidiaries. Emphasis should be placed on asset quality and the liquidity profile of the bank and key nonbank subsidiaries. The estimates are to be reflected in a statement of ''Parent Company Liquidity Position'' as restated data, with appropriate explanations as to the basis for the restatement.
3. Use the five contractual and estimated underlying maturity categories on the statement of ''Parent Company Liquidity Position'' to slot in data. The data categories are—
   a. up to 30 days,
   b. up to 90 days,
   c. up to one year,
   d. one to two years, and
   e. beyond two years.

   The schedule provides for the use of effective remaining maturity categories for the parent company's short-term assets and liabilities, highlighting funding surpluses or deficits at key specified periods of time. *Examiners have the option of including the statement in the inspection report in order to substantiate or clarify particular judgments.*
4. Use the conclusions drawn from the statement of ''Parent Company Liquidity Posi-

tion" as a basis for discussions with management. Examiners should also comment on their findings in detail on the "Analysis of Financial Factors" page in the inspection report.
5. Ascertaining whether an organization with significant funding activities has in place—
   a. internal parent liquidity management policies that address and limit the use of short-term funding sources to support various subsidiaries, and
   b. an internal contingency plan for maintaining parent liquidity under adverse situations.

4010.2.3 STATEMENT OF PARENT COMPANY LIQUIDITY POSITION

The purpose of the statement of "Parent Company Liquidity Position" is to provide a consistent method for analyzing parent liquidity. The schedule is *not* intended to address the issue of interest sensitivity. While only conclusions drawn from the schedule of estimated effective maturities are to appear in the inspection report, examiners should also collect data on contractual (remaining life) maturities of parent assets and liabilities. Examiners will treat all externally funded nonbank entities of the parent company in a similar fashion.

The maturity categories appearing on the schedule are a basic analytical framework for looking at funding mismatches and are not necessarily appropriate for all organizations. As such, categories can be adjusted to fit particular circumstances. On a conceptual basis, the 30-day period corresponds to a period during which markets might be in temporary disarray due to an external shock. For the largest companies with substantial overnight and very short-term funding operations, an additional 1- to 7-day category may be needed. The 31- to 90-day period allows for gauging the parent's ability to withstand internal adversity and demonstrate a return to "normal" business operations. The 91-day to one-year period is a reasonable planning horizon over which an organization might be able to readjust its internal funding policies substantially. In addition, the up-to-one-year categories, as a group, complement the cash-flow analysis of debt-servicing capacity by specifically addressing maturing debt that must be either paid or rolled over at prevailing rates. The one- to two-year category provides an early indication of any funding imbalances that management would have to address in the reasonably near term. As a practical matter, the over-two-year category has limited analytical value in most cases and is included principally to make certain that all deposits and advances are accounted for.

Using these categories, funding surpluses or deficits can be identified for specific maturity intervals. For examiners evaluating gaps based on estimated "underlying" maturities, guidelines on acceptable practices for funding surpluses and shortfalls are set. Examiners would be expected to place particular emphasis on the up-to-30-day period, in which a net liquidity surplus would be expected to provide at least that much time for a parent to ride out a shock. Similarly, the up-to-90-day period would be viewed as the relevant time to demonstrate to the market that problems are being addressed appropriately and are being brought under control. Imbalances in the 91-day to one-year categories would generally have less significance due to greater uncertainty regarding the assumptions that would go into any adjustments.

A logical point for assessing parent liquidity is an assessment of the contractual maturity structure of the holding company's balance sheet. Contractual maturities of assets and normal run-off of liabilities are to be slotted into the five maturity categories depicted. Once completed, the examiner is provided with an initial indication of whether the parent has an adequate cushion of short-term liquid assets within the 0- to 30-day and the 0- to 90-day categories to cover short-term liabilities or whether a pattern of significant short-term funding gaps exists. Certainly, the identification of such gaps gives guidance on obvious areas for further analysis. However, the absence of short-term funding shortfalls on a strictly contractual basis gives only limited comfort, as the parent's underlying liquidity still must be analyzed more deeply.

4010.2.4 ANALYSIS OF UNDERLYING SOURCES TO FUND DEBT AND MEET OTHER OBLIGATIONS

Adjustments to the schedule that better reflect the parent's liquidity position will be made as the next step in the analysis. These adjustments require the examiner's judgment on the underlying liquidity of the parent's assets and liabilities; particular emphasis placed on interest-bearing deposits with bank subsidiaries and advances to both bank and nonbank subsidiaries.

4010.2.4.1 Interest-Bearing Deposits with Subsidiary Banks

The parent's interest-bearing deposits[1] with the subsidiary bank(s) may represent either the temporary placement of idle funds or a more permanent source of bank funding. Temporary deposits typically are structured to mature in 90 days or less, are generally not substantial in relation to the overall size of the bank, are usually supported by substantial holdings of highly liquid bank assets, and could be repaid without triggering marketplace concerns regarding the organization's overall funding needs. Therefore, if this pattern exists, the temporary deposits may be considered highly liquid and slotted in the 0- to 30-day (or 0- to 7-day) period on the schedule, regardless of their contractual maturity dates.

Interest-bearing deposits with the subsidiary bank(s) that serve as a permanent source of bank funds are typically substantial in relation to the size of the bank and are usually placed to fund bank expansion without additional bank borrowings. Here, judgments regarding underlying liquidity should be keyed to the CAMELS ratings on the bank's liquidity and asset quality, as well as reasoned judgments on the bank's ability to liquidate assets or replace the funds in the marketplace through additional borrowings. Asset quality is critical, as it is a leading indicator of bad news that will ultimately pull down earnings and undermine market confidence. As a general principle, the liquidity of the parent's deposits in bank(s) should be no better than the liquidity of the bank(s) and should be subject to downgrading if bank asset quality is suspect. If bank asset quality is worse than fair, the liquidity of these funds should be downgraded. For banks with asset quality rated fair, the parent's deposits might still be considered liquid, but a closer analysis of the particular situation would be warranted.

Under the assumption that the bank's asset quality and liquidity positions do not negatively impact the bank's ability to liquidate or replace these funds, such deposits may be slotted in the 0- to 30-day (or 0- to 7-day for large institutions) period on the schedule, regardless of the contractual maturity. However, if these deposits are substantial, their replacement may trigger market concerns. At this point, the examiner's judgment is necessary to determine an acceptable level at which a portion of the deposits could be replaced in the marketplace without triggering such concerns. A starting point for the examiner should be to evaluate the funding gaps appearing on the contractual maturity schedule with particular attention paid to the 0- to 90-day period (0 to 30 days for large institutions). While it may be impossible for the bank(s) to replace all the parent's deposits without triggering concerns, the bank(s) may be able to replace only the portion necessary to eliminate the negative cumulative funding gap in the given time period. If even this amount is deemed to be substantial, the examiner may have no other alternative but to treat the deposits in accordance with the contractual maturity. For clarification, the following example is provided.

The contractual maturity schedule of a large holding company reflects a negative cumulative gap of $400 million in the 0- to 30-day time frame. The company's balance sheet includes $2.5 billion in interest-bearing deposits at the subsidiary bank(s), with $1 billion maturing in 30 days and $1.5 billion in 31 to 90 days.

In the examiner's judgment, the entire $1.5 billion due in over 30 days qualifies to be slotted in the under-30-day category,[2] but the bank would face liquidity pressures to replace this amount prior to its original maturity. However, $400 million, the amount needed to eliminate the negative cumulative gap position, could be replaced by the bank without undue market concern. Therefore, $400 million from the 31- to 90-day period should be re-slotted in the appropriate under 30-day-period.

4010.2.5 ADVANCES TO SUBSIDIARIES

Given the typical composition of bank holding company assets, the examiner is likely to have difficulty determining the degree of liquidity inherent in advances to subsidiaries.

For those subsidiaries with satisfactory asset quality, the examiner can usually assume the subsidiary could sell qualifying assets to affiliate bank(s) up to the quantitative limitations of section 23A, as long as the affiliated bank(s) are judged to have adequate liquidity. The examiner can also assume that a subsidiary that has an

1. In concept, the parent could also have advances to bank subsidiaries. Such advances are either booked as deposits (typically off-shore time deposits to avoid reserve requirements) or as instruments qualifying as tier 1 or tier 2 capital. To the extent that advances to banks are encountered, the analysis follows the same approach used with deposits.

2. Subject to early withdrawal penalties, which will be eliminated in consolidation.

established program of secondary-market asset sales could at least continue or even modestly expand the scope of the program. For subsidiaries without a program of asset sales, but whose assets are of the type that are readily marketable in the secondary market, a *limited* asset-sale program could be considered to provide some asset liquidity. However, caution should be used in estimating the magnitude of such sales, particularly because large transactions could not be accomplished quickly without risking market visibility and without broadcasting concerns about the corporation's funding.

When nonbank advances are substantial, the parent has little or no practical access to the funds advanced. While an arm's-length sale of such a subsidiary or a large portion of its assets to a bank affiliate may not generate a loss, the funding requirements for a large transaction at the bank level would probably initiate marketplace concerns.[3] Similarly, asset sales to an unaffiliated party that are significantly above normal would not only trigger market concerns but would probably also result in a significant discount. Furthermore, although it is possible that another nonbank subsidiary may act as the funding vehicle, the subsidiary's ability to generate the required funds may be restricted at best. Such restrictions may include marketplace concerns, as well as limitations on the maximum leverage positions or on the creation of senior debt embedded in debt covenants.

Advances to a subsidiary may be either short term or long term and are made for a variety of reasons, including providing a temporary source of income for the parent, enhancing a subsidiary's liquidity position, and supporting a subsidiary's operations. Therefore, the purpose of the loan, its maturity, and the degree to which high-quality assets of a subsidiary cover the amount due to the parent should also be considered in order to properly categorize advances.

4010.2.6. LIQUIDITY AND LIABILITIES OF THE PARENT

For liabilities of the parent, the policy presumption should be that their contractual maturity reflects the underlying availability of funds. Exceptions will reflect special circumstances, such as funding from foreign ownership interests or partners in joint ventures who have equity interests and an ongoing business relationship. The presence of backup lines of credit for commercial paper, while especially desirable in the case of regional companies, should not, by itself, cause an examiner to assume that the underlying maturity of a parent's short-term debt is materially longer than its contractual term or that these lines will always be readily available. In fact, organizations experiencing considerable problems, particularly asset-quality and liquidity problems, may find that these facilities are no longer available.

The examiner should thus review backup lines on a case-by-case basis and be aware of any escape clauses in interbank agreements. Specifically, for companies with a composite 3 or worse bank holding company RFI/C(D) rating or lead banks whose asset quality is a declining 3 or worse *or* whose asset quality *and* liquidity are rated 3 or worse, it is recommended that backup lines with "material adverse change" or similar escape clauses *not* be regarded as satisfactory support to an imbalanced parent company funding position.

Furthermore, certain holding companies' liabilities may often include unamortizing debt instruments. The company's ability to retire or replace such issues at maturity should be evaluated as part of the organization's overall liquidity analysis. If management intends to roll over the maturing issues, the evaluation should be based on the company's ability to do so. When debt retirement is the route chosen by management, the examiner's evaluation and judgment should focus on the company's ability to generate the necessary funds, either through asset liquidation or the issuance of equity instruments.

The unamortizing portion of debt issues is to be slotted in the appropriate maturity column of long-term debt. If the maturity of such issues falls due within the 0- to 90-day time frame, the examiner should comment on the organization's ability to replace the maturing issues or retire them by the deployment of funds from other sources in a footnote on the schedule. If the maturity of such debt is longer, the replacement or retirement should be addressed in the corporation's funding plan.

3. Underlying liquidity estimates should follow the approach previously stated for deposits.

4010.2.7 ANALYZING FUNDING MISMATCHES

After adjustments for the underlying liquidity of the parent's interest-bearing deposits and advances to subsidiaries and the underlying maturity of its liabilities, the resulting schedule should provide the examiner with the framework for looking at funding mismatches as a tool for assessing the parent's overall liquidity position. The position may be evaluated by the analysis of the underlying liquidity gaps (appearing on the bottom of the schedule). In the 0- to 30-day time frame, a net positive gap is expected and reflects the parent's ability to ride out a temporary market disarray. Although a negative gap in the 8- to 30-day period may be evident in larger organizations, the overall 30-day interval is expected to be positive. Similarly, for most organizations, the 0- to 90-day period is expected to reflect a positive position, regardless of a shortfall in the 31- to 90-day period. Failure to meet these conditions requires appropriate examiner comments on the "Examiner's Comments" page of the report.

The 91-day to one-year time frame (as well as the 31- to 90-day period for certain larger organizations) is less critical, and negative cumulative funding positions of modest size may be tolerated if the organization has demonstrated an ability to tap the funding markets, has readily available backup lines of credit, has a reasonable earnings-retention policy, has adequate funds-flow coverage, and has other fund-generating programs (such as a dividend reinvestment plan). Judgments on the reasonableness of any imbalances in these longer-term categories should be weighed against the examiners' estimates of the adequacy of these sources. In addition, the examiner should view these longer periods as a reasonable planning horizon over which the organization should be able to readjust its funding policies. These longer periods also provide an early indication of how management may address funding imbalances that may develop.

A significant shortfall in the 91-day to one-year period is expected to be covered by a contingency funding plan. While no single formula for such plans is recommended or possible, each organization needs to address its particular situation and the options it faces. At a minimum, the organization needs to address possible market shocks, whether they are caused by its own actions or by external events. Funding markets should be addressed individually and as a group, both as to their likely resiliency and the particular organization's position within each market. The viability of contingency sources should be tested periodically. The examiner should review the reasonableness of assumptions and the adequacy of alternative courses as part of the company's liquidity analysis. If no plan exists, a plan acceptable to the corporation's directors should be required. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.

In analyzing liquidity, the examiner will encounter the least difficulty when liquid assets equal or exceed short-term liabilities. In those instances, the liquidity position is considered adequate. If the examiner notes a declining trend in the liquidity position, an appropriate comment may be warranted, even though sufficient liquidity exists at that time.

Conversely, the examiner will encounter the most difficulty in analyzing liquidity when liquid assets are not sufficient to cover short-term obligations. When this situation exists, it is not necessarily indicative of an inadequate liquidity position. At that point, the examiner must consider other readily available sources of cash that are not shown on the balance sheet (for example, unused bank lines, dividends from subsidiaries).

Footnotes to financial statements may also play an important role in liquidity analysis. One such footnote may describe indenture restrictions on long-term debt. While a company may temporarily alleviate a liquidity bind by paying off its commercial paper with short-term bank loans, it may be faced with the problem of paying off the bank debt if it is precluded from issuing additional long-term debt.

4010.2.8 REPORTING THE RESULTS OF THE ANALYSIS

In the normal course of the inspection, the examiner should present his conclusions concerning liquidity to management. When there is an indication of some vulnerability, the examiner should solicit management's opinion and any corrective action plans being considered. If it appears that management has not addressed itself to the vulnerable or inadequate situation, an appropriate comment should be made. The results of this analysis should be discussed in the parent company section on the "Analysis of Financial Factors" page in the inspection report. In addition, the examiner has the option of incorporating the liquidity schedule in the report in order to substantiate or clarify particular judgments. Criticism with respect to a liquidity shortfall anywhere within the 0- to 90-day time frame or, in most cases, the absence of a contingency plan to cover shortfalls in the under-one-year time frame, should be carried forward to the "Examiner's Comments" page and the transmittal letter. These concerns should also be discussed with management.

4010.2.9 INSPECTION OBJECTIVES

1. To analyze the contractual maturity structure of assets and liabilities, and then extend the analysis to the underlying liquidity of intercompany advances and deposits—considering whether the underlying liquidity is short term or long term.
2. To estimate the underlying liquidity of parent liabilities and assets, paying particular attention to interest-bearing deposits in and advances to subsidiaries. Give particular attention to—
   a. asset quality, and
   b. the liquidity profile of the bank and key nonbank subsidiaries.
3. To restate, on the "Parent Company Liquidity Position" report page (see section 5030.0, pages 33–34), the estimates, using the suggested five broad contractual and underlying maturity categories.
4. To judge the adequacy of parent company liquidity, keying it to a finding as to whether the parent has adequate liquid assets, on an underlying-liquidity basis, to meet its short-term debt obligations.
5. For BHCs that have significant funding activities at the parent level, to determine if the parent company has in place—
   a. internal parent liquidity management policies that address and limit the use of short-term funding sources to support subsidiaries, and
   b. an internal contingency plan for maintaining parent liquidity in the face of adversity.
6. To draw conclusions from the estimated remaining effective maturities that appear in the report.

4010.2.10 INSPECTION PROCEDURES

1. Assess the contractual maturities of the parent company's balance sheet.
2. Slot the contractual maturities of assets and the normal runoff of liabilities into the five categories on the "Parent Company Liquidity Position" report page.
3. On the schedule, make adjustments as to the underlying maturity of the parent company's assets and liabilities.
4. Review funding mismatches.
5. Review the reasonableness of the contingency plan's assumptions and the adequacy of alternative sources.
   a. If no plan exists, a plan acceptable to the corporation's directors should be required.
   b. Even if there are no specific concerns, the existence or lack of a plan should be taken into account when assessing management.
6. Discuss the results in the parent company section of the "Analysis of Financial Factors" page in the inspection report.
7. Include in the "Examiner's Comments," page 1, criticism of liquidity shortfalls within the 0- to 90-day period or the absence of a contingency plan to cover shortfalls in the under-one-year time frame that were discussed with management.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2011, this section was revised to provide an introduction to the principal areas of concern when examining a bank, such as the CAMELS components.

In making the determination as to the condition of the holding company under inspection, an examiner must, as part of the inspection procedures, analyze the financial condition of the bank(s) owned by the holding company. Such an appraisal is obviously of paramount importance when one considers that the bulk of the consolidated assets and earnings of a holding company are represented by the bank(s). The examiner must incorporate in the analysis, results of the most recent commercial examination of the subsidiary bank(s).

Therefore, for meaningful results, the analysis of the subsidiary bank(s) should commence after the results of the latest examination of the bank(s) have been obtained. The primary areas of concern are (1) the quality and adequacy of the bank's capital (C); (2) the quality of the bank's assets (A); (3) the capability of the board of directors and management (M) to identify, measure, monitor, and control the risks of the bank's activities and to ensure that the bank has a safe, sound, and efficient operation that is in compliance with applicable laws and regulations; (4) the quantity, sustainability, and trend of the bank's earnings (E); (5) the adequacy of the bank's liquidity (L) position; and (6) the bank's sensitivity (S) to market risk—the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect the bank's earnings, capital, and liabilities that are subject to market risk. See SR-96-38, "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.* The examiner's analysis of the bank must consider and determine whether certain key facets of a bank's operations meet minimum standards and conform, where required, to bank regulatory restrictions. The examiner should be especially alert to any exceptions or violations of applicable statutes or regulations that could have a materially adverse effect upon the financial condition of the organization. In addition, the examiner should also consider the conclusions drawn as to the extent of compliance and the adequacy of internal bank policies that contribute to the overall analysis of the bank's condition.

Inspection personnel should use the examination ratings of the other federal agencies (where appropriate) when completing the inspection report. However, if substantive differences of opinion exist as to the bank's composite rating, adjustments to the rating may be made and footnoted to indicate the change.

One area of vital importance in the evaluation of a bank's condition is capital adequacy. Consideration should be given by the examiner whether the bank has sufficient capital to provide an adequate base for growth and a cushion to absorb possible losses, thereby providing protection to depositors. In that regard, the Board, has adopted capital adequacy guidelines, that include risk-based and leverage measures which apply to state member banks. The examiner should refer to section 3020.1 of the *Commercial Bank Examination Manual* for guidance on evaluating the capital adequacy of state member banks.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2011, this section was revised to more clearly explain the components in calculating the total classification ratio and the weighted classification ratio, which are used in determining the asset quality of subsidiary banks. This section was also revised to include references to SR-93-30 and SR-96-38.

The quality of a bank's assets is another area of major supervisory concern. Supervisors consider the appraisal and evaluation of a bank's assets to be one of the most important examination procedures. It will be established by the bank examiner during the examination of a subsidiary bank to what degree its funds have been invested in assets of good quality that afford reasonable assurance of ultimate collectability and regularity of income. The examiner should have further determined that a subsidiary bank's asset composition is compatible with the nature of the business conducted by the bank, the type of customer served, and the locality. The holding company examiner is expected to comment upon the total classifications determined by the bank examiner in relation to the bank's capital.[1] Consideration should also be given to the severity of the classifications. If the classified assets are considered not to possess a significant loss potential, favorable consideration should be accorded this factor.

Past due ratios should also be evaluated. In this respect, it is essential that trends be observed. Although a particular lending department's delinquent outstandings or an institution's overall past due percentage is presently considered reasonable, a noticeable upward trend may be worthy of comment to management. Excessive arrearages in any area warrant an examiner's comment in the inspection report. Management should take appropriate action to improve any undesirable past due levels.

In determining an organization's asset quality, the total classification ratio is an important indicator to review. The total classification ratio is calculated by adding the total dollar value of classified assets divided by the sum of tier 1 risk-based capital plus the allowance for loans and lease losses (ALLL). Another yardstick employed by examiners is the weighted classification ratio, which takes into consideration the severity of a bank's classified assets. In rating asset quality, the weighted classification ratio is designed to distinguish the degree of risk inherent in classified assets by ascribing weights to each category of classification thereby providing another measure of the impact of risk on bank capital.

The following weights are to be used:

Classification	*Weights*
Substandard	20%
Doubtful	50%
Loss	100%

The weighted classification ratio is calculated by taking the aggregate of 20 percent of assets classified substandard and value impaired (net of allocated transfer risk reserve), 50 percent of doubtful, and 100 percent of loss divided by the sum of tier 1 risk-based capital plus the ALLL. In addition to the total and weighted classifications ratios, examiners should also evaluate the adequacy of loan loss valuation reserves as compared to weighted classifications. Loss potential inherent in weighted classified assets must be offset by valuation reserves and equity capital or appropriate comments should be made.

Another tool that should be considered in evaluating asset quality is the bank's internal classification list, if the bank's lending procedures and management are adequate. Additional information on rating a bank's asset quality is available in the Uniform Interagency Bank Rating System. See SR 96-38, "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.*

1. See SR-93-30, specifically the attachment entitled, "Interagency Statement on the Supervisory Definition of Special Mention Assets." See also SR-04-9 on the attached "Revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts," which defines classified assets.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2016, this section was revised to include footnote 1.

Comparison of earnings trends with other banks of similar size, along with an analysis of the quality of those earnings, is an effective initial approach in determining whether or not a bank's earnings are satisfactory. Comprehensive surveys of bank earnings by peer group size are tabulated by the Board and many of the Reserve Banks. The results are sufficiently detailed to permit various methods of comparison of the earnings of a specific bank with those in its peer group.

One ratio used as a means of measuring the quality of a bank's earnings is its return on average assets (net income after taxes divided by average total assets). If the ratio is low or declining rapidly, it could signal, among other things, that the bank's net interest income or margin is declining or that the bank is experiencing increased loan losses.

A bank's current earnings should be sufficient to allow for ample provisions to offset anticipated losses. Various factors to be considered in the determination of such losses include a bank's historic loss experience, the adequacy of the valuation reserve, the quality and strength of its existing loans and investments and the soundness of the loan and administrative policies of management.

In assessing a bank's earnings performance capabilities and the quality of those earnings, an examiner should give consideration to any special factors that may affect a particular bank's earnings. For example, a bank located in an urban area of a large city may find it difficult to earn as much as a bank of similar size located in a rural community or a small city. The urban bank is usually subjected to a higher level of operating expenses, particularly in salaries and local taxes. Moreover, its proximity to the large city and the competition afforded by bigger banks may necessitate lower rates of interest on loans as well as higher rates of interest on deposits. Consideration should also be given to the adequacy of the loan loss provisions as referred to above, the inclusion of any capitalized accrued interest into interest income, or the nature of any large nonoperating gains when analyzing earnings. Further consideration should be given to the general nature of a bank's business or management's mode of operation. A bank's deposit structure and its resulting average interest paid per dollar of deposits may differ widely from that of other banks of a similar size and consequently, its earnings may be substantially below average as a direct result of the difference. For example, the maintenance of a high volume of interest bearing time accounts in relation to total deposits is a major expense and is quite often the cause for certain banks falling below the average earnings of comparably sized banks.

A bank's earnings should also be more than sufficiently adequate in relation to its current dividend rate. It is particularly important that a bank's dividend rate is prudent relative to its financial position and not be based on overly optimistic earnings scenarios. See SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies."[1] Also see section 2020.5 and its discussion of the Board's "Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies."

The percentage that should be retained in the capital accounts is not clearly established. One thing is certain, the need for retained earnings to augment capital will depend on the adequacy of the existing capital structure as well as the bank's asset growth rate. Dividend payout rates may be regarded as exceeding prudent banking practices if capital growth does not keep pace with asset growth. Prudent management dictates that a curtailment of the dividend rate be considered if capital inadequacy is obvious and greater earnings retention is required. Apparently excessive dividend payouts or a record of recent operating losses should lead the bank or BHC examiner to refer to sections 5199(b) and 5204 of the United States Revised Statutes and

1. SR-09-4 is superseded for a U. S bank holding company or an intermediate holding company of a foreign banking organization with $50 billion or more in total consolidated assets as stated in SR-15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms," and SR-15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms."

section 208.19 of Regulation H which restrict state member bank dividends.

Analysis of net interest margins is of growing importance. A comparison should be made of a bank's ability to generate interest income on earning assets relative to the interest expenses associated with the funds used to finance the earning assets.

Additional information on rating bank earnings is available in the Uniform Interagency Bank Rating System. See SR-96-38 "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.*

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to incorporate a reference to the "Liquidity Risk" sections (4020.1 to 4020.4) of the Federal Reserve System's Commercial Bank Examination Manual. This section has also been revised to include a reference to the March 2010, "Interagency Policy Statement on Funding and Liquidity-Risk Management."

Liquidity is generally defined as the ability to meet short-term obligations, to convert assets into cash or obtain cash, or to roll over or issue new short-term debt. Various techniques are employed to measure a bank's (depository institution) liquidity position. The bank examiner considers the bank's location and the nature of its operations. For example, a small rural bank has far different needs than a multibillion dollar money market institution.

In addition to cash assets, a bank will hold for liquidity purposes a portion of its investment portfolio of securities that are readily convertible into cash. Loan and investment maturities are generally matched to certain deposit or other liability maturities. However, the individual responsible for a bank's money management must be extremely flexible and have alternate means to meet unanticipated changes in liquidity needs. To offset these needs, other means of increasing liquidity may be needed, which might include increasing temporary short-term borrowings, selling longer-term assets, or a combination of both. Factors that the "money management" officer will consider include the availability of funds, the market value of the saleable assets, prevailing interest rates and the susceptibility to interest-rate risk, and the bank's earnings position and related tax considerations. Although most small banks may not have a "money manager," they too must monitor their liquidity carefully.

One of the most common methods used by large banks to increase liquidity is to use additional borrowings. Some of the other basic means of improving liquidity include the use of direct short-term credit available through the discount window from Reserve Banks, the use of Federal funds purchases, and the use of loans from correspondent banks.

4020.4.1 SOUND LIQUIDITY-RISK MANAGEMENT

All banks are affected by changes in the economic climate, and the monitoring of economic and money market trends is crucial to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones. Sound liquidity-risk management requires the following elements:[1]

- Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk.
- Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.
- Comprehensive liquidity-risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.
- Active management of intraday liquidity and collateral.
- An appropriately diverse mix of existing and potential future funding sources.
- Adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments that can be used to meet liquidity needs in stressful situations.
- Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.
- Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity-risk management process.

Information that a bank's management should consider in liquidity planning includes—

1. internal costs of funds,
2. maturity and repricing mismatches in the balance sheet,

1. See the March 10, 2010, "Interagency Policy Statement on Funding and Liquidity-Risk Management." (See section 4066.0, appendix A.) See also the guidance published by the Basel Committee on Banking Supervision, Bank for International Settlements, "Principles for Sound Liquidity-Risk Management and Supervision."

3. anticipated funding needs, and
4. economic and market forecasts.

In addition, bank management must have an effective CFP that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs. Some factors that may affect a bank's liquidity include—

1. a decline in earnings,
2. an increase in nonperforming assets,
3. deposit concentrations,
4. a downgrade by a rating agency,
5. expanded business opportunities,
6. acquisitions,
7. new tax initiatives, and
8. assured accessibility to diversified funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations to low-probability/high-impact events that can arise through institution-specific or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate-term, and long-term liquidity profile. A fundamental principle in designing a CFP that addresses each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds that could be used to provide liquidity under a variety of circumstances. Such diversification should focus not only on the number of potential funds providers but also on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event these sources are expected to address.

See also the "Liquidity Risk" sections (4020.1 to 4020.4) of the Board of Governors of the Federal Reserve System's *Commercial Bank Examination Manual.* These sections provide additional guidance on evaluating a banking organization's liquidity management.

4020.4.2 LIQUIDITY-RISK MANAGEMENT USING THE FEDERAL RESERVE'S PRIMARY CREDIT PROGRAM

The Federal Reserve's primary credit program (a type of discount window lending) offers generally sound depository institutions an additional source of available funds, although such funds are lent for managing short-term liquidity risks (at a rate above the target federal funds rate).[2] Management should fully assess the potential role that the Federal Reserve's primary credit program might play in managing the institution's liquidity. The primary credit program can be a viable source of very short-term backup funds. Management may find it appropriate to incorporate the availability of the primary credit program into their institution's diversified liquidity-management policies, procedures, and CFPs. The primary credit program has the following attributes that make it a viable source of backup or contingency funding for short-term purposes:

1. Primary credit is extended, with minimal administrative burden, to eligible discount window participants.
2. Primary credit is available only to financially sound depository institutions, as determined by the lending Federal Reserve Bank.
3. Primary credit can enhance diversification in short-term CFPs.
4. Borrowings can be secured with an array of collateral that is acceptable to the lending Federal Reserve Bank, including consumer and commercial loans.
5. Requests for primary credit advances can be made anytime during the day.[3]
6. There are generally no restrictions on the use of short-term primary credit.

If an institution incorporates primary credit into its CFP, the institution should ensure that it has in place with the appropriate Reserve Bank the necessary borrowing documentation and collateral arrangements. This is particularly impor-

2. The Federal Reserve's secondary credit program provides loans to qualifying depository institutions (for example, those depository institutions that are not eligible for the primary credit program) at an interest rate that is above the primary credit program's interest rate. See section 3010.1 of the *Commercial Bank Examination Manual* and SR-03-15, "Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management," for a further discussion of the Federal Reserve's credit programs.

3. Advances generally are booked at the end of the business day.

tant when the intended collateral consists of loans or other assets that may involve significant processing or lead time for pledging to the Reserve Bank.

It is a long-established sound practice for institutions to periodically test all sources of contingency funding. Accordingly, if an institution includes the Federal Reserve's primary and other credit programs, along with borrowing from other lenders, in its contingency plans, management should occasionally test the institution's ability to borrow from all the funding sources covered by the plan. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be used.

Institutions should ensure that any planned use of primary credit is consistent with the stated purposes and objectives of the program. Under the primary credit program, the Federal Reserve generally expects to extend funds on a very short-term basis, usually overnight. Therefore, as with any other type of short-term contingency funding, institutions should ensure that any use of primary credit facilities for short-term liquidity contingencies is accompanied by viable take-out or exit strategies to replace this funding expeditiously with other sources of funding. Institutions should factor into their CFPs an analysis of their eligibility for primary credit under various scenarios, recognizing that if their financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may be available.

Secondary credit is available at a rate above that of primary credit. Secondary credit is available to meet short-term needs (when the borrowing is constant and there is a prompt return to market funding sources) or to resolve financial difficulties. The preparations made by a bank to access primary credit (the documentation and collateral requirements) will also support the borrowing of secondary credit.

Another critical element of liquidity management is an appropriate assessment of the costs and benefits of various sources of potential liquidity. This assessment is particularly important in managing short-term and day-to-day sources and uses of funds. Given the above-market rates charged on primary credit, institutions should ensure that they adequately assess the higher costs of this form of credit relative to other available sources. Extended use of any type of relatively expensive source of funds can give rise to significant earnings implications that, in turn, may lead to supervisory concerns.

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may use in managing their liquidity-risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of readily available and confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings. (See SR-03-15.)

4020.4.2.1 Supervisory and Examiner Considerations

Because primary credit can serve as a viable source of backup, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and examiners should be cognizant of the implications that too-frequent use of this source of relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Overreliance on primary credit borrowings, or any other single source of short-term contingency funds, regardless of the relative costs, may be symptomatic of deeper operational or financial difficulties. The use of primary credit, as with the use of any potential sources of contingency funding, is an important management decision that must be made in the context of safe and sound banking practices.

4020.4.3 ANALYSIS OF LIQUIDITY

A bank's liquidity must be evaluated on the basis of the bank's capacity to satisfy promptly its financial obligations and its ability to fulfill the reasonable borrowing needs of the communities it serves. An examiner's assessment of a bank's liquidity management should not be restricted to its liquidity position on any particular date. Indeed, the examiner should also focus his or her efforts toward determining the bank's liquidity position over a specific time period. The examiner's evaluation should also encompass the overall effectiveness of the institution's asset-liability management and liquidity risk-management strategies. Factors such as the nature, volume, and anticipated takedown of a bank's credit commitments should also be considered in arriving at an overall rating for liquidity.

If the bank examiner has commented on a

liquidity deficiency at a subsidiary bank, the bank holding company examiner should consider these findings in the overall analysis of financial factors. Additional information on rating a bank's liquidity is available in the Uniform Interagency Bank Rating System. See SR-96-38, "Uniform Financial Institutions Rating System," and section A.5020.1 in the *Commercial Bank Examination Manual.*

The condition of a bank provides important insight regarding the quality of bank management. An appraisal of management's performance should be measured in terms of long-term profitability, risk exposure, liquidity, and solvency; all geared toward assuring the bank's continued profitability and overall sound financial condition. Management must meet the bank's challenges and position in the market place among its competitors. It must make plans which will achieve the objectives established by the bank's directors. Management must be constantly alert to the need for continued upgrading and expanding of services and facilities to advance, support, and encourage the bank's growth.

Just as sound management decision making will generally produce banks that are free from serious problems, ineffective management has invariably been a prominent factor in almost every serious problem bank situation. An examiner must consider the degree and severity of problems that exist in the bank under examination and attempt to establish the responsibility for such. The examiner should seek to determine to what degree the bank's problems are attributable to questionable management judgment as opposed to outside factors, such as unfavorable economic conditions.

The major portion of a bank holding company's consolidated assets are held in the bank subsidiaries. Furthermore, at the parent level, the major asset is generally the investment in subsidiaries, the principal portion of which is the investment in the bank(s). Therefore, with few exceptions, it is the overall condition of the bank subsidiaries that reflects the condition of the parent company. As the bank holding company examiner reviews the examination report(s) for each bank subsidiary, a decision must be made with respect to the general condition of each bank. When all the bank subsidiaries have been reviewed, the examiner must put these findings within their proper perspective. For example, if four of five bank subsidiaries comprise less than 10 percent of the combined banking assets, it is the condition of the fifth bank subsidiary that will weigh heavily in the analysis. In other words, if the fifth bank comprises 90 percent of the combined banking assets, the parent's investment in that bank also comprises most of the holding company's assets. Thus, the quality of the parent's assets would be reflected in the general condition of that bank and appropriate comments are warranted. It should be noted, however, that regardless of relative size, a bank experiencing problems should be commented upon in the summary analysis.

4020.9.1 DE NOVO BANK DEFINITION AND SUPERVISION POLICY

The term "de novo bank" refers to a state member bank that has been in operation for three years or less. Experience has shown that pronounced problems often surface in the early years of a de novo bank. Problems observed by supervisors have included a lack of experienced management, a revolving door in staffing and directors, dissension among directors, a lack of involvement of directors in strategic planning, and poor lending practices.

Because of the unique challenges faced by de novo state member banks, the Federal Reserve has provided guidance regarding supervisory expectations for such institutions, which are found in SR-20-16, "Supervision of De Novo State Member Banks." SR-20-16 applies to de novo insured depository institutions seeking to become state member banks, as well as 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.

This section explains supervisory expectations for a de novo state member bank's capital positions and capital distributions. For more information on submitting a de novo bank application as well as the examination frequency and scope for de novo banks, see SR-20-16, the *Commercial Bank Examination Manual's* section entitled, "Examination Strategy and Risk-Focused Examinations," as well as SR-08-5, "Processing of De Novo Bank Membership Applications."

4020.9.2 CAPITAL STANDARDS FOR SUBSIDIARY BANKS OF BANK HOLDING COMPANIES

A de novo state member bank subsidiary of a bank holding company should maintain capital ratios commensurate with its risk profile and, generally, well in excess of regulatory minimums. The Federal Reserve typically requires a de novo bank to maintain a tier 1 leverage ratio of at least 8 percent for the first three years of operation. 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.

Any exceptions to this policy that are being considered for converting banks should be discussed with Board staff.

4020.9.3 CAPITAL DISTRIBUTIONS

A de novo state member bank 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 described in SR-20-16, 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 company (if applicable) should assess the risk associated with taking on significant debt that is solely reliant on dividends from the de novo bank subsidiary 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 bank's income taxes.[1]

See also the Board's "Small Bank Holding Company and Savings and Loan Holding Company Policy Statement" (12 CFR part 225, appendix C), which permits the formation and expansion of small holding companies with debt levels that are higher than typically permitted for larger holding companies. The policy statement contains several conditions and restrictions designed to ensure that small holding companies that operate with the higher levels of debt permitted by the policy statement do not present an undue risk to the safety and soundness of their subsidiary banks.

1. Refer to SR-98-38, "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure," and SR-14-6, "Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure." See also this manual's section entitled, "Taxes (Consolidated Tax Filing)."

4030.0.1 INTRODUCTION

Generally, a subsidiary of a bank holding company is not liable for debts of any other subsidiary of the holding company unless it is contractually obligated through guarantees, endorsements, or other similar instruments. This apparent legal separation may induce false confidence that banks are insulated from problems that may befall other subsidiaries of the holding company. If a nonbank subsidiary of a bank holding company finds itself in serious financial trouble, several results are possible. The holding company may work as it was intended, in that debts of the failing subsidiary are isolated and not transferred to other subsidiaries so that at worst, the subsidiary and the parent (the holding company) fail. In this instance, other subsidiaries, including bank subsidiaries, are unharmed, and after a change in management or ownership, they continue in operation. There is no loss of confidence in the bank by its depositors. However, this is not necessarily the result.

Failure of a nonbank subsidiary may lead to a lack of confidence in the affiliated bank's ability to continue in business, which might precipitate a run on the bank's deposits. The failure of a major nonbank subsidiary then may place its affiliated bank in serious financial trouble. The examiner should assess the impact that the failure or the potential failure of a nonbank subsidiary may have on an affiliated bank with a similar name.

Usually, a financially distressed nonbank subsidiary is aided by the holding company, which will do everything in its power to rescue it from failure. At a minimum, refusal to do so would undermine confidence in the strength of the holding company. Refusal to aid its nonbank subsidiary might even result in a rise in the interest cost of the holding company's future debt in the capital markets and, more than likely, preclude issuance of commercial paper.

A holding company has considerable discretion in choosing how to assist one of its troubled subsidiaries. Because the bank is usually the largest subsidiary, the holding company may attempt to draw upon the resources of the bank to aid the nonbank subsidiary. The bank can transfer a substantial portion of its capital through dividends to the parent company, which may pass these funds on to the troubled nonbank subsidiary. Also, the nonbank may attempt to sell part of its portfolio to the bank subsidiary to improve liquidity. The Board's Interpretation 12 C.F.R. 250.250 (at FRRS 3–1133) limits the sale of nonbank subsidiary loans to the bank affiliate unless the bank had an opportunity to appraise the credit at the inception of the loan. Therefore, the examiner should closely analyze the off-balance-sheet activity of the nonbank subsidiary, particularly activity relating to the sale of loans shortly after they are made. Reference should also be made to section 2020.7, regarding the transfer of low-quality loans or other assets to avoid classification.

4030.0.2 ANALYSIS OF FINANCIAL CONDITION AND RISK ASSESSMENT

Because of the potentially damaging effect on the parent company or its bank subsidiary, the examiner should conduct a detailed analysis of the financial condition and perform a risk assessment of the nonbank subsidiaries. The loss to the holding company may not be confined to the equity in and advances to the subsidiary. The contingent liabilities arising from the nonbank subsidiary's external borrowings are quite often a large multiple of the parent's investment. Particular attention should be directed to holding companies that have made massive capital injections in order to rescue a failing subsidiary or to satisfy the external debt obligations of the subsidiary.

For each bank holding company with nonbank activities, examiners should prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below.[1] This assessment should be performed with the same frequency required for full-scope inspections. The purpose of this assessment is to identify subsidiaries with a risk profile that warrants an on-site presence, even if the subsidiary does not meet the minimum criteria set forth in section 5000.0.4.4.1, "On-site Reviews of Nonbank Subsidiaries." In formulating this assessment, the examiner should consider all available sources of information including, but not limited to—

- findings, scope, and recency of previous inspections;

1. The assessment of nonbank activities in large, complex organizations may be focused on an intermediate-tier company with oversight responsibility for multiple nonbank subsidiaries.

- ongoing monitoring efforts of surveillance and financial analysis units;
- information received through first-day letters or other pre-inspection communications;
- regulatory reports and published financial information; and,
- reports of internal and external auditors.

The risk assessment should address each nonbank subsidiary's funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off-balance-sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the bank holding company and nonbank subsidiary. The examiner should give particular attention to appraising the quality of a nonbank subsidiary's assets because asset problems therein may lead to other financial problems in the nonbank subsidiary and the parent company or bank affiliates. Examiners are expected to document in the inspection workpapers their assessment of the overall risk posed by each nonbank subsidiary and to summarize their assessment of nonbank activities in the bank holding company inspection report.

Nonbanks: Credit Extending (Classifications)

The examiner has four alternatives with respect to asset classifications. An appraisal of the degree of risk involved in a given asset leads to a selection. The examiner can either ''pass'' the asset or adversely classify the asset ''substandard,'' ''doubtful'' or ''loss,'' depending on the severity of deterioration noted.

Since the preponderance of all loans are subject to some degree of risk, the following question arises: To what point, or degree, must a given credit deteriorate to warrant a scheduled criticism in the report of inspection? Generally, a passed credit has those characteristics which are recognized as being part of a normal risk asset; the degree of risk is not unreasonable, the loan is being properly serviced, and is either adequately secured or repayment is reasonably assured from a specific source.

Classification units are designated as ''substandard,'' ''doubtful,'' and ''loss.'' A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the nonbank subsidiary will sustain some loss if the deficiencies are not corrected. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified loss are considered uncollectible and of such little value that their continuance as recordable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer reserving against this basically worthless asset even though partial recovery may be effected in the future.

Although the System does not apply bank standards when classifying nonbank assets, the classification categories are the same. Examiners of BHC nonbank subsidiaries must appraise the assets in light of industry standards and conditions inherent in the market.

For information on classifying a parent's investment in and advances to a noncredit-extending subsidiary, see Manual section 4070.0, BHC Rating System.

For information on the sufficiency of nonbank valuation reserves, see Manual section 4030.4.

Nonbanks: Credit Extending (Earnings) Section 4030.2

When analyzing the earnings of a nonbank subsidiary, the examiner should address two primary questions: (1) Is the return on assets commensurate with the risk associated with the assets? (2) What is the impact of earnings and trends on the parent company and affiliate banks? While a nonbank subsidiary operating at a loss may be in less than satisfactory condition, the loss may not necessarily result in a major adverse impact on the consolidated earnings. The nonbank subsidiary's total assets may be insignificant in relation to the consolidated assets of the BHC, but operating losses may result in a significant reduction in its consolidated earnings position.

In some cases, industry statistics will be available for comparative purposes. However, a favorable comparison should not necessarily be taken as depicting a satisfactory earnings condition. Actions by the parent company could influence the earnings of its subsidiaries. For example, management and/or service fees can be adjusted in order to alter the subsidiary's earnings to desired levels. Also, if the parent company is funding the subsidiary, the cost of funds to the subsidiary can be adjusted above or below the parent's cost of funds thus affecting net income. In addition, an undercapitalized subsidiary with only a marginal return on assets could show a better return on equity than the adequately capitalized independent counterpart experiencing a good return on its assets. As important as return on equity is as a measure of performance, for nonbank subsidiaries, particularly those that are thinly capitalized, absolute level of earnings or return on assets provide a more meaningful measure of earnings performance.

The cash return to the parent from its investment in and advances to a subsidiary less its costs to carry the assets and related expenses should exceed the cash return available from an investment of a similar amount in securities in order to justify retaining the subsidiary. If it seems that an alternative employment of funds would be more rational, the examiner should inquire as to management's plans to improve subsidiary earnings.

Questions to be answered in analyzing the earnings of credit-extending nonbank subsidiaries include:

1. What is the impact on the parent company and affiliate banks of a nonbank subsidiary operating at a loss?
2. Is the return on assets commensurate with the risk inherent in the asset portfolios for those nonbank subsidiaries operating profitably?
3. Are intercompany management/service fees appropriate? From a supervisory perspective, management and service fees should have a direct relationship to and be based solely upon the fair value of goods and services received.
4. Is the subsidiary required to reimburse the parent for the parent's interest expense on borrowed funds, the proceeds of which have been treated as "advances to subsidiaries?"
5. Is the quality of the subsidiary's earnings sound? For example, is the company understating the provision for loan losses, relying upon nonoperating gains or capitalization of accrued interest?

Special attention should be directed by the examiner to the computation of the company's net interest margin (interest income–interest expense, divided by average earning assets). A study of company yields on investments should provide a measure of the company's ability to invest its funds in earning assets that provide a rate of return above the company's cost of funds. As net interest margins narrow, the company may find it more difficult to generate sufficient income to meet operating expenses.

When discussing growth in earnings, the examiner should clearly differentiate between increases due to increased net interest income on a constant base of earning assets as compared to an increase in the earning asset base with a concurrent proportional increase in net interest income. Any improvement in net interest income as a percentage of earning assets may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds.

Nonbanks: Credit Extending (Leverage) Section 4030.3

As a general rule, credit-extending nonbank subsidiaries are funded by the proceeds of parent company borrowings through instruments such as commercial paper or medium to long-term debt or a combination thereof. Equity generally represents only a small portion of funding resources. There are instances, however, where the nonbank subsidiary will arrange direct funding from external sources. This is especially true in certain States where there are tax advantages associated with direct external funding.

Heavy reliance on borrowed funds by a nonbank subsidiary together with its limited capital position often results in a highly leveraged financial condition that is quite sensitive to changes in money market cost of funds. An examiner should consider what a change in the company's cost of funds might do to its net interest margin and earnings.

Many BHCs operate on the premise that a nonbank subsidiary needs little capital of its own as long as the parent company is adequately capitalized. Implicit in this operating practice is management's belief that the parent could act as a source of financial strength to its subsidiary in the event of difficulty at the subsidiary level. However, experience has indicated that in many cases, once trouble has developed in the subsidiary, the parent is hesitant to direct additional funds to the subsidiary, arguing that it is best to limit losses and exposure and it is imprudent for the parent to inject additional capital at this time. Given this experience, it is often considered appropriate for an examiner to comment on a subsidiary's extended leveraged position, indicating to management that the company has little, if any, capital "cushion" with which to absorb any asset "shrinkage" or loss. The examiner may then conclude and possibly recommend that additional capital be provided for the credit-extending nonbank subsidiary so that its leverage may be reduced and its capital structure altered to reflect more closely an independent organization in the same or similar industry.

Funding should be reviewed to determine that the subsidiary (or the parent) is not mismatching maturities by borrowing short-term funds and applying them to long-term assets that are not readily convertible into cash. A mismatch of maturities can lead to serious liquidity problems.

A primary concern of the holding company examiner is to determine whether the nonbank subsidiary has the capacity to service its debt in an orderly manner. Does the credit-extending nonbank subsidiary have sufficient liquidity and how much will it have to rely on the parent company for funds to retire debt to unaffiliated parties? Factors to be considered include:

1. The subsidiary's asset quality and its ability to convert assets into cash at or near current carrying value. Consider the maturities of borrowings and whether they align with the scheduled assets that will be converted to cash.
2. The subsidiary's and the parent's back-up bank lines of credit available in the event commercial paper cannot be refinanced.
3. The parent company's ability to require its bank or other nonbank subsidiaries to upstream extra dividends to support the illiquid position of one or more of its nonbank subsidiaries.

Nonbanks: Credit Extending (Reserves)

The purpose of a credit-extending nonbank subsidiary's reserve for bad debts is to provide for known and potential losses in its assets. Although there is no specific formula for measuring the adequacy of a reserve for bad debts, prudence dictates that the reserve account should be maintained at a "reasonable" level. What is reasonable depends on the quality of the subsidiary's assets, its collection history and other facts. However, from a supervisory perspective, the reserve for bad debts should at least provide total coverage for all assets classified "loss" and still be sufficient to absorb future, unidentified, "normal" losses, that are estimated based on the "doubtful" and "substandard" classifications and the company's historic experience. Valuation reserves for a going concern are not considered adequate unless they can absorb 100 percent of identified losses and still have a balance sufficient to absorb future losses from continued operations.

Examiners should recommend the maintenance of valuation reserves sufficient to offset classified losses and may recommend (as opposed to require) that management charge-off the losses to the reserve account. The charge-off of classified losses is considered appropriate in order to assure that financial statements accurately reflect the company's financial condition. The Federal Reserve System has the responsibility to monitor the bank holding company's nonbank subsidiary statements for accuracy and completeness. Failure by management to reflect accurately the financial condition of the subsidiary and/or parent company could result in a formal corrective action to require charge-offs or other adjustments to financial statements.

For additional information, see Manual section 4030.1, "Classifications."

The noncredit-extending nonbank subsidiaries provide services or financial products other than extensions of credit. Some of these companies are insurance agencies, credit life and credit accident and health insurance underwriting companies, electronic data processing centers, management consulting firms and advisory companies.

The operations of some insurance agencies are conducted on the premises of the bank subsidiary(ies) by personnel who often serve as officers or employees of the bank. These companies usually incur little or no liabilities and require only nominal capitalization because risk is limited. However, their commission income is often substantial and a steady source of funds for the parent company. Nevertheless, insurance ''underwriters'' typically have strong capital bases, good liquidity and profitable operations. Furthermore, their operating risks are generally stable and predictable.

Electronic data processing centers are often established under section 4(c)(8) of the Act, which permits them to sell their services to affiliated and unaffiliated customers. Section 4050.0 of this Manual cites examples of how an EDP servicer can have an unfavorable impact on the parent company or its affiliates. Management consulting firms and advisory companies usually require little capitalization and no funding and generate favorable earnings. Of the noncredit-extending subsidiaries, insurance underwriters and EDP servicers are generally the only companies requiring capital and funding in significant amounts.

However, all subsidiaries are subject to some level of risk, which could impact on the BHC. In the case of insurance underwriters, insurance benefits paid could exceed actuarial estimates. Such a situation, however rare, could necessitate financial support from the parent company. EDP servicers could, as a result of excessive computer down-time or equipment obsolescence, impact on consolidated earnings or require additional capital contributions. In addition, contingent liabilities, resulting from legal actions or failure to perform, could be a large multiple of a subsidiary's capital and may affect the parent.

4040.0.1 EARNINGS

In analyzing these subsidiaries, the examiner should consider the following:

1. Are any noncredit-extending subsidiaries operating at a loss or incurring low levels of earnings? If so, what is the cause and does it have a material impact on consolidated earnings?
2. Does the loss result in the subsidiary's reliance on the parent company or bank subsidiary(ies) for financial support? If so, in what form is the support provided?
3. If a loss has been incurred, has management initiated corrective measures? If not, why not?
4. Are the fees charged by the parent for services rendered limited to their *fair market value*? The answer to this question will almost always depend on information supplied by management. Management should be aware of the fair market rates charged by their competitors for similar services rendered.
5. Are the rates charged affiliates commensurate with the services provided and similar to rates charged nonaffiliated customers?

4040.0.2 RISK EXPOSURE

In noncredit-extending subsidiaries, risk exposure, of any meaningful magnitude, is often related to possible losses arising from legal actions for failure to perform services as contracted. The examiner should determine that the subsidiaries are being operated effectively by experienced and competent personnel under the direction of satisfactory management. The examiner should further determine that parent company management exercises appropriate controls over the activities of the subsidiary. Because of potential liability, the examiner should ascertain whether the subsidiaries have adequate insurance coverage (i.e., errors and omissions, public liability, etc.). The examiner should be alert to any contingent liabilities that would have a significant impact of the parent company. For example, the parent company might guarantee the payment of debt or leases for the subsidiary.

The internal services subsidiaries generally derive their business only from the parent company and its affiliates. Examples of such companies include forms printing firms, owners and operators of banking premises, and EDP servicing companies. Banking premises subsidiaries are established to hold or operate properties used wholly or substantially by the parent's subsidiary for its banking business. Generally, their operations do not impact unfavorably on the parent company. However, in instances where the banking premises are not wholly occupied by a banking subsidiary, the examiner should ascertain that the excess space is fully leased/ rented. A high vacancy level could result in unprofitable operations or result in an abnormal rental charge to the banking subsidiary in order to operate the subsidiary on a profitable, or break even, basis.

EDP service centers provide bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries, and store and process other banking, financial or related economic data. Generally, these service centers do not have a material effect on consolidated earnings performance as they provide essential services at costs comparable or below their independent counterparts. They usually operate on a break-even basis or at a nominal profit. However, there are some subsidiaries, including EDP servicers, which also provide services indirectly to unaffiliated concerns. EDP servicers operating under section 4(c)(1)(C) of the Act, may provide services to customers of its bank affiliates, provided that the service contract is between the bank and the customer. EDP servicers that operate as independent subsidiaries under section 4(c)(8) of the Act are not similarly restricted and are not considered ''not for profit'' organizations.

A financial analysis of a ''not for profit'' service subsidiary should concentrate on the organization's ability to control its expenses and its ability to provide its services to its affiliates at fair market value. Failure to control expenses may result in excessive charges to affiliates to the detriment of the affiliate.

For purposes of an analysis of earnings, analysts of bank holding companies have placed considerable weight on consolidated BHC financial data. Consolidated data, however, can be very misleading since bank assets and revenues are large in relation to their profit margins. On the other hand, the volume of nonbank assets is generally not nearly as large, but profit margins (or losses) tend to be much more substantial. The organizational structure of a holding company is of prime importance and must first be taken into consideration before attempting to analyze consolidated earnings. As an example, in the case of nonoperating shell bank holding companies with no nonbank subsidiaries, the earnings of the bank subsidiary should be nearly identical with consolidated earnings for the organization. Therefore, in these instances, the views and ratings of the applicable bank regulatory agency would normally be accepted and would apply to consolidated earnings of the BHC. This treatment would not apply to one-bank and multi-bank holding companies with substantial credit-extending nonbank subsidiaries. These holding companies require an in-depth analysis of earnings because of the adverse impact that a poorly operated subsidiary can have upon the consolidated earnings of the BHC.

In order to properly analyze consolidated earnings, it is best to review and study a consolidating statement of income and expense for the purpose of determining each entity's contribution to earnings. It is important to recognize that there need be no direct correlation between the asset size of a subsidiary and its relative contribution to total consolidated earnings. For example, a subsidiary accounting for a minute portion of consolidated assets could substantially negate satisfactory earnings of its larger asset base affiliates because of poor operations and sizeable losses.

When evaluating consolidated earnings, it is important to review the component parts of earnings for prior interim or fiscal periods for comparative purposes in order to determine trends. Considerable attention is to be focused on the various income and expense categories. The net interest income (difference between interest income and interest expense) of a company is highly revealing as it will give an indication of management's ability to borrow at attractive rates and employ those funds with maximum profitable results.

Items having a significant impact on earnings include the noncash charge, "provisions for loan losses" and the volume of nonaccrual and renegotiated or restructured credits. A large provision for loan losses is made necessary by poor quality assets which result in large charge-offs to valuation reserves. In order to replenish the reserve for loan losses to adequate levels to provide ample coverage against known and potential losses, large amounts of revenues must be "set aside." Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business. In situations where earnings are below average or unsatisfactory, a comment concerning the amount of provision for loan losses and volume of nonperforming loans is warranted in the financial analysis.

Other items of significance include taxes, particularly where tax credits are indicative of loss operations, and extraordinary or nonrecurring items. Extraordinary gains or losses are not the result of the normal operations of a company and should be analyzed independently from operating earnings. Generally, extraordinary items result from the sale of current or fixed assets. When significant amounts are involved, examiners should determine the underlying reasons behind such transactions.

After an analysis has been made of the pertinent components of earnings, analyze the "bottom line" or net income of the consolidated company. Generally, analysts relate net income to several benchmarks in order to evaluate performance. The ratios of earnings as a percentage of average equity capital or average assets are most widely used. Conclude the analysis with a comparison of a company's ratios in relation to its peer group.

Comparatively low earnings relative to its peer group may be a reflection of problems and weaknesses such as lax or speculative credit practices (resulting in nonearning assets or loan losses), high interest costs resulting from excessive debt, or rapid expansion into competitive industries subject to wide variations in income potential.

Earnings on a consolidated basis are the best measure of performance. Moreover, while the earnings of individual subsidiaries must not be ignored, the ability of holding company management to control the level of reported earnings in any one subsidiary reaffirms the practicality of using the consolidated approach to analyze holding company profitability.

Essentially, the following points summarize areas which should be considered when analyzing consolidated earnings:

1. The return on consolidated assets and equity capital, as well as historical trends and peer group comparisons.

2. The ability of earnings to provide for capital growth, especially when taking into consideration recent and planned asset and deposit growth.

3. The "quality" of earnings is affected by the sufficiency of the provision to loan loss reserves and the asset quality of the organization. A high level of earnings that did not include sufficient provisions to the loan loss reserve during a period of high charge-offs may result in reductions in the reserve balance and thereby call to question the merits of high earnings in the face of declining reserve balances.

4. The ability of management to prepare realistic earnings projections in light of the risk structure and quality of assets.

The evaluation of asset quality based on classifications of ‘‘substandard, doubtful and loss,’’ is one of the most important elements to be taken into consideration when performing a financial analysis of a holding company because of the severe impact that poor quality assets can have on the overall condition of the organization. Procedures to measure asset quality of banks involve the use of the relationship of weighted classified assets to Tier 1 capital funds and total classifications to total capital funds. Accordingly, consolidated asset quality could be based on the relationship of aggregate weighted classified assets of the parent company, bank subsidiary(ies) and nonbank subsidiary(ies), to Tier 1 capital.

However, a problem encountered when viewing asset quality on a consolidated basis is the fact that in multi-bank holding companies there is usually a large timing difference between the dates of examinations of the banking subsidiaries. Therefore, the aggregating of classified bank assets from reports prepared at different times, reduces the currentness and validity of conclusions drawn. This problem can only be eliminated by using common examination and inspection dates which are not generally available.

Despite the shortcoming of using classification information from different dates, an examiner may determine that there is a sufficient measure of validity in using the data and may present an analysis based on consolidated weighted classifications. For example, if there are a small number of bank subsidiaries and if the examination dates are near a common point in time, timing differences may be inconsequential. Or, if a review of several years of a bank’s examinations reveals a relatively constant or stable level of classifications, then the timing of the most recent examination would not invalidate use of the analytical tool. As such, the technique may be employed when circumstances permit.

Other factors to be considered in determining asset quality include the levels of nonaccrual and renegotiated loans, other real estate owned and past due loans. While these assets may not be subject to classification, they usually represent former or emerging problem loans. Moreover, in the aggregate, they may represent a significant proportion of the asset portfolio. If such is the case, they should be taken into consideration when the examiner determines his overall rating of asset quality.

It is difficult to rely on the adequacy of consolidated reserves because they are ‘‘fractured’’ and protect portfolios in different organizations and may not be interchangeable or transferable. The reserve of each entity in the corporate structure must be reviewed or analyzed individually. For example, if consolidated reserves appear inadequate, there is no consolidated reserve account per se that could be increased to adequate proportions. Consequently, the inadequacy would have to be identified at the parent or subsidiary level. Conversely, if consolidated reserves appear to adequately cover the aggregate of all ‘‘loss’’ and a certain portion of ‘‘doubtful,’’ it does not insure that all subsidiaries have adequate reserves. Nevertheless, despite the shortcomings of using consolidated reserves, the analyst should not hesitate to calculate and present a measure of the relationship of consolidated reserves to consolidated loans.

4060.8.1 ASSET-BACKED COMMERCIAL PAPER PROGRAMS

Asset-backed commercial paper (ABCP) programs provide a means for corporations to obtain funding by selling or securitizing pools of homogenous assets (for example, trade receivables) to special-purpose entities (SPEs/ABCP programs). The ABCP program raises funds for purchase of these assets by issuing commercial paper into the marketplace. The commercial-paper investors are protected by structural enhancements provided by the seller (for example, overcollateralization, spread accounts, or early-amortization triggers) and by credit enhancements (for example, subordinated loans or guarantees) provided by banking organization sponsors of the ABCP program and by other third parties. In addition, liquidity facilities are also present to ensure the rapid and orderly repayment of commercial paper should cash-flow difficulties emerge. ABCP programs are nominally capitalized SPEs that issue commercial paper. A sponsoring banking organization establishes the ABCP program but usually does not own the conduit's equity, which is often held by unaffiliated third-party management companies that specialize in owning such entities, and are structured to be bankruptcy remote.

Typical Structure

ABCP programs are funding vehicles that banking organizations and other intermediaries establish to provide an alternative source of funding to themselves or their customers. In contrast to term securitizations, which tend to be amortizing, ABCP programs are ongoing entities that usually issue new commercial paper to repay maturing commercial paper. The majority of ABCP programs in the capital markets are established and managed by major international commercial banking organizations. As with traditional commercial paper, which has a maximum maturity of 270 days, ABCP is short-term debt that may either pay interest or be issued at a discount (see figure 1).

Types of ABCP Programs

Multi-seller programs generally provide working capital financing by purchasing or advancing against receivables generated by multiple corporate clients of the sponsoring banking organizations. These programs are generally well diversified across both sellers and asset types.

Single-seller programs are generally established to fund one or more types of assets originated by a single seller. The lack of diversification is generally compensated for by increased program-wide credit enhancement.

Loan-backed programs fund direct loans to corporate customers of the ABCP program's sponsoring banking organization. These loans are generally closely managed by the banking organization and have a variety of covenants designed to reduce credit risk.

Securities-arbitrage programs invest in securities that generally are rated AA- or higher. They generally have no additional credit enhancement at the seller/transaction level because the securities are highly rated. These programs are typically well diversified across security types. The arbitrage is mainly due to the difference between the yield on the securities and the funding cost of the commercial paper.

Structured investment vehicles (SIVs) are a form of a securities-arbitrage program. These ABCP programs invest in securities typically rated AA- or higher. SIVs operate on a market-value basis similar to market-value collateralized debt obligation in that they must maintain a dynamic overcollateralization ratio determined by analysis of the potential price volatility on securities held in the portfolio. SIVs are monitored daily and must meet strict liquidity, capitalization, leverage, and concentration guidelines established by the rating agencies.

Key Parties and Roles

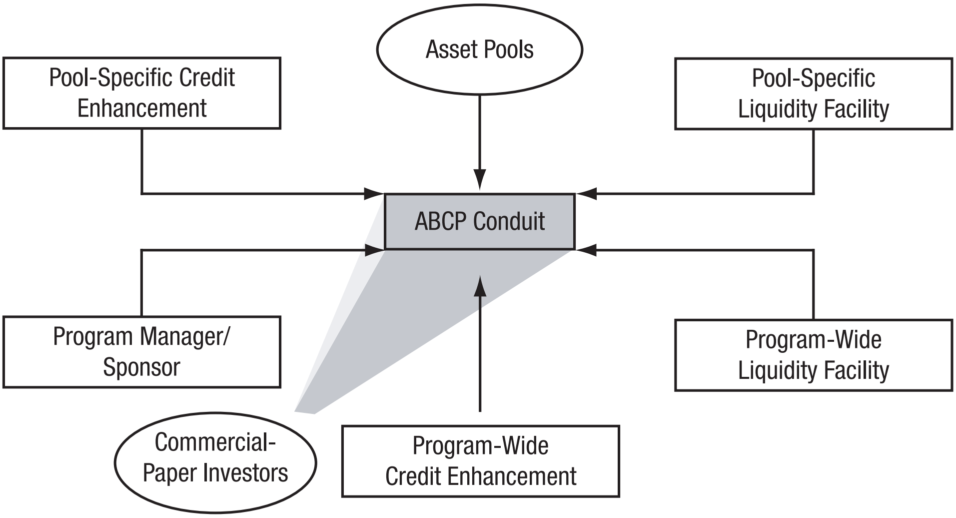
Key parties for an ABCP program include the following:

- program management/administrators
- credit-enhancement providers
- liquidity-facility providers
- seller/servicers
- commercial paper investors

Program Management

The sponsor of an ABCP program initiates the creation of the program but typically does not own the equity of the ABCP program, which is

Figure 1. Asset-backed commercial paper structure



provided by unaffiliated third-party investors. Despite not owning the equity of the ABCP program, sponsors usually retain a financial stake in the program by providing credit enhancement, liquidity support, or both, and they play an active role in managing the program. Sponsors typically earn fees—such as credit-enhancement, liquidity-facility, and program-management fees—for services provided to their ABCP programs.

Typically, an ABCP program makes arrangements with various agents/servicers to conduct the administration and daily operation of the ABCP program. This includes such activities as purchasing and selling assets, maintaining operating accounts, and monitoring the ongoing performance of each transaction. The sponsor is also actively engaged in the management of the ABCP program, including underwriting the assets purchased by the ABCP program and the type/level of credit enhancements provided to the ABCP program.

Credit-Enhancement Providers

The sponsoring banking organization typically provides pool-specific and program-wide backup liquidity facilities, and program-wide credit enhancements, all of which are usually unrated (pool-specific credit enhancement, such as overcollateralization, is provided by the seller of the assets). These enhancements are fundamental for obtaining high investment-grade ratings on the commercial paper issued to the market by the ABCP program. Seller-provided credit enhancement may exist in various forms and is generally sized based on the type and credit quality of the underlying assets as well as the quality and financial strength of seller/servicers. Higher-quality assets may only need partial support to achieve a satisfactory rating for the commercial paper. Lower-quality assets may need full support.

Liquidity-Facility Providers

The sponsoring banking organization and in some cases, unaffiliated third parties, provide pool-specific or program-wide liquidity facilities. These backup liquidity facilities ensure the timely repayment of commercial paper under certain conditions, such as when financial market disruptions or cash-flow timing mismatches were to occur, but generally not under conditions associated with the credit deterioration of the underlying assets or the seller/servicer to the extent that such deterioration is beyond what is permitted under the related asset-quality test.

Commercial Paper Investors

Commercial paper investors are typically institutional investors, such as pension funds, money market mutual funds, bank trust departments, foreign banks, and investment companies. Commercial paper maturities range from one day to 270 days, but most frequently are issued for 30 days or less. There is a limited secondary market for commercial paper since issuers can closely match the maturity of the paper to the investors' needs. Commercial paper investors are generally repaid from the reissuance of new commercial paper or from cash flows stemming from the underlying asset pools purchased by the program. In addition, to ensure timely repayment in the event that new commercial paper cannot be issued or if anticipated cash flows from the underlying assets do not occur, ABCP programs utilize backup liquidity facilities. Furthermore, the banking organization can purchase the ABCP from the conduit if the commercial paper cannot be issued. Pool-specific and program-wide credit enhancements also protect commercial paper investors from deterioration of the underlying asset pools.

4060.8.2 THE LOSS WATERFALL

The loss waterfall diagram (see figure 2) for the exposures of a typical ABCP program generally has four legally distinct layers. However, most legal documents do not specify which form of credit or liquidity enhancement is in a priority position after pool-specific credit enhancement is exhausted due to defaults. For example, after becoming aware of weakness in the seller/servicer or in asset performance, an ABCP program sponsor may purchase assets out of the conduit using pool-specific liquidity. Liquidity agreements must be subject to a valid asset-quality test that prevents the purchase of defaulted or highly delinquent assets. Liquidity facilities that are not limited by such an asset-quality test are to be viewed as credit enhancement and are subject to the risk-based capital requirements applicable to direct-credit substitutes.

Pool-Specific Credit Enhancement

The form and size of credit enhancement for each particular asset pool is dependent upon the nature and quality of the asset pool and the seller/servicer's risk profile. In determining the level of credit enhancement, consideration is given to the seller/servicer's financial strength, quality as a servicer, obligor concentrations, and obligor credit quality, as well as the historic performance of the asset pool. Credit enhancement is generally sized to cover a multiple level of historical losses and dilution for the particular asset pool. Pool-specific credit enhancement can take several forms, including overcollateralization, cash reserves, seller/servicer guarantees (for only highly rated seller/servicers), and subordination. Credit enhancement can either be dynamic (that is, increases as the asset pool's performance deteriorates) or static (that is, fixed percentage). Pool-specific credit enhancement is generally provided by the seller/servicer (or carved out of the asset pool in the case of overcollateralization) but may be provided by other third parties.

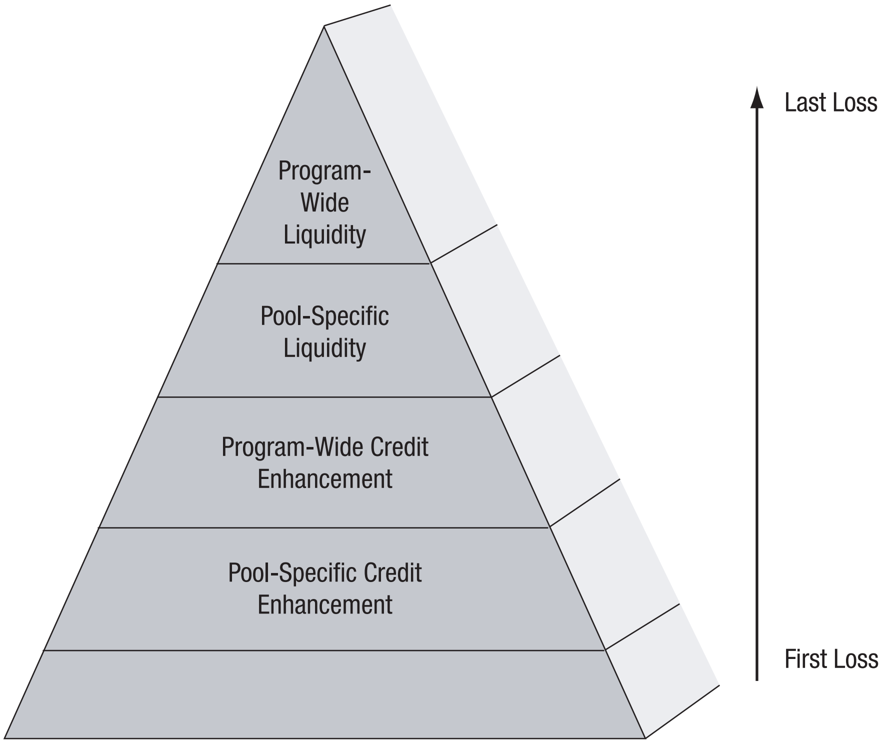
The ABCP program sponsor or administrator will generally set strict eligibility requirements for the receivables to be included in the purchased asset pool. For example, receivable eligibility requirements will establish minimum credit ratings or credit scores for the obligors and the maximum number of days the receivable can be past due.

Usually the purchased asset pools are structured (credit-enhanced) to achieve a credit-quality equivalent of investment grade (that is, BBB or higher). The sponsoring banking organization will typically utilize established rating agency criteria and structuring methodologies to achieve the desired internal rating level. In certain instances, such as when ABCP programs purchase ABS, the pool-specific credit enhancement is already built into the purchased ABS and is reflected in the security's credit rating. The internal rating on the pool-specific liquidity facility provided to support the purchased asset pool will reflect the inclusion of the pool-specific credit enhancement and other structuring protections.

Program-Wide Credit Enhancement

The second level of contractual credit protection is the program-wide credit enhancement, which may take the form of an irrevocable loan facility, a standby letter of credit, a surety bond from a monoline insurer, or an issuance of subordinated debt. Program-wide credit enhancement protects commercial paper investors if one or more of the underlying transactions exhaust the pool-specific credit enhancement and other structural protections. The sponsoring banking organization or third-party guarantors are providers of this type of credit protection. The program-wide credit enhancement is generally sized by

Figure 2. The Loss Waterfall



the rating agencies to cover the potential of multiple defaults in the underlying portfolio of transactions within ABCP conduits and takes into account concentration risk among seller/servicers and industry sectors.

Pool-Specific Liquidity

Pool-specific liquidity facilities are an important structural feature in ABCP programs because they ensure timely payment on the issued commercial paper by smoothing timing differences in the payment of interest and principal on the pooled assets and ensuring payments in the event of market disruptions. The types of liquidity facilities may differ among various ABCP programs and may even differ among asset pools purchased by a single ABCP program. For instance, liquidity facilities may be structured either in the form of (1) an asset-purchase agreement, which provides liquidity to the ABCP program by purchasing nondefaulted assets from a specific asset pool, or (2) a loan to the ABCP program, which is repaid solely by the cash flows from the underlying assets.[1] Some older ABCP programs may have both pool-specific liquidity and program-wide liquidity coverage, while more-recent ABCP programs tend to utilize only pool-specific facilities. Typically, the seller-provided credit enhancement continues to provide credit protection on an asset pool that is purchased by a liquidity banking organization so that the institution is protected against credit losses that may arise due to subsequent deterioration of the pool.

Pool-specific liquidity, when drawn prior to the ABCP program's credit enhancements, is subject to the credit risk of the underlying asset pool. However, the liquidity facility does not provide direct credit enhancement to the commercial paper holders. Thus, the pool-specific liquidity facility generally is in an economic second-loss position after the seller-provided credit enhancements and prior to the program-

1. Direct-liquidity loans to an ABCP program may be termed a *commissioning agreement* (most likely in a foreign bank program) and may share in the security interest in the underlying assets when commercial paper ceases to be issued due to deterioration of the asset pool.

wide credit enhancement even when the legal documents state that the program-wide enhancement would absorb losses prior to the pool-specific liquidity facilities. This is because the sponsor of the ABCP program would most likely manage the asset pools in such a way that deteriorating portfolios or assets would be put to the liquidity banking organizations prior to any defaults that would require a draw against the program-wide credit enhancement.[2] While the liquidity banking organization is exposed to the credit risk of the underlying asset pool, the risk is mitigated by the seller-provided credit enhancement and the asset-quality test.[3] At the time that the asset pool is put to the liquidity banking organization, the facility is usually fully drawn because the entire amount of the pool that qualifies under the asset-quality test is purchased by the banking organization. However, with respect to revolving transactions (such as credit card securitizations) it is possible to average less than 100 percent of the commitment.

Program-Wide Liquidity

The senior-most position in the waterfall, program-wide liquidity, is provided in an amount sufficient to support that portion of the face amount of all the commercial paper that is issued by the ABCP program that is necessary to achieve the desired external rating on the issued paper. In some cases, a liquidity banking organization that extends a direct liquidity loan to an ABCP program may be able to access the program-wide credit enhancement to cover losses while funding the underlying asset pool.

2. In fact, according to the contractual provisions of some conduits, a certain level of draws on the program-wide credit enhancement is a condition for unwinding the conduit program, which means that this enhancement is never meant to be used.

3. An asset-quality test or liquidity-funding formula determines how much funding the liquidity banking organization will extend to the conduit based on the quality of the underlying asset pool at the time of the draw. Typically, liquidity banking organizations will fund against the conduit's purchase price of the asset pool less the amount of defaulted assets in the pool.

WHAT'S NEW IN THIS REVISED SECTION

The guidance in this section does not apply to U.S. bank holding companies (BHCs) or intermediate holding companies of foreign banking organizations with $50 billion or more in total consolidated assets. See SR letter 15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms" (section 4063.0.1) and SR letter 15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms" (section 4065.0.1) for more information. In addition, inactive guidance references in this section have been updated.

This supervisory guidance provides direction to supervisory staff and BHCs on the declaration and payment of dividends,[1] capital redemptions, and capital repurchases by BHCs in the context of their capital planning processes. The guidance establishes Federal Reserve expectations that a BHC will inform and consult with Federal Reserve supervisory staff sufficiently in advance of (1) declaring and paying a dividend that could raise safety-and-soundness concerns (e.g., declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid); (2) redeeming or repurchasing regulatory capital instruments when the BHC is experiencing financial weaknesses; or (3) redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction as of the end of a quarter in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred.

While these principles (as stated in SR-09-4) are applicable to all BHCs, they are especially relevant for BHCs that are experiencing financial difficulties and/or receiving public funds. Supervisory staff should document their analyses of the issues discussed below and include such documentation in workpapers related to supervisory activities.[2] Such documentation not only provides a basis for constructive dialogue with an organization's management, but also supports current and future supervisory actions or initiatives. Reserve Bank and Board staff will develop a supervisory response in all instances where concerns regarding depletion of capital arise for a BHC that is experiencing financial difficulties.[3]

4060.9.1 REVIEW OF CAPITAL ADEQUACY MANAGEMENT

A fundamental principle underlying the Federal Reserve's supervision and regulation of BHCs is that a BHC should serve as a source of managerial and financial strength to its subsidiary banks.[4] Consistent with this premise, the Federal Reserve expects an organization to hold capital commensurate with its overall risk profile. The risk-based capital rules state that the capital requirements are minimum standards based primarily on broad credit-risk considerations. The risk-based capital ratios do not take explicit account of the quality of individual asset portfolios or the range of other types of risk to which banking organizations may be exposed (e.g., interest-rate, liquidity, market, and operational risks). For this reason, banking organizations are generally expected to operate with capital positions well above the minimum ratios, with the amount of capital held by a banking organization corresponding to its broad risk exposure. Because an overall assessment of capital adequacy must take into account factors

1. The term "dividends" as used in SR-09-4 refers to dividends on common stock and preferred stock, as well as dividends or interest on the subordinated notes underlying trust preferred securities and other tier 1 capital instruments, in cash or other value (collectively, "dividends"). Stock dividends (i.e., dividends in the form of common stock) are excluded. The priority of payment of dividends is based on the level of seniority of the instrument, which is established by contract between an issuer and its investors.

2. As discussed in SR-13-21, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less," risk-focused supervision of certain noncomplex BHCs with consolidated assets of less than $1 billion relies extensively on off-site monitoring, surveillance, and the assessments of primary banking supervisors of holding company subsidiaries. For such BHCs, supervisory staff generally will be able to rely to a large extent on off-site surveillance and monitoring activities to identify potential supervisory issues related to capital adequacy as discussed in SR-09-4. Expectations for related documentation are likewise commensurate with the size and complexity of the BHC.

3. Notwithstanding the general guidance in SR-09-4, the Federal Reserve may establish more stringent institution-specific requirements under its supervisory or enforcement authority. To the extent those requirements are more stringent than this guidance, those requirements supersede this guidance.

4. See 12 CFR 225.4(a)(1).

beyond those reflected in the minimum regulatory capital ratios, supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization's risk-based capital ratio.

Consequently, an organization's internal process for assessing capital adequacy should reflect a full understanding of its risks and ensure that it holds capital corresponding to those risks to maintain overall capital adequacy. Key among these risks is the risk of illiquidity, particularly that a perceived lack of financial strength (e.g., a capital shortfall relative to potential losses in a stress scenario) may lead investors and counterparties to withhold funds or otherwise cease engaging in business with the organization. This is particularly important for a banking organization that is a core clearing and settlement organization or that has a significant presence in critical financial markets; such an organization is expected to have especially rigorous and effective internal processes for assessing capital adequacy.[5]

In addition to evaluating the appropriateness of a BHC's capital level given its overall risk profile, supervisory staff should focus on the quality of a BHC's capital and trends in its capital composition. In this regard, the Board's risk-based capital rules state that voting common stockholders' equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within tier 1 capital, and that banking organizations should avoid overreliance on non-common-equity capital elements.[6] Accordingly, a BHC should place primary reliance on its common equity, followed by perpetual preferred stock, which is included in equity under generally accepted accounting principles (GAAP) and absorbs losses on a going-concern basis (that is, helps a BHC avoid insolvency despite losses on its assets). Tax-deductible hybrid capital instruments, such as trust preferred securities, provide a limited supplement within tier 1 capital to a BHC's common stock and preferred stock.

In assessing a BHC's capital adequacy, supervisory staff should evaluate the comprehensiveness and effectiveness of management's capital planning. An effective capital planning process requires a banking organization to assess the risks to which it is exposed and its processes for managing and mitigating those risks, evaluate its capital adequacy relative to its risks, and consider the potential impact on its earnings and capital base from current and prospective economic conditions. A BHC's capital planning process should be commensurate with the BHC's size, complexity, and risk profile[7] and should entail consideration of a variety of factors. The supervisory guidance within SR-09-4 is not intended to describe comprehensively all elements of a BHC's capital planning process, but rather to focus on those factors that a BHC's board of directors should take into account when considering the payment of dividends, stock redemptions, or stock repurchases. Factors that the BHC's board of directors should consider include the following:

1. overall asset quality, potential need to increase reserves and write down assets, and concentrations of credit;
2. potential for unanticipated losses and declines in asset values;
3. implicit and explicit liquidity and credit commitments, including off-balance-sheet and contingent liabilities;
4. quality and level of current and prospective earnings, including earnings capacity under a number of plausible economic scenarios;
5. current and prospective cash flow and liquidity;
6. ability to serve as an ongoing source of financial and managerial strength to depository institution subsidiaries insured by the Federal Deposit Insurance Corporation, including the extent of double leverage[8] and the condition of subsidiary depository institutions;

5. As discussed in SR-03-9, "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System," core clearing and settlement organizations are defined as large-value payment system operators and market utilities that provide critical clearing and settlement services for critical financial markets. The term also includes firms that provide clearing and settlement services that are integral to a critical financial market (i.e., their market share is significant enough to present systemic risk in the event of their sudden failure to carry on those activities because there are no immediately viable alternatives). Firms that play significant roles in critical financial markets are those that consistently clear or settle at least five percent of the value of transactions in a critical market.

6. See 12 CFR 225, appendix A, section II.A.1.c.(3).

7. Large BHCs and others with complex risk profiles should have in place robust internal capital adequacy assessment processes. (See sections 4063.0.1 and 4065.0.1 of this manual for more information.) BHCs that use the advanced approaches in the risk-based capital framework may be subject to further requirements in this regard.

8. Double leverage refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity. In this regard, supervisory staff should also consider the impact of any potential overreliance a BHC may have on dividends received from subsidiaries as a source of payment for its liabilities.

7. other risks that affect the BHC's financial condition and are not fully captured in regulatory capital calculations;
8. level, composition, and quality of capital; and
9. ability to raise additional equity capital in prevailing market and economic conditions.

Supervisory findings in the areas discussed in SR-09-4 should be incorporated into the assessment of the "Capital" subcomponent for the BHC's "Financial Condition" rating component in the RFI (Risk Management, Financial Condition, and Impact) rating[9] assigned to a BHC. See section 4060.9.3 for information that supervisory staff should seek from BHCs in developing this assessment.

4060.9.1.1 Dividends in Cash or Other Value

Crucial to any capital plan are the effects on a BHC's financial condition of the payment of dividends on common stock[10] and other tier 1 capital instruments, as described previously in footnote 1. Consistent with the Board's November 14, 1985, ''Policy Statement on the Payment of Cash Dividends'' (see section 2020.5, or the *FRRS* at 4-185), a banking organization should have comprehensive policies on dividend payments that clearly articulate the organization's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. These policies should take into account the potential drain on a BHC's resources posed by the payment not just of cash dividends, but also of non-cash dividends, which can take many different forms (e.g., the distribution of assets to shareholders, particularly insiders, or the assumption or guarantee of certain shareholders' liabilities), other than those in the form of common stock, which generally do not raise supervisory concerns.

When a BHC's board of directors is deciding on the level of dividends to declare,[11] it should consider, among other things, the factors discussed above in 4060.9.1. It is particularly important for a banking organization's board of directors to ensure that the dividend level is prudent relative to the organization's financial position and is not based on overly optimistic earnings scenarios. Supervisory staff should engage in discussions with a BHC on its overall dividend policies and practices as part of the ongoing supervisory assessment of capital adequacy. Moreover, because the period between declaration of a dividend and the payment date may be as much as 60 days, in making a declaration, the board of directors should consider any potential events that may occur before the payment date that could affect its ability to pay while still maintaining a strong financial position.[12]

While many organizations place great importance on consistently paying dividends, a board of directors should strongly consider, after careful analysis of the factors described above under "Review of Capital Adequacy Management" (see section 4060.9.1), reducing, deferring, or eliminating dividends when the quantity and quality of the BHC's earnings have declined or the BHC is experiencing other financial problems, or when the macroeconomic outlook for the BHC's primary profit centers has deteriorated.[13] As a general matter, the board of directors of a BHC should inform the Federal Reserve and should eliminate, defer, or significantly reduce the BHC's dividends if

1. The BHC's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
2. The BHC's prospective rate of earnings retention is not consistent with the BHC's capital needs and overall current and prospective financial condition; or
3. The BHC will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Failure to do so could result in a supervisory finding that the organization is operating in an unsafe and unsound manner.

Moreover, a BHC should inform the Federal

9. See SR-04-18, "Bank Holding Company Rating System" and section 4070.0.

10. This includes dividends paid on common stock by BHCs qualifying under Subchapter S of Chapter 1 of the Internal Revenue Code. For regulatory and supervisory purposes, such dividends are treated the same as those paid by other BHCs.

11. As a general matter, the declaration of a dividend to shareholders establishes a legal obligation to pay that dividend and is recorded as a liability on the balance sheet.

12. Payments on trust preferred securities are not declared. Rather, the BHC must make a decision not to make a payment; typically, this decision must be made 15 days before payment is due.

13. Contractual arrangements typically dictate that a banking organization may not defer dividends on senior instruments (e.g., preferred stock) unless dividends have been fully deferred on more junior instruments (e.g., common stock).

Reserve reasonably in advance of declaring or paying a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the organization's capital structure. Declaring or paying a dividend in either circumstance could raise supervisory concerns. Likewise, a BHC should apprise the Federal Reserve reasonably in advance of declaring any material increase in its common stock dividend to ensure that it does not raise safety-and-soundness concerns.

4060.9.1.2 Stock Redemptions and Repurchases

It is an essential principle of safety and soundness that a banking organization's redemption of instruments included in regulatory capital and repurchases of common stock, preferred stock, and other regulatory capital instruments from investors be consistent with the organization's current and prospective capital needs. In assessing such needs, the board of directors and management of a BHC should consider the factors discussed above in section 4060.9.1.

Federal Reserve supervisory staff should continue exercising their supervisory oversight and regulatory authority in evaluating BHCs' capital planning processes, as discussed above, and consulting with BHCs regarding their proposed redemptions and repurchases of common stock, preferred stock, and other regulatory capital instruments. There are explicit regulatory requirements for Federal Reserve review of such transactions in several situations:

1. Certain non-exempted BHCs are required under section 225.4(b)(1) of Regulation Y to notify the Federal Reserve of actions that would reduce a BHC's consolidated net worth by 10 percent or more.[14]
2. Under the Board's risk-based capital rule for BHCs, most instruments included in tier 1 capital[15] with features permitting redemption at the option of the issuing BHC (e.g., perpetual preferred stock and trust preferred securities) may qualify as regulatory capital only if redemption is subject to prior Federal Reserve approval.[16]
3. The risk-based capital rule directs BHCs to consult with the Federal Reserve before redeeming any equity or other capital instrument included in tier 1 or tier 2 capital prior to stated maturity, if such redemption could have a material effect on the level or composition of the organization's capital base.[17]

In addition, Federal Reserve supervisory staff should exercise the above regulatory authorities, as well as the Federal Reserve's general supervisory and enforcement authority, to prevent a BHC from repurchasing its common stock, preferred stock, trust preferred securities, and other regulatory capital instruments in the market, if such action would be inconsistent with the BHC's prospective capital needs and continued safe and sound operation. BHCs experiencing financial weaknesses, or that are at significant risk of developing financial weaknesses, should consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration. Similarly, any BHC considering expansion, either through acquisitions or through new activities, also generally should consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration.

In evaluating the appropriateness of a BHC's proposed redemption or repurchase of capital instruments, Federal Reserve supervisory staffs

14. Section 225.4(b)(1) of Regulation Y requires that a BHC that is not well capitalized or well managed, or that is subject to any unresolved supervisory issues, provide prior notice to the Federal Reserve for any repurchase or redemption of its equity securities for cash or other value that would reduce by 10 percent or more the BHC's consolidated net worth aggregated over the preceding 12-month period. All repurchases and redemptions within a 12-month period are aggregated for the application of this rule, regardless of any other approval or supervisory consultation process that was followed by the BHC with regard to its repurchases and redemptions of equity securities.

15. See 12 CFR 217.

16. Unlike the process noted above for transactions requiring notification of the Federal Reserve under Regulation Y, such approvals and the consultative process for other repurchases and redemptions are part of the Federal Reserve's general supervisory processes and do not, therefore, require formal applications.

17. See 12 CFR 225, appendix A, section II.(iii). Such consultation by small BHCs subject to the Board's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement ("Small BHC Policy Statement"; see Regulation Y: 12 CFR 225, appendix C), however, is only required for the redemption of instruments included in equity as defined under GAAP—such as common and perpetual preferred stock—and not for other instruments included in regulatory capital solely under the risk-based capital rule.

are directed to consider:

1. the potential losses that a BHC may suffer from the prospective need to increase reserves and write down assets from continued asset deterioration and
2. the BHC's ability to raise additional common stock and other tier 1 capital to replace capital instruments that are redeemed or repurchased.

In addition, supervisory staff should consider the potential negative effects on capital of a BHC

1. replacing common stock with lower-quality forms of regulatory capital (e.g., hybrids or subordinated debt) or
2. redeeming or repurchasing equity and other capital instruments from investors, including selective repurchases or redemptions from insiders, with cash or other value that could be better used to strengthen the BHC's regulatory capital base or its overall financial condition.

Furthermore, to facilitate such supervisory oversight, a BHC should inform Federal Reserve supervisory staff of a redemption or repurchase[18] of common stock or perpetual preferred stock for cash or other value resulting in a net reduction of a BHC's outstanding amount of common stock or perpetual preferred stock below the amount of such capital instrument outstanding at the beginning of the quarter in which the redemption or repurchase occurs. It is not necessary to inform supervisory staff pursuant to SR-09-4 when reductions in a BHC's tier 1 capital during a quarter will result from other causes, such as a reduction of the BHC's retained earnings due to negative earnings.

BHCs should advise Federal Reserve supervisory staff sufficiently in advance of such redemptions and repurchases to provide reasonable opportunity for supervisory review and possible objection should Federal Reserve supervisory staff determine a transaction raises safety-and-soundness concerns. When informing Federal Reserve supervisory staff of redemptions and repurchases, including requests for approval of redemptions under the risk-based capital rule as discussed above, a BHC may provide information either for a proposed transaction or for a number of transactions within a given quarter on its tier 1 capital composition. Such information should include the dollar amount and percentage breakdown of the BHC's tier 1 capital components (that is, common equity, perpetual preferred stock, and other tier 1 capital instruments), as well as its regulatory capital ratios, at the beginning of the previous quarter and most recent four-quarter period, as well as pro forma changes to its capital composition and ratios resulting from its proposed redemptions or repurchases.

18. Redemptions of most instruments (e.g., preferred stock or trust preferred securities) included in regulatory capital require Federal Reserve approval under the risk-based capital rule, but such redemptions by small BHCs are not required under the small BHC policy statement.

4060.9.2 INSPECTION OBJECTIVES

1. To analyze and document issues discussed above that are present at the BHC and include such documentation in the inspection's workpapers, including those related to supervisory activities.
2. To evaluate the quality of a BHC's capital and the trends in its capital composition.
3. To determine if the BHC has informed and consulted with Federal Reserve supervisory staff sufficiently in advance of
   a. declaring and paying a dividend that could raise safety-and-soundness concerns (for example, declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid);
   b. redeeming or repurchasing regulatory capital instruments when the BHC is experiencing financial weaknesses; or
   c. redeeming or repurchasing any common stock or perpetual preferred stock that would result in a net reduction as of the end of a quarter in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred.
4. To evaluate the comprehensiveness and effectiveness of management's capital planning.

4060.9.3 INSPECTION PROCEDURES[19]

Capital Planning

1. Determine if the existing capital level is

19. These procedures are not intended to encompass comprehensively a BHC's capital planning, and are focused on information that may be useful in reviewing the impact of dividends and repurchases or redemptions on capital adequacy. More comprehensive inspection procedures for assessing capital adequacy of BHCs are available in section 4060.3.11.

adequate for the BHC's risk profile when considering the following items:
   a. the level and trend of adversely classified assets;
   b. the adequacy of the allowance for loan and lease losses;
   c. the volume of charged-off loans and recoveries;
   d. the balance sheet structure and liquidity needs;
   e. the level and type of concentrations;
   f. compliance with state and federal capital requirements; and
   g. composition of elements of capital.
2. Determine if earnings performance enables the BHC to fund its growth, remain competitive in the marketplace, and support its overall risk profile. Consider the level and trend of equity capital to total assets as well as asset and equity growth rates.
   a. Review the current level of the provision for loan and lease losses.
   b. Review whether the bank is relying on core earnings or income from nonrecurring events.
   c. Determine if dividends are excessive when compared to current earnings or potential capital needs, or could otherwise result in a material adverse change to the organization's capital structure.
3. Determine the effect of current capital levels on the future viability of the BHC and its subsidiary depository institutions.
   a. Assess management's ability to reverse deteriorating trends and to augment capital through earnings.
   b. Assess the ability of the BHC to raise capital from existing shareholders, issue new capital instruments, or access alternative sources of capital.
   c. Assess the reasonableness of capital plans.

Dividend in Cash or Other Value

4. Determine whether the BHC has a comprehensive dividend policy at the holding company and for each of its subsidiaries that help it in its capital planning processes.
5. Assess whether provisions contained in the policies and practices conform to the guidance outlined in the Federal Reserve Board's 1985 dividend policy statement.
6. Determine whether, and if so, how, the BHC has changed in any way its dividend policy to accommodate the current economic environment.
7. Assess whether dividends in cash or other value are consistent with the BHC's current and prospective capital needs, including likely future reserve increases and asset write-downs, as well as the feasibility in the near term of the BHC raising additional capital in the market.

Stock Repurchases and Redemptions

8. Review schedule HI-A (Changes in Equity Capital) of the BHC's FR Y-9C report for any changes in components of capital.
9. Review any correspondence from the BHC to the Federal Reserve that indicates any plans to initiate common or preferred stock repurchases or redemptions in the foreseeable future.
10. Review the BHC's strategic plan for any mention of stock repurchases or redemptions.
11. Review the BHC's capital plan for any mention of stock repurchases or redemptions.
12. Discuss with management whether they are in any other way contemplating stock repurchases or redemptions, and if so, what the likely magnitude and timeline of such repurchases will be.
13. Assess whether such repurchases or redemptions foster sound capital positions, especially if the organization is (or could be) experiencing financial weakness.

4060.9.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
BHC should serve as a source of financial and managerial strength to its subsidiaries		225.4(a)(1)		
Purchase or redemption by BHC of its own securities		225.4(b)(1)		
Voting common stockholders' equity should be the dominant form of tier 1 capital		225, appendix A, section II.A.1.c.(3)		
Directed advance consultation with Federal Reserve if a redemption of capital prior to stated maturity would materially affect the level or composition of BHC's capital base		225, appendix A, section II.iii		
Board policy on payment of cash dividends			4-877	
Small BHC Policy Statement		225, appendix C		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 CFR, unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

This section is being revised to include the March 1, 2016, "Interagency Guidance on Funds Transfer Pricing Related to Funding Contingency Risks." The guidance was issued to address weaknesses observed in large financial institutions' funds transfer pricing (FTP) practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk. The interagency guidance builds on the principles of sound liquidity risk management that are described below. FTP is an important tool for managing a firm's balance sheet structure and measuring risk-adjusted profitability. By allocating funding and contingent liquidity risks to business lines, products, and activities within a firm, FTP influences the volume and terms of new business and ongoing portfolio composition. If done effectively, FTP promotes more resilient, sustainable business models. (Refer to SR-16-03.)

The March 17, 2010, interagency policy statement on "Funding and Liquidity Risk Management" targets funding and risk-management principles for insured depository institutions, including state member banks. The basic principles presented in this policy statement also apply to bank holding companies (BHCs). The Federal Reserve expects supervised financial institutions and BHCs to manage liquidity risk using processes and systems that are commensurate with their complexity, risk profile, and scope of operations. Liquidity risk-management processes and plans should be well documented and available for supervisory review. (See SR-10-6 and its attachment.)

BHCs are expected to manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. Appropriate liquidity risk management is especially important for BHCs since liquidity difficulties can easily spread to both depository and non-depository subsidiaries, particularly in cases of similarly named companies where customers may not always understand the legal distinctions between the holding company and subsidiaries. For this reason, BHCs should ensure that liquidity is sufficient at all levels of the organization to fully accommodate funding needs during periods of stress.

Liquidity risk-management processes and funding programs should take into full account the institution's lending, investment, and other activities and should ensure that adequate liquidity is maintained at the parent holding company and each of its subsidiaries. These processes and programs should fully incorporate real and potential constraints, including legal and regulatory restrictions, on the transfer of funds among subsidiaries and between subsidiaries and the parent holding company. BHC liquidity should be maintained at levels sufficient to fund holding company and affiliate operations for an extended period of time in a stressed environment when access to normal funding sources are disrupted, without having a negative impact on insured depository institution subsidiaries.

Material nonbank subsidiaries, such as broker-dealers, are expected to have liquidity-management processes and funding programs that reflect the principles outlined in the interagency policy statement guidance below (section 4066.0.1) and are consistent with the subsidiaries' complexity, risk profile, and scope of operations. A nonbank subsidiary that directly accesses market sources of funding and/or manages specific funding programs should pay particular attention to

- maintaining sufficient liquidity, cash flow, and capital strength to service its debt obligations and cover fixed charges;
- assessing the potential that funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions; and
- ensuring the adequacy of policies and practices that address the stability of funding and integrity of the institution's liquidity risk profile as evidenced by funding mismatches and the degree of dependence on potentially volatile sources of short-term funding.

For guidance on liquidity risk-measurement techniques, see section 4020.1, Appendix 1, of the *Commercial Bank Examination Manual*. For the supervisory plans (areas of focus) for BHCs that are designed to help ensure that the funding and liquidity practices of the parent company and its nonbank subsidiaries do not have an adverse impact on the organization's depository institution subsidiaries, see SR-08-8 and section 1050.1.3.3.2 for large complex banking organizations. For the similar supervisory plans for regional banking organizations, see SR-08-9 and section 1050.2.3.3.2. Both manual sections are titled "Parent Company and Nonbank Funding and Liquidity."

4066.0.1 APPENDIX A—INTERAGENCY POLICY STATEMENT ON FUNDING AND LIQUIDITY RISK MANAGEMENT

The Board of Governors of the Federal Reserve System (FRB)[1] issued this guidance to provide consistent interagency expectations on sound practices for managing funding and liquidity risk. The guidance summarizes the principles of sound liquidity risk management that the agencies have issued in the past[2] and, where appropriate, harmonizes these principles with the international statement recently issued by the Basel Committee on Banking Supervision titled "Principles for Sound Liquidity Risk Management and Supervision."[3]

Recent events illustrate that liquidity risk management at many financial institutions is in need of improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.

1. The policy statement in section 4066.0.1 is slightly amended to address those institutions supervised by the Federal Reserve. The interagency policy statement was also issued by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) (collectively, the agencies)—and the depository institutions those agencies supervise—in conjunction with the Conference of State Bank Supervisors (CSBS). For the complete text of the interagency policy statement see 75 *Fed. Reg.*13656. The various state banking supervisors may implement this policy statement through their individual supervisory process.

2. For national banks, see the *Comptroller's Handbook on Liquidity*. For state member banks and bank holding companies, see the Federal Reserve's *Commercial Bank Examination Manual* (section 4020), *Bank Holding Company Supervision Manual* (section 4010), and *Trading and Capital Markets Activities Manual* (section 2030). For state non-member banks, see the FDIC's *Revised Examination Guidance for Liquidity and Funds Management* (Trans. No. 2002-01) (Nov. 19, 2001) as well as Financial Institution Letter 84-2008, *Liquidity Risk Management* (August 2008). Also see Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," (September 2008).

3. Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," September 2008. See www.bis.org/publ/bcbs144.htm.

The following guidance reiterates the process that institutions should follow to appropriately identify, measure, monitor, and control their funding and liquidity risk. In particular, the guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal well-developed contingency funding plan (CFP) as primary tools for measuring and managing liquidity risk. The agencies expect every depository financial institutions[4] to manage liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile, and scope of operations. Liquidity risk management processes and plans should be well documented and available for supervisory review. Failure to maintain an adequate liquidity risk management process will be considered an unsafe and unsound practice.

Liquidity and Liquidity Risk

Liquidity is a financial institution's capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the institution's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution.

Liquidity risk is the risk that an institution's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations. An institution's obligations, and the funding sources used to meet them, depend significantly on its business mix, balance-sheet structure, and the cash flow profiles of its on- and off-balance-sheet obligations. In managing their cash flows, institutions confront various situations that can give rise to increased liquidity risk. These include funding mismatches, market constraints on the ability to convert assets into cash or in accessing sources of funds (i.e., market liquidity), and contingent liquidity events. Changes in economic conditions or exposure to credit, market, operation, legal, and reputation risks also can affect an institution's liquidity risk profile and should be considered in the assessment of liquidity and asset/liability management.

4. Unless otherwise indicated, this interagency guidance uses the term "depository financial institutions" or "institutions" to include banks and saving associations.

Sound Practices of Liquidity Risk Management

An institution's liquidity management process should be sufficient to meet its daily funding needs and cover both expected and unexpected deviations from normal operations. Accordingly, institutions should have a comprehensive management process for identifying, measuring, monitoring, and controlling liquidity risk. Because of the critical importance to the viability of the institution, liquidity risk management should be fully integrated into the institution's risk management processes. Critical elements of sound liquidity risk management include:

1. Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk.
2. Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.
3. Comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.
4. Active management of intraday liquidity and collateral.
5. An appropriately diverse mix of existing and potential future funding sources.
6. Adequate levels of highly liquid marketable securities, which are free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs in stressful situations.
7. Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.
8. Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process.

Supervisors will assess these critical elements in their reviews of an institution's liquidity risk management process in relation to its size, complexity, and scope of operations.

Corporate Governance

The board of directors is ultimately responsible for the liquidity risk assumed by the institution. As a result, the board should ensure that the institution's liquidity risk tolerance is established and communicated in such a manner that all levels of management clearly understand the institution's approach to managing the trade-offs between liquidity risk and short-term profits. The board of directors or its delegated committee of board members should oversee the establishment and approval of liquidity management strategies, policies and procedures, and review them at least annually. In addition, the board should ensure that it:

- Understands the nature of the liquidity risks of its institution and periodically reviews information necessary to maintain this understanding.
- Establishes executive-level lines of authority and responsibility for managing the institution's liquidity risk.
- Enforces management's duties to identify, measure, monitor, and control liquidity risk.
- Understands and periodically reviews the institution's CFPs for handling potential adverse liquidity events.
- Understands the liquidity risk profiles of important subsidiaries and affiliates as appropriate.

Senior management is responsible for ensuring that board-approved strategies, policies, and procedures for managing liquidity (on both a long-term and day-to-day basis) are appropriately executed within the lines of authority and responsibility designated for managing and controlling liquidity risk. This includes overseeing the development and implementation of appropriate risk measurement and reporting systems, liquid buffers (e.g., cash, unencumbered marketable securities, and market instruments), CFPs, and an adequate internal control infrastructure. Senior management is also responsible for regularly reporting to the board of directors on the liquidity risk profile of the institution.

Senior management should determine the structure, responsibilities, and controls for managing liquidity risk and for overseeing the liquidity positions of the institution. These elements should be clearly documented in liquidity risk policies and procedures. For institutions comprised of multiple entities, such elements should be fully specified and documented in policies for each material legal entity and subsidiary. Senior management should be able to monitor liquidity risks for each entity across the institution on an ongoing basis. Processes should be in place to ensure that the group's senior management is actively monitoring and quickly responding to all material developments and reporting to the boards of directors as appropriate.

Institutions should clearly identify the individuals or committees responsible for implementing and making liquidity risk decisions. When an institution uses an asset/liability committee (ALCO) or other similar senior management committee, the committee should actively monitor the institution's liquidity profile and should have sufficiently broad representation across major institutional functions that can directly or indirectly influence the institution's liquidity risk profile (e.g., lending, investment securities, and wholesale and retail funding). Committee members should include senior managers with authority over the units responsible for executing liquidity-related transactions and other activities within the liquidity risk management process. In addition, the committee should ensure that the risk measurement system adequately identifies and quantifies risk exposure. The committee also should ensure that the reporting process communicates accurate, timely, and relevant information about the level and sources of risk exposure.

Strategies, Policies, Procedures, and Risk Tolerances

Institutions should have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposures that appropriately reflect the institution's risk tolerances. Strategies should identify primary sources of funding for meeting daily operating cash outflows, as well as seasonal and cyclical cash flow fluctuations. Strategies should also address alternative responses to various adverse business scenarios.[5] Policies and procedures should provide for the formulation of plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions. Policies, procedures, and limits also should address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material, and should allow for legal, regulatory, and operational limits for the transferability of liquidity as well. Senior management should coordinate the institution's liquidity risk management with disaster, contingency, and strategic planning efforts, as well as with business line and risk management objectives, strategies, and tactics.

Policies should clearly articulate a liquidity risk tolerance that is appropriate for the business strategy of the institution, considering its complexity, business mix, liquidity risk profile, and its role in the financial system. Policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. Policy guidelines should employ both quantitative targets and qualitative guidelines. For example, these measurements, limits, and guidelines may be specified in terms of the following measures and conditions, as applicable:

1. Cash flow projections that include discrete and cumulative cash flow mismatches or gaps over specified future time horizons under both expected and adverse business conditions.
2. Target amounts of unencumbered liquid asset reserves.
3. Measures used to identify unstable liabilities and liquid asset coverage ratios. For example, these may include ratios of wholesale funding to total liabilities, potentially volatile retail (e.g., high-cost or out-of-market) deposits to total deposits, and other liability dependency measures, such as short-term borrowings as a percent of total funding.
4. Asset concentrations that could increase liquidity risk through a limited ability to convert to cash (e.g., complex financial instruments,[6] bank-owned (corporate-owned) life insurance, and less marketable loan portfolios).
5. Funding concentrations that address diversification of funding sources and types, such as large liability and borrowed funds dependency, secured versus unsecured funding sources, exposures to single providers of funds, exposures to funds providers by market segments, and different types of brokered deposits or wholesale funding.
6. Funding concentrations that address the term, re-pricing, and market characteristics of funding sources with consideration given to the nature of the assets they fund. This may include diversification targets for short-, medium-, and long-term funding; instrument type and securitization vehicles; and guid-

5. In formulating liquidity management strategies, members of complex banking groups should take into consideration their legal structures (e.g., branches versus separate legal entities and operating subsidiaries), key business lines, markets, products, and jurisdictions in which they operate.

6. Financial instruments that are illiquid, difficult to value, or marked by the presence of cash flows that are irregular, uncertain, or difficult to model.

ance on concentrations for currencies and geographical markets.

7. Contingent liability exposures such as unfunded loan commitments, lines of credit supporting asset sales or securitizations, and collateral requirements for derivatives transactions and various types of secured lending.
8. Exposures of material activities, such as securitization, derivatives, trading, transaction processing, and international activities, to broad systemic and adverse financial market events. This is most applicable to institutions with complex and sophisticated liquidity risk profiles.
9. Alternative measures and conditions that may be appropriate for certain institutions.

Policies also should specify the nature and frequency of management reporting. In normal business environments, senior managers should receive liquidity risk reports at least monthly, while the board of directors should receive liquidity risk reports at least quarterly. Depending upon the complexity of the institution's business mix and liquidity risk profile, management reporting may need to be more frequent. Regardless of an institution's complexity, it should have the ability to increase the frequency of reporting on short notice, if the need arises. Liquidity risk reports should impart to senior management and the board a clear understanding of the institution's liquidity risk exposure, compliance with risk limits, consistency between management's strategies and tactics, and consistency between these strategies and the board's expressed risk tolerance.

Institutions should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes. Significant business activities should be evaluated for both liquidity risk exposure and profitability. More complex and sophisticated institutions should incorporate liquidity costs, benefits, and risks in the internal product pricing, performance measurement, and new product approval process for all material business lines, products, and activities. Incorporating the cost of liquidity into these functions should align the risk-taking incentives of individual business lines with the liquidity risk exposure their activities create for the institution as a whole. The quantification and attribution of liquidity risks should be explicit and transparent at the line management level and should include consideration of how liquidity would be affected under stressed conditions.

Liquidity Risk Measurement, Monitoring, and Reporting

The process of measuring liquidity risk should include robust methods for comprehensively projecting cash flows arising from assets, liabilities, and off-balance-sheet items over an appropriate set of time horizons. For example, time buckets may be daily for very short timeframes or extend out to weekly, monthly, and quarterly for longer time frames. Pro forma cash flow statements are a critical tool for adequately managing liquidity risk. Cash flow projections can range from simple spreadsheets to very detailed reports depending upon the complexity and sophistication of the institution and its liquidity risk profile under alternative scenarios. Given the critical importance that assumptions play in constructing measures of liquidity risk and projections of cash flows, institutions should ensure that the assumptions used are reasonable, appropriate, and adequately documented. Institutions should periodically review and formally approve these assumptions. Institutions should focus particular attention on the assumptions used in assessing the liquidity risk of complex assets, liabilities, and off-balance-sheet positions. Assumptions applied to positions with uncertain cash flows, including the stability of retail and brokered deposits and secondary market issuances and borrowings, are especially important when they are used to evaluate the availability of alternative sources of funds under adverse contingent liquidity scenarios. Such scenarios include, but are not limited to, deterioration in the institution's asset quality or capital adequacy.

Institutions should ensure that assets are properly valued according to relevant financial reporting and supervisory standards. An institution should fully factor into its risk management practices the consideration that valuations may deteriorate under market stress and take this into account in assessing the feasibility and impact of asset sales on its liquidity position during stress events.

Institutions should ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs of one year or more. These assessments should include vulnerabilities to events, activities, and strategies that can significantly strain the capability to generate internal cash.

Stress Testing

Institutions should conduct stress tests regularly for a variety of institution-specific and marketwide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the financial institution and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the institution's cash flows, liquidity position, profitability, and solvency. Stress tests should also be used to ensure that current exposures are consistent with the financial institution's established liquidity risk tolerance. Management's active involvement and support is critical to the effectiveness of the stress testing process. Management should discuss the results of stress tests and take remedial or mitigating actions to limit the institution's exposures, build up a liquidity cushion, and adjust its liquidity profile to fit its risk tolerance. The results of stress tests should also play a key role in shaping the institution's contingency planning. As such, stress testing and contingency planning are closely intertwined.

Collateral Position Management

An institution should have the ability to calculate all of its collateral positions in a timely manner, including the value of assets currently pledged relative to the amount of security required and unencumbered assets available to be pledged. An institution's level of available collateral should be monitored by legal entity, jurisdiction, and currency exposure, and systems should be capable of monitoring shifts between intraday and overnight or term collateral usage. An institution should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (i.e., the custodian institution or securities settlement system with which the collateral is held). Institutions should also fully understand the potential demand on required and available collateral arising from various types of contractual contingencies during periods of both marketwide and institution-specific stress.

Management Reporting

Liquidity risk reports should provide aggregate information with sufficient supporting detail to enable management to assess the sensitivity of the institution to changes in market conditions, its own financial performance, and other important risk factors. The types of reports or information and their timing will vary according to the complexity of the institution's operations and risk profile. Reportable items may include but are not limited to cash flow gaps, cash flow projections, asset and funding concentrations, critical assumptions used in cash flow projections, key early warning or risk indicators, funding availability, status of contingent funding sources, or collateral usage. Institutions should also report on the use of and availability of government support, such as lending and guarantee programs, and implications on liquidity positions, particularly since these programs are generally temporary or reserved as a source for contingent funding.

Liquidity across Currencies, Legal Entities, and Business Lines

A depository institution should actively monitor and control liquidity risk exposures and funding needs within and across currencies, legal entities, and business lines. Also, depository institutions should take into account operational limitations to the transferability of liquidity, and should maintain sufficient liquidity to ensure compliance during economically stressed periods with applicable legal and regulatory restrictions on the transfer of liquidity among regulated entities. The degree of centralization in managing liquidity should be appropriate for the depository institution's business mix and liquidity risk profile.[7] The agencies expect depository institutions to maintain adequate liquidity both at the consolidated level and at significant legal entities.

Regardless of its organizational structure, it is important that an institution actively monitor and control liquidity risks at the level of individual legal entities, and the group as a whole, incorporating processes that aggregate data across multiple systems in order to develop a groupwide view of liquidity risk exposures. It is also important that the institution identify constraints on the transfer of liquidity within the group.

7. Institutions subject to multiple regulatory jurisdictions should have management strategies and processes that recognize the potential limitations of liquidity transferability, as well as the need to meet the liquidity requirements of foreign jurisdictions.

Assumptions regarding the transferability of funds and collateral should be described in liquidity risk management plans.

Intraday Liquidity Position Management

Intraday liquidity monitoring is an important component of the liquidity risk management process for institutions engaged in significant payment, settlement, and clearing activities. An institution's failure to manage intraday liquidity effectively, under normal and stressed conditions, could leave it unable to meet payment and settlement obligations in a timely manner, adversely affecting its own liquidity position and that of its counterparties. Among large, complex organizations, the interdependencies that exist among payment systems and the inability to meet certain critical payments has the potential to lead to systemic disruptions that can prevent the smooth functioning of all payment systems and money markets. Therefore, institutions with material payment, settlement and clearing activities should actively manage their intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. Senior management should develop and adopt an intraday liquidity strategy that allows the institution to:

1. Monitor and measure expected daily gross liquidity inflows and outflows.
2. Manage and mobilize collateral when necessary to obtain intraday credit.
3. Identify and prioritize time-specific and other critical obligations in order to meet them when expected.
4. Settle other less critical obligations as soon as possible.
5. Control credit to customers when necessary.
6. Ensure that liquidity planners understand the amounts of collateral and liquidity needed to perform payment-system obligations when assessing the organization's overall liquidity needs.

Diversified Funding

An institution should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. An institution should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

An institution should diversify available funding sources in the short-, medium-, and long-term. Diversification targets should be part of the medium- to long-term funding plans and should be aligned with the budgeting and business planning process. Funding plans should take into account correlations between sources of funds and market conditions. Funding should also be diversified across a full range of retail as well as secured and unsecured wholesale sources of funds, consistent with the institution's sophistication and complexity. Management should also consider the funding implications of any government programs or guarantees it uses. As with wholesale funding, the potential unavailability of government programs over the intermediate- and long-term should be fully considered in the development of liquidity risk management strategies, tactics, and risk tolerances. Funding diversification should be implemented using limits addressing counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market. In general, funding concentrations should be avoided. Undue over-reliance on any one source of funding is considered an unsafe and unsound practice.

An essential component of ensuring funding diversity is maintaining market access. Market access is critical for effective liquidity risk management as it affects both the ability to raise new funds and to liquidate assets. Senior management should ensure that market access is being actively managed, monitored, and tested by the appropriate staff. Such efforts should be consistent with the institution's liquidity risk profile and sources of funding. For example, access to the capital markets is an important consideration for most large complex institutions, whereas the availability of correspondent lines of credit and other sources of wholesale funds are critical for smaller, less complex institutions.

An institution should identify alternative sources of funding that strengthen its capacity to withstand a variety of severe institution-specific and marketwide liquidity shocks. Depending upon the nature, severity, and duration of the liquidity shock, potential sources of funding include, but are not limited to, the following:

1. Deposit growth.
2. Lengthening maturities of liabilities.
3. Issuance of debt instruments.
4. Sale of subsidiaries or lines of business.
5. Asset securitization.
6. Sale (either outright or through repurchase agreements) or pledging of liquid assets.
7. Drawing down committed facilities.
8. Borrowing.

Cushion of Liquid Assets

Liquid assets are an important source of both primary (operating liquidity) and secondary (contingent liquidity) funding at many institutions. Indeed, a critical component of an institution's ability to effectively respond to potential liquidity stress is the availability of a cushion of highly liquid assets without legal, regulatory, or operational impediments (i.e., unencumbered) that can be sold or pledged to obtain funds in a range of stress scenarios. These assets should be held as insurance against a range of liquidity stress scenarios including those that involve the loss or impairment of typically available unsecured and/or secured funding sources. The size of the cushion of such high-quality liquid assets should be supported by estimates of liquidity needs performed under an institution's stress testing as well as aligned with the risk tolerance and risk profile of the institution. Management estimates of liquidity needs during periods of stress should incorporate both contractual and noncontractual cash flows, including the possibility of funds being withdrawn. Such estimates should also assume the inability to obtain unsecured and uninsured funding as well as the loss or impairment of access to funds secured by assets other than the safest, most liquid assets.

Management should ensure that unencumbered, highly liquid assets are readily available and are not pledged to payment systems or clearing houses. The quality of unencumbered liquid assets is important as it will ensure accessibility during the time of most need. An institution could use its holdings of high-quality securities, for example, U.S. Treasury securities, securities issued by U.S. government-sponsored agencies, excess reserves at the central bank or similar instruments, and enter into repurchase agreements in response to the most severe stress scenarios.

Contingency Funding Plan[8]

All financial institutions, regardless of size and complexity, should have a formal CFP that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. It should be regularly tested and updated to ensure that it is operationally sound. For certain components of the CFP, affirmative testing (e.g., liquidation of assets) may be impractical. In these instances, institutions should be sure to test operational components of the CFP. For example, ensuring that roles and responsibilities are up-to-date and appropriate; ensuring that legal and operational documents are up-to-date and appropriate; ensuring that cash and collateral can be moved where and when needed; and ensuring that contingent liquidity lines can be drawn when needed.

Contingent liquidity events are unexpected situations or business conditions that may increase liquidity risk. The events may be institution-specific or arise from external factors and may include:

1. The institution's inability to fund asset growth.
2. The institution's inability to renew or replace maturing funding liabilities.
3. Customers unexpectedly exercising options to withdraw deposits or exercise off-balance-sheet commitments.
4. Changes in market value and price volatility of various asset types.
5. Changes in economic conditions, market perception, or dislocations in the financial markets.
6. Disturbances in payment and settlement systems due to operational or local disasters.

Insured institutions should be prepared for the specific contingencies that will be applicable to them if they become less than Well Capitalized pursuant to Prompt Correction Action (PCA) provisions under the Federal Deposit Insurance Corporation Improvement Act.[9] Contingencies may include restricted rates paid for deposits, the need to seek approval from the FDIC/NCUA to accept brokered deposits, and the inability to

8. Financial institutions that have had their liquidity supported by temporary government programs administered by the Department of the Treasury, Federal Reserve, and/or FDIC should not base their liquidity strategies on the belief that such programs will remain in place indefinitely.

9. See 12 USC 1831o, 12 CFR 6 (OCC), 12 CFR 208.40 (FRB), and 12 CFR 325.101 (FDIC).

accept any brokered deposits.[10]

A CFP provides a documented framework for managing unexpected liquidity situations. The objective of the CFP is to ensure that the institution's sources of liquidity are sufficient to fund normal operating requirements under contingent events. A CFP also identifies alternative contingent liquidity resources[11] that can be employed under adverse liquidity circumstances. An institution's CFP should be commensurate with its complexity, risk profile, and scope of operations. As macroeconomic and institution-specific conditions change, CFPs should be revised to reflect these changes.

Contingent liquidity events can range from high-probability/low-impact events to low-probability/high-impact events. Institutions should incorporate planning for high-probability/low-impact liquidity risks into the day-to-day management of sources and uses of funds. Institutions can generally accomplish this by assessing possible variations around expected cash flow projections and providing for adequate liquidity reserves and other means of raising funds in the normal course of business. In contrast, all financial institution CFPs will typically focus on events that, while relatively infrequent, could significantly impact the institution's operations. A CFP should:

1. *Identify Stress Events*. Stress events are those that may have a significant impact on the institution's liquidity given its specific balance-sheet structure, business lines, organizational structure, and other characteristics. Possible stress events may include deterioration in asset quality, changes in agency credit ratings, PCA capital categories and CAMELS ratings downgrades, widening of credit default spreads, operating losses, declining financial institution equity prices, negative press coverage, or other events that may call into question an institution's ability to meet its obligations.
2. *Assess Levels of Severity and Timing.* The CFP should delineate the various levels of stress severity that can occur during a contingent liquidity event and identify the different stages for each type of event. The events, stages, and severity levels identified should include temporary disruptions as well as those that might be more intermediate term or longer-term. Institutions can use the different stages or levels of severity identified to design early-warning indicators, assess potential funding needs at various points in a developing crisis, and specify comprehensive action plans. The length of the scenario will be determined by the type of stress event being modeled and should encompass the duration of the event.
3. *Assess Funding Sources and Needs.* A critical element of the CFP is the quantitative projection and evaluation of expected funding needs and funding capacity during the stress event. This entails an analysis of the potential erosion in funding at alternative stages or severity levels of the stress event and the potential cash flow mismatches that may occur during the various stress levels. Management should base such analysis on realistic assessments of the behavior of funds providers during the event and incorporate alternative contingency funding sources. The analysis also should include all material on-and off-balance-sheet cash flows and their related effects. The result should be a realistic analysis of cash inflows, outflows, and funds availability at different time intervals during the potential liquidity stress event in order to measure the institution's ability to fund operations. Common tools to assess funding mismatches include:
   a. *Liquidity gap analysis*—A cash flow report that essentially represents a base case estimate of where funding surpluses and shortfalls will occur over various future time frames.
   b. *Stress tests*—A pro forma cash flow report with the ability to estimate future funding surpluses and shortfalls under various liquidity stress scenarios and the institution's ability to fund expected asset growth projections or sustain an orderly liquidation of assets under various stress events.
4. *Identify Potential Funding Sources.* Because liquidity pressures may spread from one funding source to another during a significant liquidity event, institutions should identify alternative sources of liquidity, and ensure ready access to contingent funding sources. In some cases, these funding sources may rarely be used in the normal course of busi-

10. Section 38 of the FDI Act (12 USC 1831o) requires insured depository institutions that are not well capitalized to receive approval prior to engaging in certain activities. Section 38 restricts or prohibits certain activities and requires an insured depository institution to submit a capital restoration plan when it becomes undercapitalized.

11. There may be time constraints, sometimes lasting weeks, encountered in initially establishing lines with FRB and/or FHLB. As a result, financial institutions should plan to have these lines set up well in advance.

ness. Therefore, institutions should conduct advance planning and periodic testing to ensure that contingent funding sources are readily available when needed.

5. *Establish Liquidity Event Management Processes.* The CFP should provide for a reliable crisis management team and administrative structure, including realistic action plans used to execute the various elements of the plan for given levels of stress. Frequent communication and reporting among team members, the board of directors, and other affected managers optimize the effectiveness of a contingency plan during an adverse liquidity event by ensuring that business decisions are coordinated to minimize further disruptions to liquidity. Such events may also require the daily computation of regular liquidity risk reports and supplemental information. The CFP should provide for more frequent and more detailed reporting as the stress situation intensifies.
6. *Establish a Monitoring Framework for Contingent Events.* Institution management should monitor for potential liquidity stress events by using early-warning indicators and event triggers. The institution should tailor these indicators to its specific liquidity risk profile. The early recognition of potential events allows the institution to position itself into progressive states of readiness as the event evolves, while providing a framework to report or communicate within the institution and to outside parties. Early-warning signals may include, but are not limited to, negative publicity concerning an asset class owned by the institution, increased potential for deterioration in the institution's financial condition, widening debt or credit default swap spreads, and increased concerns over the funding of off-balance-sheet items.

To mitigate the potential for reputation contagion, effective communication with counterparties, credit-rating agencies, and other stakeholders when liquidity problems arise is of vital importance. Smaller institutions that rarely interact with the media should have plans in place for how they will manage press inquiries that may arise during a liquidity event. In addition, groupwide contingency funding plans, liquidity cushions, and multiple sources of funding are mechanisms that may mitigate reputation concerns.

In addition to early-warning indicators, institutions that issue public debt, use warehouse financing, securitize assets, or engage in material over-the-counter derivative transactions typically have exposure to event triggers embedded in the legal documentation governing these transactions. Institutions that rely upon brokered deposits should also incorporate PCA-related downgrade triggers into their CFPs since a change in PCA status could have a material bearing on the availability of this funding source. Contingent event triggers should be an integral part of the liquidity risk monitoring system. Institutions that originate and/or purchase loans for asset securitization programs pose heightened liquidity risk concerns due to the unexpected funding needs associated with an early amortization event or disruption of warehouse funding. Institutions that securitize assets should have liquidity contingency plans that address these risks.

Institutions that rely upon secured funding sources also are subject to potentially higher margin or collateral requirements that may be triggered upon the deterioration of a specific portfolio of exposures or the overall financial condition of the institution. The ability of a financially stressed institution to meet calls for additional collateral should be considered in the CFP. Potential collateral values also should be subject to stress tests since devaluations or market uncertainty could reduce the amount of contingent funding that can be obtained from pledging a given asset. Additionally, triggering events should be understood and monitored by liquidity managers.

Institutions should test various elements of the CFP to assess their reliability under times of stress. Institutions that rarely use the type of funds they identify as standby sources of liquidity in a stress situation, such as the sale or securitization of loans, securities repurchase agreements, Federal Reserve discount window borrowing, or other sources of funds, should periodically test the operational elements of these sources to ensure that they work as anticipated. However, institutions should be aware that during real stress events, prior market access testing does not guarantee that these funding sources will remain available within the same time frames and/or on the same terms.

Larger, more complex institutions can benefit by employing operational simulations to test communications, coordination, and decision making involving managers with different responsibilities, in different geographic locations, or at different operating subsidiaries. Simulations or tests run late in the day can highlight specific problems, such as difficulty in selling assets or borrowing new funds at a time when business in the capital markets may be less active.

Internal Controls

An institution's internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide assurance that the institution manages liquidity risk consistent with board-approved policy. Appropriate internal controls should address relevant elements of the risk management process, including adherence to policies and procedures, the adequacy of risk identification, risk measurement, reporting, and compliance with applicable rules and regulations.

Management should ensure that an independent party regularly reviews and evaluates the various components of the institution's liquidity risk management process. These reviews should assess the extent to which the institution's liquidity risk management complies with both supervisory guidance and industry sound practices, taking into account the level of sophistication and complexity of the institution's liquidity risk profile.[12] Smaller, less-complex institutions may achieve independence by assigning this responsibility to the audit function or other qualified individuals independent of the risk management process. The independent review process should report key issues requiring attention, including instances of noncompliance, to the appropriate level of management for prompt corrective action consistent with approved policy.

4066.0.2 APPENDIX B—INTERAGENCY GUIDANCE ON FUNDS TRANSFER PRICING RELATED TO FUNDING AND CONTINGENT LIQUIDITY RISKS

The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued this guidance on funds transfer pricing (FTP) practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk at large financial institutions (hereafter referred to as "firms") to address weaknesses observed in some firms' FTP practices.[13] The guidance builds on the principles of sound liquidity risk management described in the "Interagency Policy Statement on Funding and Liquidity Risk Management,"[14] and incorporates elements of the international statement issued by the Basel Committee on Banking Supervision titled "Principles for Sound Liquidity Risk Management and Supervision."[15] Refer to SR-16-03.

Background

For purposes of this guidance, FTP refers to a process performed by a firm's central management function that allocates costs and benefits associated with funding and contingent liquidity risks (FTP costs and benefits), as measured at transaction or trade inception, to a firm's business lines, products, and activities. While this guidance specifically addresses FTP practices related to funding and contingent liquidity risks, firms may incorporate other risks in their overall FTP frameworks.

FTP is an important tool for managing a firm's balance sheet structure and measuring risk-adjusted profitability. By allocating funding and contingent liquidity risks to business lines, products, and activities within a firm, FTP influences the volume and terms of new business and ongoing portfolio composition. This process helps align a firm's funding and contingent liquidity risk profile and risk appetite and complements, but does not replace, broader liquidity and interest rate risk management programs (for example, stress testing) that a firm uses to capture certain risks (for example, basis risk). If

12. This includes the standards established in this interagency guidance as well as the supporting material each agency provides in its examination manuals and handbooks directed at their supervised institutions. Industry standards include those advanced by recognized industry associations and groups.

13. For purposes of this guidance, large financial institutions include: national banks, federal savings associations and state-chartered banks with consolidated assets of $250 billion or more, domestic bank and savings and loan holding companies with consolidated assets of $250 billion or more or foreign exposure of $10 billion or more, and foreign banking organizations with combined U.S. assets of $250 billion or more.

14. Refer to: FRB's SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management"; FDIC's FIL-13-2010, "Funding and Liquidity Risk Management Interagency Guidance"; and OCC Bulletin 2010-13, "Final Policy Statement: Interagency Policy Statement on Funding and Liquidity Management."

15. The Basel Committee on Banking Supervision statement on "Principles for Sound Liquidity Risk Management and Supervision" (September 2008) is available at www.bis.org/publ/bcbs144.htm.

done effectively, FTP promotes more resilient, sustainable business models. FTP is also an important tool for centralizing the management of funding and contingent liquidity risks for all exposures. Through FTP, a firm can transfer these risks to a central management function that can take advantage of natural offsets, centralized hedging activities, and a broader view of the firm.

Failure to consistently and effectively apply FTP can misalign the risk-taking incentives of individual business lines with the firm's risk appetite, resulting in a misallocation of financial resources. This misallocation can arise in new business and ongoing portfolio composition where the business metrics do not reflect risks taken, thereby undermining the business model. Examples include entering into excessive off-balance sheet commitments and on-balance sheet asset growth because of mispriced funding and contingent liquidity risks.

The 2008 financial crisis exposed weak risk management practices for allocating liquidity costs and benefits across business lines. Several firms "acknowledged that if robust FTP practices had been in place earlier, and if the systems had charged not just for funding but for liquidity risks, they would not have carried the significant levels of illiquid assets and the significant risks that were held off-balance sheet that ultimately led to sizable losses."[16]

Funds Transfer Pricing Principles

A firm should have an FTP framework to support its broader risk management and governance processes that incorporates the general principles described in this section and is commensurate with its size, complexity, business activities, and overall risk profile. The framework should incorporate FTP costs and benefits into product pricing, business metrics, and new product approval for all material business lines, products, and activities to align risk-taking incentives with the firm's risk appetite.

Principle 1: A firm should allocate FTP costs and benefits based on funding risk and contingent liquidity risk.

A firm should have an FTP framework that allocates costs and benefits based on the following risks.

- *Funding risk,* measured as the cost or benefit (including liquidity and interest rate components) of raising funds to finance ongoing business operations, should be allocated based on the characteristics of the business lines, products, and activities that give rise to those costs or benefits (for example, higher costs allocated to assets that will be held over a longer time horizon and greater benefits allocated to stable sources of funding).
- *Contingent liquidity risk,* measured as the cost of holding standby liquidity composed of unencumbered, highly liquid assets, should be allocated to the business lines, products, and activities that pose risk of contingent funding needs during a stress event (for example, draws on credit commitments, collateral calls, deposit run-off, and increasing haircuts on secured funding).

Principle 2: A firm should have a consistent and transparent FTP framework for identifying and allocating FTP costs and benefits on a timely basis and at a sufficiently granular level, commensurate with the firm's size, complexity, business activities, and overall risk profile.

FTP costs and benefits should be allocated based on methodologies that are set forth by a firm's FTP framework. The methodologies should be transparent, repeatable, and sufficiently granular such that they align business decisions with the firm's desired funding and contingent liquidity risk appetite. To the extent a firm applies FTP at an aggregated level to similar products and activities, the firm should include the aggregating criteria in the report on FTP.[17] Additionally, the senior management group that oversees FTP should review the basis for the FTP methodologies. The attachment to this interagency guidance describes illustrative FTP methodologies that a firm may consider when implementing its FTP framework.[18]

A firm should allocate FTP costs and benefits, as measured at transaction or trade inception, to the appropriate business line, product, or activity. If a firm retains any FTP costs or benefits in a centrally managed pool pursuant to its FTP framework, it should analyze the implications of

16. Senior Supervisors Group report on "Risk Management Lessons from the Global Financial Crisis of 2008" (October 21, 2009) is available at https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2009/SSG_report.pdf.

17. See Principle 3 for a discussion of the report on FTP.

18. The FRB, the FDIC, and the OCC will monitor evolving FTP practices in the market and may update or add to the illustrative methodologies in the interagency guidance attachment.

such decisions on business line incentives and the firm's overall risk profile. The firm customarily would include its findings in the report on FTP.

The FTP framework should be implemented consistently across the firm to appropriately align risk-taking incentives. While it is possible to apply different FTP methodologies within a firm due to, among other things, legal entity type or specific jurisdictional circumstances, a firm should generally implement the FTP framework in a consistent manner across its corporate structure to reduce the likelihood of misaligned incentives. If there are implementation differences across the firm, management should analyze the implications of such differences on business line incentives and the firm's overall funding and contingent liquidity risk profile. The firm customarily would include its findings in the report on FTP.

A firm should allocate, report, and update data on FTP costs and benefits at a frequency that is appropriate for the business line, product, or activity. Allocating, reporting, and updating of data should occur more frequently for trading exposures (for example, on a daily basis). Infrequent allocation, reporting, or updating of data for trading exposures (for example, based on month-end positions) may not fully capture a firm's day-to-day funding and contingent liquidity risks. For example, a firm should monitor the age of its trading exposures, and those held longer than originally intended should be reassessed and FTP costs and benefits should be reallocated based on the modified holding period.

A firm's FTP framework should address derivative activities commensurate with the size and complexity of those activities. The FTP framework may consider the fair value of current positions, the rights of rehypothecation for collateral received, and contingent outflows that may occur during a stress event.

To avoid a misalignment of risk-taking incentives, a firm should adjust its FTP costs and benefits as appropriate based on both market-wide and idiosyncratic conditions, such as trapped liquidity, reserve requirements, regulatory requirements, illiquid currencies, and settlement or clearing costs. These idiosyncratic conditions should be contemplated in the FTP framework, and the firm customarily would include a discussion of the implications in the report on FTP.

Principle 3: A firm should have a robust governance structure for FTP, including the production of a report on FTP and oversight from a senior management group and central management function.

A firm should have a senior management group that oversees FTP, which should include a broad range of stakeholders, such as representatives from the firm's asset-liability committee (if separate from the senior management group), the treasury function, and business line and risk management functions. This group should develop the policy underlying the FTP framework, which should identify assumptions, responsibilities, procedures, and authorities for FTP. The policy should be reviewed and updated on a regular basis or when the firm's asset-liability structure or scope of activities undergoes a material change. Further, senior management with oversight responsibility for FTP should periodically, but no less frequently than quarterly, review the report on FTP to ensure that the established FTP framework is being properly implemented.

A firm should also establish a central management function tasked with implementing the FTP framework. The central management function should have visibility over the entire firm's on- and off-balance sheet exposures. Among its responsibilities, the central management function should regularly produce and analyze a report on FTP generated from accurate and reliable management information systems. The report on FTP should be at a sufficiently granular level to enable the senior management group and central management function to effectively monitor the FTP framework (for example, at the business line, product, or activity level, as appropriate). Among other items, all material approvals, such as those related to any exception to the FTP framework, including the reason for the exception, would customarily be documented in the report on FTP. The report on FTP may be standalone or included within a broader risk management report.

Independent risk and control functions and internal audit should provide oversight of the FTP process and assess the report on FTP, which should be reviewed as appropriate to reflect changing business and financial market conditions and to maintain the appropriate alignment of incentives. Lastly, consistent with existing supervisory guidance on model risk management,[19] models used in FTP implementation should be independently validated and regularly reviewed to ensure that the models continue to

19. Refer to: FRB's SR-11-7, "Guidance on Model Risk Management"; OCC Bulletin 2011-12, "Supervisory Guidance on Model Risk Management." Refer to section 2126.0 of this manual.

perform as expected, that all assumptions remain appropriate, and that limitations are understood and appropriately mitigated.

Principle 4: A firm should align business incentives with risk management and strategic objectives by incorporating FTP costs and benefits into product pricing, business metrics, and new product approval.

Through its FTP framework, a firm should incorporate FTP costs and benefits into product pricing, business metrics, and new product approval for all material business lines, products, and activities (both on- and off-balance sheet). The framework, the report on FTP, and any associated management information systems should be designed to provide decision makers sufficient and timely information about FTP costs and benefits so that risk-taking incentives align with the firm's strategic objectives.

The information may be either at the transaction level or, if the transactions have homogenous funding and contingent liquidity risk characteristics, at an aggregated level. In deciding whether to allocate FTP costs and benefits at the transaction or aggregated level, firms should consider advantages and disadvantages of both approaches when developing the FTP framework. Although transaction-level FTP allocations may add complexity and involve higher implementation and maintenance costs, such allocations may provide a more accurate measure of risk-adjusted profitability. A firm assigning FTP allocations at an aggregated level should have aggregation criteria based on funding and contingent liquidity risk characteristics that are transparent.

There should be ongoing dialogue between the business lines and the central function responsible for allocating FTP costs and benefits to ensure that funding and contingent liquidity risks are being captured and are well-understood for product pricing, business metrics, and new product approval. The business lines should understand the rationale for the FTP costs and benefits, and the central function should understand the funding and contingent liquidity risks implicated by the business lines' transactions. Decisions by senior management to incentivize certain behaviors through FTP costs and benefits customarily would be documented and included in the report on FTP.

Conclusion

A firm should use the principles laid out in this guidance to develop, implement, and maintain an effective FTP framework. In doing so, a firm's risk-taking incentives should better align with its risk management and strategic objectives. The framework should be adequately tailored to a firm's size, complexity, business activities, and overall risk profile.

Interagency Guidance Attachment Illustrative Funds Transfer Pricing Methodologies

March 1, 2016

The Funds Transfer Pricing (FTP) methodologies described below are intended for illustrative purposes only and provide examples for addressing principles set forth in the guidance. A firm's FTP framework should be commensurate with its size, complexity, business activities, and overall risk profile. In designing its FTP framework, a firm may utilize other methodologies that are consistent with the principles set forth in the guidance. Therefore, these illustrative methodologies should not be interpreted as directives for implementing any particular FTP methodology.

Non-Trading Exposures

For non-trading exposures, a firm's FTP methodology may vary based on its business activities and specific exposures. For example, certain firms may have higher concentrations of exposures that have less predictable time horizons, such as non-maturity loans and non-maturity deposits.

Matched-Maturity Marginal Cost of Funding

Matched-maturity marginal cost of funding is a commonly used methodology for non-trading exposures. Under this methodology, FTP costs and benefits are based on a firm's market cost of funds across the term structure (for example, wholesale long-term debt curve adjusted based on the composition of the firm's alternate sources of funding such as Federal Home Loan Bank advances and customer deposits). This methodology incentivizes business lines to generate stable funding (for example, core deposits) by crediting them the benefit or premium associated with such funding. It also ensures that business lines are appropriately charged the cost of funding for the life of longer-dated assets (for example, a five-year commercial loan). Given that funding costs can change over time, the market cost of funds across the term structure should be derived from reliable and readily available data sources and be well understood by FTP users.

FTP rates should, as closely as possible, match the characteristics of the transaction or the aggregated transactions to which they are applied. In determining the appropriate point on the derived FTP curve for a transaction or pool of transactions, a firm could consider a variety of characteristics, including the holding period, cash flow, re-pricing, prepayments, and expected life of the transaction or pool. For example, for a five-year commercial loan that has a rate that resets every three months and will be held to maturity, the interest rate component of the funding risk could be based on a three-month horizon for determining the FTP cost, and the liquidity component of the funding risk could be based on a five-year horizon for determining the FTP cost. Thus, the total FTP cost for holding the five-year commercial loan would be the combination of these two components.

Contingent Liquidity Risk

A firm may calculate the FTP cost related to non-trading exposure contingent liquidity risk using models based on behavioral assumptions. For example, charges for contingent commitments could be based on their modeled likelihood of drawdown, considering customer drawdown history, credit quality, and other factors; whereas, credits applied to deposits could be based on volatility and modeled behavioral maturity. A firm should document and include all modeling analyses and assumptions in the report on FTP. If behavioral assumptions used in a firm's FTP framework do not align with behavioral assumptions used in its internal stress test for similar types of non-trading exposures, the firm should document and include in the report on FTP these inconsistencies.

Trading Exposures

For trading exposures, a firm could consider a variety of factors, including the type of funding source (for example, secured or unsecured), the market liquidity of the exposure (for example, the size of the haircut relative to the overall exposure), the holding period of the position, the prevailing market conditions, and any potential impact the chosen approach could have on firm incentives and overall risk profile. If a firm's trading activities are not material, its FTP framework may require a less complex methodology for trading exposures. The following FTP methodologies have been observed for allocating FTP costs for trading exposures.

Weighted Average Cost of Debt (WACD)

WACD is the weighted average cost of outstanding firm debt, usually expressed as a spread over an index. Some firms' practices apply this rate to the amount of an asset expected to be funded unsecured (repurchase agreement market haircuts may be used to delineate between the amount being funded secured and the amount being funded unsecured). A firm using WACD should analyze whether the methodology misaligns risk-taking incentives and document such analyses in the report on FTP.

Marginal Cost of Funding

Marginal cost of funding sets the FTP costs at the appropriate incremental borrowing rate of a firm. Some firms' practices apply a marginal secured borrowing rate to the amount of an asset expected to be funded secured and a marginal unsecured borrowing rate to the amount of an asset expected to be funded unsecured (repurchase agreement market haircuts may be used to delineate between the amount being funded secured and the amount being funded unsecured). A firm using marginal cost of funding should analyze whether the methodology misaligns risk-taking incentives, considering current market rates compared to historical rates, and document such analyses in the report on FTP.

Contingent Liquidity Risk

A firm may calculate the FTP costs related to contingent liquidity risk from trading exposures by considering the unencumbered liquid assets that are held to cover the potential for widening haircuts of trading exposures that are funded secured. If haircuts used in a firm's FTP framework do not align with haircuts used in its internal stress test for similar types of trading exposures, the firm should document and include in the report on FTP these inconsistencies. Haircuts should be updated at a frequency that is appropriate for a firm's trading activities and market conditions.

A firm may also include the FTP costs related to contingent liquidity risk from potential derivative outflows in stressed market conditions, which may be due to, for example, credit rating downgrades, additional termination rights, or market shocks and volatility.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2009, this section has been revised to recognize the supervisory guidance contained in SR-08-12 and its interagency attachment, "Changes to the Interagency Country Exposure Review Committee (ICERC) Process." A significant change was made to the ICERC rating process—ICERC will only rate countries that are in default.[1]

4090.0.05 DEFINITION, COMPOSITION, AND EXPOSURES OF COUNTRY RISK AND EVALUATING THE ADEQUACY OF COUNTRY-RISK MANAGEMENT

Apart from the consideration of the creditworthiness of individual borrowers, holding companies engaged in international activities are subject to elements of country risk. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country, as well as the governmental policies structured to respond to these conditions. These factors may have potentially favorable or adverse consequences for foreigners' debt and equity investments in a particular country. The Federal Reserve, along with the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, have issued supervisory guidance concerning the elements of an effective country-risk management process for banking organizations. (See SR-02-05 and SR-08-12, including their attachments.)

Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk.[2] Country risk is also an important consideration when evaluating the level of credit risk associated with individual counterparties in a country. Regardless of the availability of foreign exchange, macroeconomic conditions and events that are beyond the control of individual borrowers can strain or impair the financial capacity of otherwise sound borrowers. Significant depreciation of a country's exchange rate, for example, increases the cost of servicing external debt and can adversely affect not only transfer risk for the country, but also the credit risk associated with even the strongest counterparties in the country.

Country risk can occur in many different forms, and the nature of specific risks can change over time. It is essential that a U.S. banking organization with significant direct or indirect international exposure have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. More specifically, country risk focuses on a borrower's capacity to obtain the foreign exchange required to service cross-currency debt. A borrower's debt-service capacity may also be affected by the risks of political and social upheaval, nationalization and expropriation, governmental repudiation of external indebtedness, exchange controls, and devaluation. Events such as these may materially affect the condition of investments and the profitability of lending activities overseas; examiners must alert management to those risks that may be difficult for the holding company and its subsidiaries to absorb.

Using uniform examination procedures and techniques for evaluating country-risk exposures for domestic banks, examiners segregate country-risk factors from the evaluation of other lending risks. The procedures emphasize diversification of exposure to individual countries as the primary method of moderating country risk in international portfolios. The approach generally consists of three parts:

1. measuring exposure in each country where a business relationship exists
2. analyzing exposure in relation to the bank's capital resources and the economic and financial conditions of each country in which the bank has outstanding credits
3. evaluating the risk-management system used by the bank in relation to the size and nature of its foreign lending activities

Examiners should evaluate the adequacy of the country-risk management process at internationally active bank holding companies. This risk-assessment process should include, at a

1. With the adoption of revised ICERC procedures in November 2008, the Federal Reserve and the other banking agencies eliminated the rating categories of Other Transfer Risk Problems, Weak, Moderately Strong, and Strong.

2. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor. For more information, see the "Guide to the Interagency Country Exposure Review Committee Process" (SR-08-12's attachment).

minimum, effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk, first at the consolidated level and then within the parent company and nonbank subsidiaries, as well as to any concentrations reported by supervisors at the bank subsidiaries.

4090.0.1 COUNTRY RISKS AND FACTORS

Country or sovereign risk encompasses the entire spectrum of risks and factors that arise from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. A detailed description of these factors is described below.

4090.0.1.1 Macroeconomic Factors

The first factor affecting country risk is the size and structure of a country's external debt in relation to its economy, more specifically—

1. the current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations, and
2. to the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including—

1. the level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed);
2. the level of import coverage provided by the country's international reserves;
3. the importance of commodity exports as a source of revenue, the existence of any price-stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity; and
4. the potential for sharp movements in exchange rates and the effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including—

1. the country's access to international financial markets and the potential effects of a loss of market liquidity;
2. the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
3. the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
4. the trend in foreign investments and the country's ability to attract foreign investments in the future; and
5. the opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including—

1. the degree to which the country's economy may be adversely affected through the contagion of problems in other countries;
2. the size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government;
3. the extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies; and
4. for both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

4090.0.1.2 Social, Political, and Legal Climate

The analysis of country risk should also consider the country's social, political, and legal climate, including—

1. the country's natural- and human-resource potential;
2. the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
3. the degree to which political or regional factionalism or armed conflicts are adversely affecting the government of the country;
4. any trends toward government-imposed price, interest-rate, or exchange controls;
5. the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
6. the accounting standards in the country and the reliability and transparency of financial information;
7. the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
8. the extent to which government policies promote the effective management of the bank holding company's exposures; and
9. the level of adherence to international legal and business-practice standards.

4090.0.1.3 Factors Specific to Banking Organizations

Finally, a bank holding company's analysis of country risk should consider factors relating to the nature of its actual (or approved) exposures in the country, including, for example—

1. the bank holding company's business strategy and its exposure-management plans for the country;
2. the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
3. the economic outlook for any specifically targeted industries within the country;
4. the degree to which political or economic developments in a country are likely to affect the bank holding company's chosen lines of business in the country (for instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others);
5. for a bank holding company involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rise, the counterparty may become less financially sound, thus increasing the risk of nonpayment (this is especially true for over-the-counter derivative instruments.));
6. the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (for example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country); and
7. the bank holding company's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

4090.0.2 RISK-MANAGEMENT PROCESS FOR COUNTRY RISK

Country risk has an overarching effect on a bank holding company's international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance-sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure should have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should be continually evaluating the adequacy of the country-risk management process at internationally active bank holding companies, and they should regularly update their assessments. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk at the parent level or within its bank and nonbank subsidiaries.

Country risk is not necessarily limited to banking organizations with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to banking organizations that do not have direct international activity. While banking organizations are not required to incorporate indirect country risk into a formal country-risk management process, they should, nevertheless, take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all Federal Reserve–supervised banking organizations.

To effectively control the risk associated with international activities, bank holding companies must have a risk-management process that focuses on the broadly defined concept of country risk. The elements of a sound country-risk management process are discussed in further detail below.

4090.0.2.1 Oversight by the Board of Directors

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing its international activities to ensure that they are consistent with the bank holding company's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the bank holding company's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which it is exposed.

4090.0.2.2 Policies and Procedures for Managing Country Risk

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that—

1. establish risk-tolerance limits;
2. delineate clear lines of responsibility and accountability for country-risk management decisions;
3. specify authorized activities, investments, and instruments; and
4. identify both desirable and undesirable types of business.

Management should also ensure that country-risk management policies, standards, and practices are clearly communicated to the affected offices and staff.

4090.0.2.3 Country-Exposure Reporting System

To effectively manage country risk, the bank holding company must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the bank holding company's operations, whether conducted through paper transactions or electronically. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in a bank holding company is significant,[3] or if a country to which the bank holding company is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the bank holding company.

3. For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the bank holding company's or bank's tier 1 capital plus the ALLL are considered significant. However, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

4090.0.2.4 Country-Risk Analysis Process

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary, depending on the size and sophistication of the banking organization's international operations, a number of considerations are relevant to evaluating the process in all banking organizations:

1. Is there a quantitative and qualitative assessment of the risk associated with each country in which the banking organization is conducting or planning to conduct business?
2. Is a formal analysis of country risk conducted at least annually, and does the banking organization have an effective system for monitoring developments in the interim?
3. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the banking organization may have targeted in its business strategy?
4. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the banking organization's exposures in a country?
5. Given the size and sophistication of the banking organization's international activities, are the resources devoted to the analysis of country risk adequate?
6. As a final check of the process, are the banking organization's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

4090.0.2.5 Country-Risk Ratings

Country-risk ratings summarize the conclusions of the country-risk analysis process. The ratings are an important component of country-risk management because they provide a framework for establishing country-exposure limits that reflect the bank holding company's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for banking organizations to distinguish between different types of exposures when assigning their country-risk ratings. For example, trade-related and banking-sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk-rating systems of some banking organizations differentiate between public-sector and private-sector exposures. In some banking organizations, a country's private-sector credits cannot be rated less severely than its public-sector credits (that is, the banking organization imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

A banking organization's country-risk ratings may differ from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. A banking organization's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool to identify countries where concentrations of transfer risk might warrant greater scrutiny and to determine whether some minimum level of reserves against transfer risk should be established. The ICERC rating process only rates countries in default. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers. For more information on ICERC ratings, see section 7040.3 of the *Commercial Bank Examination Manual* and SR-08-12.

4090.0.2.6 Country-Exposure Limits

As part of their country-risk management process, internationally active bank holding companies should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the banking organization (such as the country managers, the bank holding company's overall country-risk manager, and the country-risk committee), country-risk limits will usually reflect a balancing of several considerations, including—

1. the overall strategy guiding the bank holding company's international activities,
2. the country's risk rating and the bank holding company's appetite for risk,
3. perceived business opportunities in the country, and
4. the desire to support the international business needs of domestic customers.

Country-exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually—and more frequently when concerns about a particular country arise.

A bank holding company's board of directors and senior management should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. A bank holding company might also limit its exposure to local currencies. Bank holding companies that have both substantial capital-market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, bank holding companies should also consider limiting (or at least monitoring) exposures on a broader (for example, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, bank holding companies are in a better position to respond if the adverse effects of a country's problems begin to spread.

For bank holding companies that are engaged primarily in direct lending activities, monthly monitoring of compliance with country-exposure limits is adequate. However, bank holding companies with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country-exposure limits should be reported to an appropriate level of management or the board of directors so that it can consider corrective measures.

4090.0.2.7 Monitoring Country Conditions

The bank holding company should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the bank holding company's level of exposure and the perceived level of risk. If the bank holding company maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The bank holding company may also draw on information from rating agencies and other external sources.

Communication between senior management and the responsible country managers should be regular and ongoing. The bank holding company should not rely solely on informal lines of communication and ad hoc decision making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

4090.0.2.8 Stress Testing

Bank holding companies should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all bank holding companies to evaluate in some way the potential impact different scenarios may have on their country-risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the bank holding company's overall operations.

4090.0.2.9 Internal Controls and Audit

Bank holding companies should ensure that their country-risk management process includes adequate internal controls and that an audit mechanism ensures the integrity of the information used by senior management and the board to monitor compliance with country-risk policies and exposure limits. The system of internal controls should, for example, ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

4090.0.3 REPORTING REQUIREMENTS

4090.0.3.1 Country Exposure Report (FFIEC 009)

Banks and bank holding companies required to file the Country Exposure Report (Form FFIEC 009, formerly Form FR 2036) when the bank or banks have a foreign branch, a foreign subsidiary, or an Edge corporation, and when they have, on a consolidated basis, total outstanding claims on residents of foreign countries of $30 million or more. The report is to be filed quarterly within 45 days of the end of March, June, September, and December.

The report measures lending to residents of foreign countries by U.S. banking organizations. It is used to provide information on the distribution, by country, of foreign claims held by such banking organizations to (1) determine the degree of risk in bank portfolios and how adverse developments in particular countries affect the U.S. banking system; (2) assess country risk for supervisory purposes, and (3) assist the Bank for International Settlements in compiling worldwide data on cross-border claims. The report also includes information on revaluation gains for off-balance-sheet items and for securities held in trading accounts.

4090.0.3.2 Country Exposure Information Report (FFIEC 009a)

The County Exposure Information Report (Form FFIEC 009a) supplements the Country Exposure Report. The purpose of FFIEC 009a is to provide public disclosure of significant country exposures of U.S. banking institutions. Every institution that submits the FFIEC 009 and that has exposures to a country that exceed 1 percent of total assets or 20 percent of capital of the reporting institution submits the FFIEC 009a. FFIEC 009a respondents also furnish a list of countries in which exposures were between ¾ of 1 percent and 1 percent of total assets or between 15 and 20 percent of capital. Filing of the report is required.

4090.0.3.3 Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019)

The Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (Form FFIEC 019) is similar to the FFIEC 009 report that is filed by U.S. banks. The FFIEC 019 report collects information, by country, on the direct claims, indirect claims, and total adjusted claims on foreign residents; information on direct claims on related non–U.S. offices domiciled in countries other than the home country of the parent bank that are ultimately guaranteed in the home country that are included in total adjusted claims on the home country; and information on the breakdown of adjusted claims on unrelated foreign residents. The data are used by the supervisory agencies to monitor significant foreign-country exposures of U.S. branches and agencies of foreign banks. The reports are also used to evaluate the financial condition of these branches and agencies.

The FFIEC 019 is collected quarterly from those branches and agencies of foreign banks that have, as of the quarterly report date, more than $30 million in total direct claims on residents of foreign countries. The FFIEC 019 provides data on the foreign-risk exposure of each reporting branch and agency.

Respondents to the FFIEC 019 must prepare the data as of the close of each calendar quarter and submit the forms to the appropriate Reserve Bank no later than 45 days following the report date. Data are due at the Board 60 days following the report date. Bank holding companies should obtain, from the management of their respective foreign bank subsidiaries, written confirmation that the FFIEC 019 and all other Federal Reserve and FFIEC reports have been filed, as required.

4090.0.4 INSPECTION OBJECTIVES

1. If the bank holding company is internationally active, to determine the nature and extent of its direct and indirect country-risk exposures.
2. If the bank holding company has significant

direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.

3. To review and determine if the bank holding company's system of policies, procedures, internal controls, rating system, and stress testing for county-risk management are adequate and reliable.
4. To determine if the bank holding company's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank holding company's country-risk management policies, standards, and practices to the affected offices and staff.
6. To (1) determine if the scope of the bank holding company's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank holding company's country-risk management process, and (2) ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank holding company's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank holding company is properly preparing the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, both of which are required to be filed quarterly with the respective Reserve Banks, as applicable.
9. To identify and report individual exposures considered significant in relation to the bank holding company's capital and the economic performance of the country.
10. To prepare a report on the bank holding company's country-exposure management system and on any noted deficiencies.

4090.0.5 INSPECTION PROCEDURES

When performing and updating the bank holding company's risk assessment, the central point of contact for the bank holding company should include an analysis of its direct and indirect country-risk exposures (including any significant country-risk concentrations) and of the adequacy and reliability of its country-risk management. The analysis of the bank holding company's country-risk management systems should consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where the bank holding company's funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; on-site reports from bank branches, subsidiaries, or affiliates; or bank-officer visits to the country.

In the second component, the board of directors and senior management define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank holding company's international credit portfolio.

The third component is the bank holding company's internal reporting system, which should be designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board of directors, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, as applicable. The review should include a review of the exposures for at least several countries. The report page, Examiners' Comments and Matters Requiring Special Board

Attention, should be used to comment on material exceptions.

1. Obtain any written policies, procedures, or summaries of the bank holding company's country-risk management system. Determine whether the bank holding company's country-risk management system includes—
   a. effective oversight by the board of directors,
   b. adequate risk-management policies and procedures,
   c. an accurate country-exposure reporting system,
   d. an effective country-risk analysis process,
   e. a country-risk rating system,
   f. country-exposure limits,
   g. ongoing monitoring of country conditions,
   h. periodic stress testing of foreign exposures, and
   i. adequate internal controls and an audit function. (See SR-02-05.)
2. Review international-lending policies and determine—
   a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
   b. who initiates the country ratings and country limits;
   c. how frequently and by whom country ratings and limits are reviewed and changed;
   d. how the bank holding company defines the ratings assigned to the various countries;
   e. how country limits are determined;
   f. who is responsible for monitoring compliance with country limits;
   g. if country-risk limits consider—
      (1) the overall strategy guiding the institution's international activities,
      (2) the country's risk rating and the institution's appetite for risk,
      (3) perceived business opportunities in the country, and
      (4) the desire to support the international business needs of domestic customers;
   h. to what extent country limits are viewed as guidelines that may be exceeded;
   i. if the bank holding company has different sublimits for private- and public-sector credits;
   j. if separate limits are established for private- and public-sector credits;
   k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank holding company's performance against those standards;
   l. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits;
   m. how the system has been changed since the last examination;
   n. if the bank holding company has a reliable system for capturing and categorizing the volume and nature of foreign exposures;
   o. whether the bank holding company has a system to monitor current conditions in each of the countries where it is significantly exposed;
   p. if there is regular, ongoing communication between senior management and the responsible country managers;
   q. if established procedures are in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country; and
   r. whether the bank holding company periodically conducts stress tests (financial modeling or measuring the impact of various scenarios on its country-risk profiles) of its foreign exposures, and if the results are reported to senior management and the board of directors.
3. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
4. Obtain the bank holding company's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
5. During a discussion with senior management, direct inquiries to—
   a. gain insight into general management's international-lending philosophy, and
   b. elicit management's responses for correction of deficiencies.
6. When reporting on the bank holding company's country-risk management system, consider factors such as—
   a. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
   b. the scope and adequacy of the internal

loan-review system as it pertains to country risk;
c. causes of existing problems;
d. commitments from management for correction of deficiencies;
e. expectations for continued sound international lending or correction of existing deficiencies;
f. the ability of management to monitor and control transfer risk;
g. the general level of adherence to internal policies, practices, procedures, and controls; and
h. the scope and adequacy of the bank holding company's analysis of country conditions.

This part of the manual presents policies and procedures for the inspection process, the collection and presentation of data, and coordination of inspection activities of bank holding companies (BHCs).

5000.0.1 INSPECTION OF NONBANK SUBSIDIARIES OF BHCS

Notwithstanding the risk assessment that is to be performed for each nonbank subsidiary, an on-site review is required for the following nonbank subsidiaries:[1]

1. *Any individual subsidiary that meets either of the following two significance criteria or that is otherwise deemed by the Reserve Bank to have a significant impact on the BHC's condition or performance:*[2]
   - The subsidiary has total assets equal to 10 percent or more of the BHC's consolidated tier 1 capital.
   - The subsidiary's total operating revenue equals 10 percent or more of the BHC's consolidated total operating revenue.[3]
2. *Nonbank subsidiaries that are issuing debt to unaffiliated parties or relying to a significant degree on affiliated banks for funding.* "Significant" is defined as debt that exceeds the lesser of $10 million or 5 percent of the BHC's consolidated tier 1 capital.
3. *Those mortgage banking subsidiaries and other nonbank subsidiaries involved in asset securitization, and all nonbank subsidiaries that generate assets and sell them to affiliated parties.* Examiners involved in the on-site review of these subsidiaries should consider the appropriate examination guidelines for asset securitization, for example, those set forth in SR-90-16 (May 25, 1990). (See section 2128.02.)
4. *All nonbank subsidiaries that broker or deal in derivative instruments, as a principal or agent, to unaffiliated parties.*

Furthermore, for each credit-extending nonbank subsidiary that meets the above on-site review criteria, examiners are to review sufficient credit files through either judgmental or attribute sampling to assess the adequacy and accuracy of internal risk-identification systems.

5000.0.1.1 Off-Site Review of Nonbank Activities

Reserve Banks should review reports submitted to the Federal Reserve to monitor the condition and performance of significant nonbank subsidiaries between inspections. FR Y-series reports on individual and combined nonbank subsidiaries should be used for this purpose and, when available, financial statements on nonbank activities that are included with the FR Y-6 annual reports of BHCs should also be reviewed.[4]

When warranted by (1) a deterioration in the condition and performance of nonbank subsidiaries, (2) the significance of the nonbank subsidiaries (including those selected for on-site review as discussed above), or (3) other reasons, Reserve Banks should require BHCs to submit additional information (for example, balance sheets, income statements, and schedules on nonperforming assets and off-balance-sheet activities) obtained from a company's internal systems. Furthermore, on an exception basis, Reserve Banks will be expected to obtain, from a BHC's internal systems, information on the off-balance-sheet exposures of nonbank subsidiaries. When exposures are considered significant, Reserve Banks will be expected to monitor the risks posed by these exposures. If the Reserve Bank determines that a situation warrants material departure from these procedures, it should be discussed with Board staff.

1. See SR-93-19 for more information. The on-site review for these nonbank subsidiaries should be performed with the same frequency as required for a full-scope inspection but may be performed as a targeted review that is not concurrent with the full-scope inspection.

2. Generally, examiners would not be required to conduct an on-site review of those nonbank subsidiaries that hold premises that are necessary for the operation of the banks or other affiliates. Furthermore, these criteria are not intended to include nonbank subsidiaries that have been subject to recent on-site review by another federal or state banking agency in accordance with interagency agreements or Reserve Bank agreements with state banking supervisors (for example, the Interagency EDP Examination, Scheduling, and Distribution Policy). These criteria also should not limit Reserve Bank flexibility in coordinating supervisory efforts with functional regulators at the federal or state level.

3. For BHCs, "total operating revenue" is the sum of total interest income and total noninterest income (before extraordinary items).

4. See the Board's public website for more information on report forms and reporting requirements.

5000.0.2 MULTI-TIER BHC INSPECTIONS

The Federal Reserve has had longstanding supervisory guidance addressing the coordination of supervisory activities among the Reserve Banks. For banking organizations that operate in more than one district, it is particularly important that (1) all relevant and significant supervisory findings are assessed and weighed when the consolidated banking organization is being evaluated and (2) a consistent and coordinated supervisory message is communicated to the organization.

Many multi-tier BHC structures exist in which the top-tier and second-tier institutions (as well as other lower-level tiers) are in different Federal Reserve Districts. The System has long operated under the principle that there is one responsible Reserve Bank (RRB) for each fully consolidated banking organization (i.e., each top-tier consolidated banking organization). For domestic banking organizations, the RRB typically will be the district where the head office of the top-tier organization is located and its overall strategic direction is established and overseen. For foreign banking organizations, the RRB typically will be the district where the Federal Reserve has the most direct involvement in the conduct of day-to-day supervision of the U.S. banking operations of the organization. The RRB is accountable for all aspects of supervision of the fully consolidated banking organization, including all subsidiaries and affiliates (domestic, foreign, and Edge corporations) of the organization for which the Federal Reserve has supervisory oversight responsibility. (See SR-05-27/CA-05-11.)

5000.0.3 INTERAGENCY INSPECTION OR EXAMINATION AGREEMENTS

To ensure continuing close coordination and consistency in the examination and supervision of banking organizations, the three federal bank regulatory agencies, that is, the Federal Reserve System, Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), have adopted expectations intended to enhance the interagency supervision of BHCs and their bank and nonbank subsidiaries.

5000.0.3.1 Interagency Policy Statement on Examination Coordination

On June 10, 1993, an interagency policy statement was developed to strengthen coordination and cooperation among the federal banking agencies responsible for examining and supervising depository institutions and their holding companies, thus minimizing the disruptions and burdens associated with the examination process. The policy expands on existing interagency agreements. (See SR-93-30.)

5000.0.3.1.1 Primary Supervisory and Coordination Responsibility

Examinations or inspections of a particular legal entity are to be conducted by the federal regulatory agency that has primary supervisory authority for that entity. In carrying out its supervisory responsibilities for a particular entity within a banking organization, each regulatory agency, to the extent possible, is to rely on examinations or inspections conducted by the primary regulator of the affiliate, thereby avoiding unnecessary duplication and unnecessary disruption of the banking organization. In certain situations, however, it may be necessary for a regulatory agency other than the entity's primary supervisory authority to participate in the examination or inspection in order to fulfill its regulatory responsibilities.

Primary supervisory authority and coordination responsibilities are organized as follows:

OCC national banks, federal savings associations

FDIC state nonmember banks, state savings associations

FRB parent BHCs, nonbank subsidiaries of BHCs, the consolidated BHC, FHCs, SLHCs, and state member banks

The primary federal regulator is responsible for scheduling, staffing, and setting the scope of supervisory activities, including coordinating formal and informal *administrative* actions, as necessary. In fulfilling these responsibilities, the primary regulatory agency is to consult closely with the other appropriate agencies when there is need for coordination.

5000.0.3.1.2 Overview of Examination Coordination and Implementation Guidelines

The agencies are to make every effort to coordinate the examinations and the inspections of banking organizations. Coordinated examinations and inspections may not be practical in all cases because of resource constraints, serious scheduling conflicts, or geographic considerations; however, particular emphasis will be placed on coordinating examinations and inspections of banking organizations with over $10 billion in consolidated assets and those banking organizations (generally, with assets in excess of $1 billion) that exhibit financial weaknesses.

5000.0.3.1.3 Coordinating the Planning, Timing, and Scope of Examinations and Inspections

When multiple regulators have authority over a legal entity, representatives from the appropriate supervisory offices should, if necessary, meet quarterly to discuss supervisory strategies for specific banking organizations. They should meet at least annually to review and establish examination and inspection schedules, to plan for the next year, and to consider the need for coordination in the following areas:

1. sharing the strategy and scope of each examination or inspection
2. determining if agencies other than the primary regulator of a particular entity should participate in the examination or inspection of that entity
3. determining whether a consolidated request letter should be prepared to avoid duplicative information requests
4. sharing workpapers and resultant findings and conclusions from prior examinations and inspections
5. other areas as necessary

5000.0.3.1.4 Interagency Review of Bank, Nonbank, and Parent-Company Activities

Certain functions and procedures—such as internal audit, credit review, and the procedures for determining the allowance for loan and lease losses—transcend the boundaries that distinguish legal entities. Such functions and procedures may be located at the bank or holding company level. The primary regulator of the depository institution and the holding company both may have supervisory responsibility to assess such functions. In these cases, coordinated and concurrent examinations or inspections should be conducted to avoid duplicative reviews and unnecessary disruption.

The primary regulator of the entity being examined or inspected should take the lead in a coordinated examination or inspection, unless there is an agreement that another agency will serve as the lead agency. The responsibilities of the lead agency, in consultation with other appropriate agencies, include developing the scope of the examination or inspection and determining the staff requirements. The lead agency will also coordinate scheduling of the examination or inspection and the presentation of examination or inspection findings to the appropriate management.

5000.0.3.1.5 Joint Meetings Between Regulators and Bank or BHC Management

At the conclusion of examinations or inspections conducted under the guidelines, the agencies should coordinate and plan joint meetings with the board of directors to discuss the findings and conclusions. The agencies will coordinate responsibility as outlined in the guidelines.

5000.0.3.1.6 Significant Differences in Agencies' Findings, Conclusions, and Recommendations

Before examination or inspection results are forwarded to management or boards of directors, every effort should be made to resolve any significant differences in major findings, conclusions, and recommendations. These differences should be resolved by examiners or officials at the regional level within 10 business days of identification. If the regional offices cannot resolve the matter, it should be referred to the national level, where it will be resolved within a reasonable time frame.

5000.0.3.1.7 Inspection and Examination Reports

The primary regulator should prepare the formal report of examination or inspection covering the entity for which it is the primary federal regulator. The primary regulator will also prepare the report when it serves as the lead agency. The report should be addressed and transmitted to the directors of the entity for which the regulator is the primary federal supervisory authority. The report may also be sent to the directors of other entities that have a need for the information. The agencies may agree, if necessary and appropriate, to prepare a joint report.

5000.0.3.1.8 Coordinating Information Requests

Any request for information to be obtained from an entity for supervisory purposes should normally be made through the entity's primary regulator. The primary regulator should also share relevant supervisory information with the other appropriate regulatory agencies.

5000.0.3.1.9 Coordinating Enforcement Actions

When one or more regulatory agencies are contemplating an enforcement action, the agencies should consider initiating a joint enforcement action to address and correct deficiencies within a banking organization. *At a minimum,* each agency considering enforcement action should inform the other agencies. This provision reaffirms the existing interagency enforcement agreement. (See SR-18-4 / CA-18-5.)

5000.0.3.1.10 State Banking Departments

The agencies will endeavor to coordinate with state banking departments, when appropriate and feasible.

5000.0.4 POLICY FOR COMMUNICATING PROBLEMS OF SUPERVISORY CONCERN TO MANAGEMENT AND BOARDS OF DIRECTORS

5000.0.4.1 Introduction

On October 7, 1985, the Board announced a second policy to strengthen and formalize practices for communicating the findings of examinations or inspections to management and boards of directors and to set out guidelines for such meetings. The policy—

1. establishes specific criteria for determining which examination findings require follow-up meetings with boards of directors and sets out guidelines for such meetings,
2. requires that, in addition to providing a complete examination or inspection report to the bank or BHC, a written summary of findings be sent to the bank or BHC for distribution to each director, and requires that senior Reserve Bank officials become more involved in presenting examination findings to boards of directors, and
3. requires that senior Reserve Bank officials become more involved in presenting examination findings to boards of directors.

The policy was effective immediately, with initial implementation on January 1, 1986.

5000.0.4.2 Meetings with Directors

The decision to hold a meeting with the board of directors at the conclusion of a state member bank examination or a BHC inspection is to be determined on the basis of the organization's financial condition, its size, the type of examination or inspection conducted, and other factors that, in the judgment of the Reserve Bank, indicate the need for a meeting. To the extent possible, meetings with the boards of directors of state member banks should include representatives of the state banking department. When appropriate, meetings with the boards of BHCs may be held jointly with the meeting of the lead bank subsidiary's board of directors and the bank's primary federal or state bank supervisor.

5000.0.4.2.1 Criteria for Conducting Meetings

5000.0.4.2.1.1 Condition

For those BHCs with consolidated assets of $1 billion or more, a meeting with the board of directors is to be held at the conclusion of any full-scope inspection in which a BHC is rated composite 4 or 5. A meeting between Reserve Bank staff and the board of directors to communicate findings is not required for—

1. complex holding companies with consolidated assets of less than $1 billion; and
2. noncomplex holding companies with consolidated assets of less than $1 billion that have a subsidiary depository institution in less-than-satisfactory condition, or with a less-than-satisfactory risk-management rating, or where a material supervisory issue is otherwise indicated.

However, a meeting should be conducted between Reserve Bank staff and the board of directors to communicate findings when supervisory concerns warrant such action.

Except for the above situation, meetings are required if an organization is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since the previous examination or inspection in which it received a composite 3 rating.[5] A meeting should also be held with all these organizations following a limited-scope or targeted examination or inspection, if deemed appropriate and desirable by the Reserve Bank. (See SR-95-19.)

5000.0.4.2.1.2 Size

A meeting will be required at the conclusion of a full-scope examination or inspection of all multinational organizations and major regional organizations with assets in excess of $5 billion. Reserve Banks are also encouraged to conduct such meetings at the conclusion of a full-scope examination or inspection of regional institutions with assets of $1 billion or more.

5. Reserve Banks also are encouraged to hold a meeting at the conclusion of a full-scope inspection (1) for an organization with assets of $1 billion or more rated composite 2 if its condition appears to be deteriorating and (2) for an organization rated composite 3, even if showing some improvement.

5000.0.4.2.1.3 Guidelines for Meetings

Meetings with boards of directors will have to be tailored to meet the needs of each specific situation. In general, meetings with the full board are preferred, but in certain cases the Reserve Bank may determine that a meeting with a committee of the board of directors, such as the executive or audit committee, will serve adequately. In all cases, however, the written summary of examination or inspection findings is to be provided to each member of an organization's board of directors.

For BHCs with consolidated assets of $1 billion or more, the Reserve Bank's presentation to the board should ordinarily be chaired by a Reserve Bank official, with the examination staff in attendance. The larger the organization or the more serious its problem, the more senior the Federal Reserve official should be.

Reserve Bank presidents are expected to become directly involved in the supervision of multinational organizations and regional institutions with more than $5 billion in assets that have been rated composite 3, 4, or 5. Reserve Banks have the discretion to determine the circumstances under which the participation of Reserve Bank presidents is appropriate and necessary. It may be necessary for the Reserve Bank president to meet with the board of directors and become involved in other ways; the precise nature of involvement will depend on the situation.

A meeting with the board of directors should include a formal, structured presentation containing a clear statement that an institution is considered a "problem" institution or is about to become a problem institution if existing conditions deteriorate.[6] The use of slides, other visual aids, and hard-copy handouts is encouraged. Information should also be presented on financial trends and peer-group comparisons. The presentation should make clear the nature of problems uncovered, such as—

1. deficiencies in capital, asset quality, earnings, or liquidity;
2. violations of law;
3. inadequacies in policies, practices, and reporting systems necessary for the proper administration of the organization;

6. As has been long-standing Federal Reserve practice, the exact composite or component ratings assigned in the examination or inspection are not to be disclosed to persons other than the directors or senior management.

4. the lack of well-documented lending, collection, investment, and liability-management policies;
5. the failure of management to address previously discussed deficiencies;
6. the lack of reporting systems sufficient to keep senior management and the board of directors fully informed; and
7. the failure of the board of directors to participate in the active management of the organization.

5000.0.5 COMBINED EXAMINATION/INSPECTION REPORT FOR BHCs WITH LEAD STATE MEMBER BANKS

Reserve Banks are permitted, under the circumstances and procedures specified in SR-94-46, to issue a combined report for a BHC and its lead state member bank subsidiary. A letter should be sent to the qualified holding companies that explains their option of receiving a combined report. The combined report may be issued when—

1. a BHC's lead bank subsidiary is a state member bank,[7] and
2. the holding company's board of directors formally approves, by board resolution, a combined report being released to its lead state member bank subsidiary.

A combined examination/inspection report format is attached to SR-94-46. At a minimum, a combined report will contain all examination report pages required by the interagency bank examination report instructions as well as information on the parent holding company, its bank and nonbank subsidiaries, and the consolidated BHC organization. For detailed information on required and optional report pages, see the *Commercial Bank Examination Manual.*

Separate examination and inspection Supervisory Information System (SIS) entries are required for each combined report. The combined report's cover page is to be green, must provide BHC and Bank RSSD numbers, and must clearly indicate that the report is a combined report.[8]

7. In cases in which the company has more than one state member bank, separate examination reports should be prepared for all other state member bank subsidiaries.

8. Research, Statistics, Supervision and Regulation, and Discount and Credit (RSSD)

5040.0.1 OBJECTIVES

The limited-scope inspection will review all areas of activity covered by a full-scope inspection report but less intensively.

5040.0.2 IMPLEMENTATION GUIDELINES

The ultimate responsibility for determining the appropriateness of the limited scope, and the actual elements of the scope of the inspection beyond the guidelines, rests with the Reserve Bank.

Certain report pages are required to be included in the limited-scope inspection. Other pages are required when certain events trigger their applicability, "exception (E)" pages. Pages not required may be included at the Reserve Bank's option. These are labeled as "optional" pages.

5040.0.2.1 Required Report Pages

As in the full-scope inspection report,[1] the limited-scope inspection report is divided into three parts: a core section, a section consisting of report pages that provide support to the core section, and a confidential section.

Core section. The core section of the report serves as the main vehicle for communicating the results of the inspection to management. The core pages contain the scope of the inspection, comments on administration of policies and supervision over subsidiaries, and an analysis of the RFI/C(D) rating components (see section 4070.0), any or all of which could be used to support supervisory action, when necessary.

Support section. The supporting report pages contain narrative and financial and other data to support the analyses in the core section. The *required* pages provide the primary statistical support when addressing important supervisory problems or issues, and as appropriate, the RFI/C(D) rating, or supervisory action, when needed.

Confidential section. The pages in this section are also required since they address matters of supervisory importance and other matters not deemed appropriate in the open section.

For a limited-scope inspection, the following report pages are *required:*

Manual Section No.	*Page Location*	*Page Title*
5010.2		Cover (FR 1427)
5010.3	Page i	Table of Contents
5010.4	Core Page 1	Examiner's Comments
5010.5	Core Page 2	Scope of Inspection
5010.41	Confidential Page B	Condition of the BHC

The Directors' Summary Report will be required as in the full-scope inspection. Appropriate information provided by other reporting vehicles, inspection/examination activities, or other financial institution regulatory agencies should be considered. Refer to footnote 3 for further guidance as to the need for a Directors' Summary Report.

1. The basis for the limited-scope inspection report will be the "large" report, FR 1225.

5040.0.2.2 Exception Limited-Scope Report Pages

The following "exception (E)" pages should be included in the report as indicated below:

Manual Section No.	*Page Location*	*Page Title*
5010.6	Core Page 3	Structure and Abbreviations
5010.7	Core Page 4	Analysis of Financial Factors
5010.10	Core Page 7	Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems
5010.11	Core Page 8	Consolidated Comparative Balance Sheet
5010.12	Core Page 9	Comparative Statement of Income and Expenses (Consolidated)
5010.13	Core Page 11*	Capital Structure (Consolidated)[2]
5010.14	Page	Policies and Supervision
5010.15	Page	Violations
5010.16	Page	Other Matters
5010.17	Page*	Classified Assets and Capital Ratios of Subsidiary Banks
5010.19	Page*	History and Structure
5010.27	Page	Cash Flow Statement (Parent)
5010.28	Page	Parent Company Liquidity Position
5010.29	Page*	Parent Company and Nonbank Assets Subject to Classification
5010.31	Page*	Nonbank Subsidiary
5020.2	Page	Other Supervisory Issues
5010.40	Confidential Page A*	Principal Officers and Directors
5010.43	Confidential Page D	Administrative Matters

Pages with an (*) are optional if the limited-scope inspection is preceded by a full-scope inspection within the same annual period.

2. The corresponding FR 1241 page may be used if the basis is to be a lead bank subsidiary rather than on a consolidated position.

5040.0.2.2.1 Reasoning for Including "E" Pages

The "E" pages are included when the activities are present, or have been disclosed through the inspection process, or when significant findings or issues must be reported and communicated to management or to the appropriate supervising agency(ies). The limited-scope inspection report may include, at the discretion of the appropriate Reserve Bank, copies of the Bank Holding Company Financial Statements (FR Y-9) and Reports of Condition of Subsidiary Banks in place of pages containing required or optional financial statements. The FR Y-9 statements or the Reports of Condition should only be included when the financial statements accurately represent the condition of the bank holding company as determined during the inspection.

5040.0.2.3 Optional Limited-Scope Report Pages

In the limited-scope inspection, several pages have been labeled as optional because of the nonexistence of an activity or the absence of a problem in that area. Any inspection report page may be included in the report at the option of the Reserve Bank or the examiner-in-charge. Note that the "Commercial Paper" and related pages (5010.21 through 5010.23) are optional since the existence of this activity would be a "complex" organization, requiring a full-scope inspection within the same annual period.

The *optional* pages are:

Manual Section No.	*Page Location*	*Page Title*
5010.8	Core Page 5	Parent Company Comparative Balance Sheet
5010.9	Core Page 6	Comparative Statement of Income and Expenses (Parent)
5010.18	Page	Organization Chart
5010.20	Page	Investment in and Advances to Subsidiaries
5010.21	Page	Commercial Paper (Parent)
5010.22	Page	Lines of Credit (Parent)
5010.23	Page	Commercial Paper and Lines of Credit (Parent)
5010.24	Page	Contingent Liabilities and Schedule of Balance Sheet Accounts Not Detailed Elsewhere (Parent)
5010.25	Page	Statement of Changes in Stockholders' Equity
5010.26	Page	Income from Subsidiaries (Fiscal and Interim)
5010.30	Page	Bank Subsidiaries
5010.32	Page	Nonbank Subsidiary Financial Statements and Condition
5010.33	Page	Fidelity and Other Indemnity Insurance
5010.34	Page	Audit Program
5010.37	Page	Interest Rate Sensitivity—Assets and Liabilities
5010.42	Confidential Page C	Liquidity and Debt Information

5040.0.3 LIMITED-SCOPE INSPECTION PROCEDURES

Procedure:	Complete FR 1417 and indicate that the scope was limited ("L").
Nature of Inspection:	Disclose on the "Scope of Inspection" page that the scope is limited, including any additional procedures utilized for a certain area or activity during the inspection that might be comparable to a full-scope inspection.
Directors' Summary:	Required under the same conditions as in the full scope.[3]
Rating:	Assign RFI/C(D) rating (see section 4070.0) as appropriate. Indicate under what circumstances the rating was assigned and what components were changed, including the reasons why they were changed.
Inspection Cover:	Cover will designate "limited" scope (FR 1427) and will be a designated color other than the full-scope reports.

3. Should generally be prepared in accordance with the requirement for the preparation of written reports to directors summarizing the inspection finding following a full-scope inspection. Reserve Banks that have previously identified the problems and provided a report to the directors are not required to prepare the summary for the limited-scope inspection.

5040.0.4 LIMITED-SCOPE INSPECTION REPORT COVER (FR 1427)

FR 1427–Cover
(Revised 7/08)

REPORT OF
BANK HOLDING COMPANY
INSPECTION
(Limited Scope)

Name: ______________________

Location: ______________________

RSSD ID Number: ______________________

Inspection Commenced: ______________________

Inspection Concluded: ______________________

Inspection Date: ______________________

THIS REPORT OF INSPECTION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is furnished to directors and management for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 USC 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR 261.20). Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors. Any unauthorized disclosure of the report may subject the person or persons disclosing or receiving such information to the penalties of Section 641 of the U.S. Criminal Code (18 USC 641). Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this report. In making this review, it should be noted that this report is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF

5050.0.1 OBJECTIVES OF A TARGETED INSPECTION

A targeted inspection is designed to focus intensively on one or more specific areas, activities, or problems relating to a bank holding company. Such inspections may be conducted for various reasons, including serving as a complement to an annual full-scope inspection.[1] Targeted inspections are conducted as directed by the System or at the discretion of the individual Reserve Banks. As a minimum, the inspection procedures used are comparable to a full-scope inspection.

1. FR 1225 will serve as the basis for a targeted inspection.

Report Pages Included:	Cover (FR 1428)
	Table of Contents for included pages and a key for abbreviations used in the report
	Examiner's Comments
	Scope of Inspection
	Other report pages supporting the scope, and the nature of the targeted inspection, as deemed appropriate by the Reserve Bank and the examiner-in-charge.
	Confidential pages consisting of confidential page B, "Condition of the Bank Holding Company," and confidential page D, "Administrative Matters."
Nature of Inspection:	Disclose on the "Scope of Inspection" that the scope is targeted and describe the procedures utilized for the targeted areas or activities.
Directors' Summary:	Required as prescribed in the full scope.[2]
Rating:	A new RFI/C(D) *composite rating* of 1 through 5 would only be assigned if the bank holding company inspection results provide sufficient information to either reaffirm or modify the most recently assigned RFI/C(D) composite rating. At least one component area must be rated between 1 and 5 in order to assign a new composite rating; otherwise, a composite rating of 0 should be assigned.

2. Should generally be prepared in accordance with the requirement for the preparation of written reports to directors summarizing the inspection's findings following a full-scope inspection. Reserve Banks that have previously identified the problems and provided a summary report to the directors are not required to prepare the summary for the targeted inspection.

5050.0.2 TARGETED INSPECTION REPORT COVER (FR 1428)

FR 1428–Cover
(Revised 7/08)

REPORT OF BANK HOLDING COMPANY INSPECTION
(Targeted Scope)

Name: ____________________

Location: ____________________

RSSD ID Number: ____________________

Inspection Commenced: ____________________

Inspection Concluded: ____________________

Inspection Date: ____________________

THIS REPORT OF INSPECTION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is furnished to directors and management for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 USC 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR 261.20). Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors. Any unauthorized disclosure of the report may subject the person or persons disclosing or receiving such information to the penalties of Section 641 of the U.S. Criminal Code (18 USC 641). Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this report. In making this review, it should be noted that this report is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF

A management information system (MIS) can be described as an automatic data processing system designed to aid in the performance of management functions. The MIS system is used in the decision-making process, which facilitates the collection and presentation of information to plan, organize, and control activities within the confines of the organizational culture. MIS encompasses the policies, procedures, and internal controls pertaining to management reporting which provide the information needed by the board to monitor and ensure control of operations and activities. MIS supports all levels of the organization in the execution of their duties—from the board of directors down to the lowest level of management within the company. A successful MIS will support the strategic direction of the company and promote the process by which decisions are made.

The objective of a targeted MIS inspection is to determine if the corporation has in place a management information system which is capable of providing its board of directors and senior management committees with sufficient, reliable, and timely data from which informed decisions can be made to monitor and manage risks. As a result, the targeted inspection uses a "top-down" approach, which focuses on the information used by the board and senior management committees and on the overall MIS architecture. For further inspection guidance, see the MIS sections 2060.0 to 2060.5 and SR-95-45 and its exhibits. The MIS supporting other levels of management should be reviewed during subsequent bank holding company inspections.

A targeted MIS inspection should be performed in companies in which there has been a notable alteration in the risk profile or aggressive expansion, or in which significant changes in information systems have occurred. This will ensure that executive management and the board have taken into consideration MIS and its ability to keep up with the changes in the organization. It should be noted that there is no one management reporting system. Depending on the structure of the organization, the activities that it engages in, the risk profile that results, and the technological environment that it operates under, MIS will be different in each bank holding company.

A key element of a successful MIS is the creation of the necessary technological support system. Since MIS is the primary tool for executive management and the board to monitor risk and measure performance, it is vital that the generated reports are accurate, provide sufficient information, and address all areas of the organization. Thus, data integrity is a key factor in analyzing the MIS process; inaccurate data can lead to faulty conclusions by management and the board. In addition, information flows to the top level of the organization should be comprehensive enough to allow for informed decisions. An overload of trivial information can cause confusion and slow the decision-making process.

The MIS inspection process focuses on three broad areas:

1. Relevance and Use of MIS
   - overall risk assessment of the corporation
   - identification of risk responsibilities and reporting lines within the organization
   - evaluation of the quality and relevancy of MIS reports
2. Internal Controls over MIS Integrity
   - identification of information flows and internal control points
   - evaluation of internal controls over information flows
   - evaluation of the report-development process and contingency plans
3. MIS Architecture and Planning
   - analysis of corporate strategic and technology plans, and the effect of their interrelationship on MIS
   - identification of the system architecture, including planned enhancements, and its effect on MIS
   - evaluation of the capability of system architecture to assimilate acquired organizations and the subsequent effect on MIS

The targeted MIS inspection evaluates the information flows to senior management and the computer or manual systems which support them. Bank holding company inspections place emphasis on reports generated by MIS rather than on the process by which they are created.

Management information systems are made up of various subsystems and will generally be unique to the organization. MIS will be influenced by the structure of the organization, its activities, its risk profile, and its technological capabilities. The targeted MIS inspection guidelines and procedures focus on the three broad areas outlined above and provide examiners with guidance on how to evaluate a bank holding company's MIS process.

5052.0.1 RELEVANCY AND USE OF MIS

Management information requirements will be determined by the size and complexity of an organization's operations. As an organization grows in size and its operations become more complex, management must recognize that information needs change. In addition, strategic goals may dictate a change in the focus of the company, requiring revisions in data collection and presentation. Guidelines and requirements for reports that flow to executive management and the board should be established, recognizing, however, that different levels of the organization have different informational needs.

The effectiveness of MIS has to be analyzed in terms of its ability to assist executive management and the board in identifying, monitoring, and controlling risks throughout the organization. Reports should be analyzed for quality, timeliness, and consistency. They should provide coverage of the major areas in the institution and communicate information clearly and concisely. An organization might have a comprehensive MIS, but if pertinent information is not flowing to executive management and the board of directors, the system is not effective.

Information must be presented in a summarized form, which is easy to read and understand. Procedures must be in place to allow for rapid collection and assimilation of data allowing for timely presentation to executive management and the board. The presentation of data should be consistent from one period to another to avoid any undue confusion. Changes in format need to be agreed on by all users of the report before implementation. Data should cover all areas of risk within the organization and provide comparisons to enable executive management and the board to measure performance.

An assessment of the executive management committee and board members should be performed. A review of reporting lines should also be performed. (See section 2060.4.)

5052.0.2 INTERNAL CONTROLS OVER MIS INTEGRITY

The review of data integrity of reports to the board of directors and executive management committee is essential to ensure that information flows are accurate and that reports are consistently prepared. For each report reviewed, the flow of information through MIS must be identified, including computer platforms, applications software, and interrelationships with other computer systems. Controls such as data entry and modification, data security, disaster recovery, back-up, and program changes should be assessed. Any points in the system where manual intervention occurs should be identified, and information on the flexibility of the system should be obtained.

The procedures used to assess the data integrity controls will vary depending on the nature of the computer platform and application software and on the amount of manual intervention required to produce the report. However, in all cases, the assessment of MIS data integrity controls should begin with a review of the results of prior inspections and the result of internal and external audit reports. Previously identified deficiencies that have not been corrected can affect the integrity of current data.

Reports produced by a mainframe application system should have controls within the mainframe environment and in the application system used to produce the report. These controls are reviewed during EDP examinations and periodic EDP audits. These examination and audit reports should be used as leverage during the MIS inspection, and the current status of deficiencies noted should be ascertained through discussions with internal auditors and management.

Reports may also be produced by personal computers using spreadsheet and other office-product software in a distributed processing environment. Reviews of distributed processing systems require interviews with the persons responsible for preparing the reports. Any instances of manual intervention in such an environment must be identified and evaluated. The most recent EDP examination report should also be reviewed for any deficiencies noted in the bank holding company's microcomputer policies and procedures. A review of internal audit reports for the applicable business area and discussions with audit personnel will reveal whether this PC/spreadsheet application has been audited recently.

5052.0.3 MIS ARCHITECTURE AND PLANNING

The business plan and the computer system's architecture plan should be designed to complement each other and must support the strategic plan. The business plan identifies the goals, target markets, and areas of risk of the organization. The architecture plan describes the corporate technological plans for implementing the systems that will achieve the strategic and business goals, and it should include MIS.

Information is a valuable corporate asset. In a competitive banking environment, the ability to effectively manage this asset is crucial to a bank holding company's ability to remain competitive, introduce new products and services, and achieve desired goals. Therefore, the computer system's architecture plan should be developed in conjunction with its business plan. The architecture plan should ensure that mainframe processing and MIS are appropriately integrated and in place for the banking organization to achieve its strategic goals.

The dynamic and competitive banking and technology environments make effective planning critical. Reconcilement of the business and computer system's architecture plans is necessary to determine the effectiveness of the banking organization's planning process. With the proliferation of mergers and acquisitions in the financial industry, this process becomes more complicated. It is essential that management have a clear vision of its strategic and business goals and the technology required to achieve them if it is to effectively manage the divergent technologies that may be inherited through mergers and acquisitions. Bank holding companies in this situation should decide which acquired systems will survive. Documentation should support management's decision, and formal conversion plans should be documented. Telecommunications, compatibility of systems, data integrity, capacity, contingency planning, and data security are especially critical in this situation and should be evaluated in the planning and conversion process.

Ultimately, the business and the computer system's architecture plans should support the strategic plan. If these plans do not complement one another, the ability of management to achieve its goals may be difficult.

5052.0.4 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, risk assessment, and controls, including board and executive management committees.
2. To assess the adequacy of the management reports generated for their timeliness, quality, accuracy, and coverage of crucial areas.
3. To evaluate reports in terms of their ability to measure the company's progress in meeting its financial and business goals, including the capability to produce forecasts using various scenarios.
4. To evaluate management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by the MIS, and the system's ability to adapt to change caused by regulatory and accounting issues or by other market conditions.
5. To determine if the policies, practices, procedures, and internal controls regarding management information systems and management reporting are adequate.
6. To evaluate the controls in place to ensure the integrity of the information within MIS, including data security, disaster recovery, and the system's development life cycle.
7. To determine if the functions of automated systems, reconcilement procedures, and reporting processes are completely understood by staff and that these functions are fully documented.
8. To ensure that an architecture plan exists that includes MIS and that it supports the business and strategic plans.
9. To determine if a management process exists for MIS planning, including organizational responsibility, development, and implementation.
10. To determine if a strategy exists for an effective consolidation of systems in the event of a merger or acquisition.
11. To recommend enhancements and/or corrective action when policies, practices, procedures, internal controls, or MIS are deficient.

5052.0.5 INSPECTION PROCEDURES

5052.0.5.1 General

1. Present the first-day request letter to executive management well in advance of the targeted inspection commencement date, allowing sufficient time for data collection (e.g., at least two weeks before). (See SR-95-45, exhibit A, for a sample first-day letter.) The examiner-in-charge should review the responses well in advance of the start of the inspection.
2. Solicit the cooperation of key senior officials

in organizing and conducting a meeting to discuss with them the identification, control, and reporting of identified risks within the various key operating areas of the bank holding company. Request that key senior management officials make or arrange for presentations during this meeting that will identify the major departments, functions, and activities within the organization and how MIS is used to identify and manage risk. (See SR-95-45, exhibit B.)
3. Draft the inspection report for participating examiners to review before the close of the on-site phase of the inspection, ensuring the inclusion of all relevant findings.

5052.0.5.2 Relevancy and Use of MIS

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls. Determine if there are any corporate policies specific to risk management or internal reporting requirements.
2. Review the board and executive management committee structure, including its membership, mission, and authority and the experience levels of the members.
3. Read board and committee minutes and obtain sample copies of the board and committee packets.
4. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors. Ask that copies of each of these *top-level* reports be attached to the listing.
   a. Review each listed report for timeliness, clarity, completeness, relevancy, and measurability.
   b. Analyze the management reports for information sufficient to measure the company's progress in meeting its financial and business goals, including the ability to produce various forecasting scenarios.
5. Identify management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Evaluate the system's ability to handle regulatory and accounting issues and to adapt to change.
6. Discuss the examiners' perceptions of MIS reports with executive management as to their timeliness, clarity, completeness, relevancy, and measurability.

5052.0.5.3 MIS Integrity and Internal Controls

1. Review and analyze any policies, procedures, and practices governing the corporation's MIS, including descriptions of existing controls to ensure data integrity throughout the system, disaster-recovery plans, and standardized procedures for the development and use of systems and applications.
2. Review the architecture of MIS. Determine whether there is a single MIS system or a number of related systems. Ascertain if MIS is produced by the mainframe, distributed processors, personal computers, or a combination of these systems. Identify the databases in use for MIS reporting.
3. For each board and executive management report identified, review and verify the flow of data through MIS to the reports, include all computer platforms and application software used. Identify risk points and the controls in place to ensure data integrity. (See SR-95-45, exhibit C for a suggested format.)
4. For each report, verify the controls over data input and the report-distribution process. Determine that sufficient controls are in place to reasonably ensure the accuracy and confidentiality of the data.
5. Review all internal and external audit, regulatory examination, and outside consultant reports concerning MIS since the previous inspection. Note any deficiencies and/or recommendations, and determine whether management has taken appropriate corrective action. Perform follow-up action on any unresolved issues.
6. Through discussions with management and other personnel, determine if any significant changes to MIS are planned. If so, obtain and document the details and analyze their potential effect on MIS integrity.

5052.0.5.4 MIS Architecture and Planning

1. Review the corporate strategic, business, and computer architecture plans, if applicable, to determine if the architecture plan supports the strategic and business goals. The business plan should reflect goals in support of the strategic plan, and any differences between these plans should be reconciled. If a reconcilement has not been performed, request that management complete one during the inspection. Otherwise, complete the reconcilement.

2. Request (or create) a conceptual overview model to identify the flow of information through the organization. (See SR-95-45, exhibit D.)
3. Evaluate management's conversion planning process by selecting a recently converted or consolidated MIS application for review. This application will be emphasized when completing other sections of the work program.
4. After determining the extent of merger and acquisition activity at the institution, review conversion plans and the methodology for consolidating systems and ascertain their effectiveness.
5. Review a copy of development plans for any significant MIS-related projects. Determine if they address cited MIS weaknesses, meet strategic and business goals of the organization, and are in compliance with established policies.
6. Discuss with executive management any inconsistencies among the business, system architecture, and strategic plans.

Examiners' access to automated databases that include supervisory data on state member banks (SMBs) and bank holding companies (BHCs) has been significantly enhanced. In addition, the increased availability of copiers, fax machines, and personal computers has made it possible for SMBs and BHCs to more easily transfer data to Reserve Banks. As a result, the volume of information on SMBs and BHCs available to examiners in Reserve Bank offices has been greatly augmented, and many inspection activities that have traditionally been conducted in the field can now be completed in Reserve Bank offices.

The option to complete certain inspection activities in Reserve Bank offices has various advantages. For example, examiners' ability to access automation resources, reference materials, and senior staff is much better in the office than on-site. In addition, in completing more activities off-site, Reserve Banks can reduce the burdens of on-site evaluations of SMBs and BHCs. Further, greater reliance on off-site work can allow Reserve Banks to reduce travel-related expenses.

5060.0.1 CONDUCTING INSPECTION ACTIVITIES IN RESERVE BANK OFFICES

Examiners should conduct in Reserve Bank offices all inspection activities that can be efficiently and effectively completed off-site. Activities that may be completed off-site include planning the inspection, reviewing historical information, completing preliminary financial analyses, and preparing certain report pages using data maintained at Reserve Bank offices. For additional information, see SR-95-13 (SUP) and SR 02-1.

When using this approach, examiners should contact BHCs by letter and ask them to forward to Reserve Bank offices financial and other information to be used in the off-site portion of the inspection. Most information that has traditionally been requested in first day letters and made available to examiners at the start of an inspection should be requested, with the exception of documents such as minute books or bulky printouts that would be inappropriate or impractical to have sent. While it is anticipated that this approach will be preferred to approaches that require a longer on-site examiner presence, BHCs are not required to be inspected under this approach and should be given the option to be inspected using traditional on-site approaches. Given the burdens imposed on BHCs to prepare and mail materials to Reserve Bank offices, Reserve Banks should also offer to pay the shipping costs and give adequate lead time in requesting materials.

In the cases of certain shell BHCs, Reserve Banks are authorized to complete all inspection activities off-site on an every-other-inspection basis. As noted above, however, these BHCs should be given the option to be inspected using the traditional on-site approach. Noncomplex shell bank holding companies (NCSBHCs)[1] with consolidated assets of less than $1 billion and that on their last inspection were rated RFI/C(D) 3 or better may be inspected off-site, subject to the following restrictions.

- If information becomes available to the Reserve Bank in the period between inspections suggesting that the condition of an organization is deteriorating significantly, an on-site inspection should be scheduled or commenced immediately if warranted.
- Deteriorating 3-rated BHCs are excluded and must be inspected on-site.
- When a BHC's lead bank subsidiary is an SMB, the inspection of the BHC should be carried out in the field concurrently with the examination of its lead bank.
- NCSBHCs in the same metropolitan statistical area as the Reserve Bank or its bank supervision staff should be inspected on-site unless there is good reason to do otherwise. Newly formed NCSBHCs or those that have recently undergone a change in control should also be inspected on-site.
- If a BHC is unable to forward the information necessary to conduct an off-site inspection, or if the company is assigned a RFI/C(D) rating of 4 or 5 or is determined to be a deteriorating 3-rated organization as a result of an off-site inspection, an on-site inspection should be scheduled or commenced immediately if warranted.
- Information requested from the NCSBHC should include all information typically requested in a first day letter, as well as copies from the company's general and subsidiary

1. Noncomplex shell bank holding companies are those companies with less than $1 billion in consolidated assets without credit-extending nonbank subsidiaries or debt held by the general public whose condition is predicated almost entirely on the condition of subsidiary banks.

ledgers that document all significant accounting entries made since the last on-site inspection, copies of cancelled checks written since the last on-site inspection, copies of the BHC's notes payable and receivable, copies of all agreements between the BHC and its bank subsidiaries, and any other information considered necessary to complete an off-site inspection of the institution.
- Findings on the BHC's condition and compliance with laws and regulations should be conveyed to management by telephone or, if the situation requires, in person at company or Reserve Bank offices. The examiner-in-charge should then complete an inspection report for transmission to the company.

5060.0.2 OFF- AND ON-SITE BHC INSPECTION PROCEDURES—APPENDIX 1

This appendix includes inspection procedures that can be completed in the Reserve Bank's offices and those procedures that should be conducted on-site. A sample first day letter information request form is included.

5060.0.2.1 Activities That Can Be Completed in the Office

Work to be performed in the office in preparation for a bank holding company inspection should include the—

- determination of the scope of inspection,
- completion of financial schedules and certain other pages, and
- review of historical financial and supervisory data leading to preparation of draft financial analyses (for example, parent, subsidiary banks, consolidated entity).

In addition, if centralized management functions (for example, investments, asset/liability management, internal audit, or loan review) are performed by the bank holding company, a preliminary understanding of these functions can be obtained in the office by reviewing policies, reports, and other relevant materials. Further, if the bank holding company has nonbank subsidiaries, the preliminary risk assessment mandated by SR-93-19 (see sections 5010.6.3 and 5010.31) can be performed in the office, based on information submitted by the institution.

5060.0.2.2 BHC Inspection Activities That Should Be Conducted On-Site

The following inspection activities are recommended and should continue to be performed at the bank holding company:

- review of credit and investment files at holding company and nonbank subsidiaries for quality, documentation, and compliance with policy, laws, and regulations;
- in-depth discussions with management;
- verification of selected financial information;
- review of selected tax workpapers, including the review of intercompany tax allocations;
- observation of operations and internal controls;
- collection of follow-up documentation to complete the financial analysis;
- review of documents such as minute books for the holding company and nonbank subsidiaries and bulky printouts that would be inappropriate or impractical to have sent to the Reserve Bank's office;
- exit meetings with management.

5060.0.2.3 Sample Information Request for a Bank Holding Company

Information To Be Sent to the Federal Reserve Bank

1. Exhibits A through N (See attachment #2, SR-95-13). Also, please assemble applicable workpapers that correspond to reported information for verification on-site.
2. The corporation's current legal-entity and management organization charts, detailing line and staff authority from the chairman of the board through the various division heads.
3. Copies of any strategic planning documents.
4. A copy of the most recent information package provided to the directors in connection with regular board meetings.
5. A copy of any other management reports that summarize the performance of the subsidiary banks.
6. Schedules of internal audits and internal loan reviews for the prior and current year. In addition, please furnish a copy of the most recent management letter provided to the corporation by its external auditing firm and management's formal response.
7. List of consolidated past-due, restructured, and nonaccrual loans and overdrafts; watch-list

report; and any results of internal loan-grading systems.

8. Loan-loss reserve adequacy evaluation (consolidated and lead bank). Include the most recent calculation for assessing the adequacy of the loan-loss reserve based on the organizations's internal methodology.

9. Risk-based capital analysis (consolidated and lead bank) for the most recent quarter-end and two prior year-ends, including workpapers. Break out guaranteed loans and loans secured by certificates of deposit. Also include the total amount and proportionate guarantee of each loan guaranteed by such entities as the FmHA, SBA, and VA.

10. Current and upcoming year's budgets (consolidated and lead bank).

11. A copy of any capital, dividend, or cash-flow plans or projections.

12. Most recent internal consolidated interest-rate-sensitivity analysis and liquidity analysis.

13. Parent-company consolidating entries and consolidated comparative financial statements as of the most recent quarter-end.

14. Parent-company-only comparative financial statements as of the most recent quarter-end.

15. The parent company's trial balance as of the most recent quarter-end.

16. Details of any items included in parent-company "other" assets, liabilities, income, or expense, which cannot be readily identified from the most recent quarter-end trial balance.

17. A summary of insurance coverage for the parent company and its subsidiaries. Please include a copy of the cover pages of each policy, along with the amount of coverage and expiration date. In addition, also indicate the most recent board approval of such coverage.

18. A detailed schedule of all consolidated borrowings as of the most recent quarter-end. Include the average interest rate paid on each type of borrowing.

19. For the parent company only, please provide the following information on all outstanding obligations: (a) amount outstanding, (b) lender (if publicly held, only note holders of greater than 10 percent), (c) origination and maturity dates, (d) interest rate and payable dates, (e) principal repayment schedule, and (f) reason for incurring debt.

20. A schedule of the fiduciary holdings of the parent company's stock and convertible debt by the parent's subsidiaries. Indicate the degree of investment authority the respective trust departments have over these shares.

21. Copies of all intercompany management and service agreements along with (1) the names of the staff members responsible for the administration of these activities and (2) documentation showing the basis of the assessments.

22. Litigation letter from the holding company's attornies relating to the status of all lawsuits in which the holding company or its subsidiaries is named defendant. If none, please submit a letter from an officer of the holding company indicating such.

23. A complete copy of all written policies that have been amended or adopted since the previous FRB inspection.

24. A copy of the bank's most recent Report of Condition and Income (call report), including the corresponding internal balance sheet and income statement (daily statement) for the lead bank.

25. Daily statement for the lead bank as of the inspection date.

26. Copies of any "key man" or "split-dollar" life insurance policies held at the holding company or the subsidiaries.

27. Copy of compensation agreements with subsidiary bank personnel who sell credit-related life insurance for the holding company, along with any tie-in policies, if applicable.

28. Copy of any other compensation arrangement either at the holding company or between the holding company and the subsidiary banks.

29. Most recent market-rate survey for local deposits at the lead bank.

30. For all nonbank subsidiaries, please provide (a) financial statements for the most recent quarter-end; (b) strategic plans; (c) directors' monthly reports; (d) internal audit reports; and (e) a trial balance of all credits, delinquency reports, nonperforming reports, and watch-listed loans for credit-extending subsidiaries.

Information To Be Provided at the Holding Company

31. Access to all written policies pertaining to specific operational areas (for example, due diligence/acquisitions, lending, funds management, tax allocation, and dividends).

32. Access to internal audit and internal loan review reports and workpapers.

33. Minutes of meetings of the board of directors, shareholders, and any committees. Please include a list of committees and their members, and fees paid to directors.

34. Holding company articles of incorporation and by-laws.

35. Stock register.

36. Access to federal tax returns filed since the most recent FRB inspection, along with workpapers. In addition, provide schedules of intercompany tax allocations for the corresponding periods, including projected allocations.

37. Access to parent company accounting records such as ledgers, journals, and check registers.

38. Access to monthly account-analysis statements for any parent company transaction accounts held at a subsidiary bank.

39. For all nonbank subsidiaries, please provide (a) directors' minutes; (b) annual budgets and cash flow projections; (c) checking account statements and check registers and/or cash receipts and disbursements registers; (d) a listing of directors and officers; and (e) access to credit policies and credit files for all nonbank credit-extending subsidiaries.

40. Access to due-diligence reports and workpapers and assimilation plans.

41. Any available information on local economic conditions.

5060.0.3 PROCEDURES FOR IMPLEMENTING OFF-SITE INSPECTIONS FOR CERTAIN SHELL BHCS—APPENDIX 2

This appendix includes procedures for implementing the program authorizing off-site inspections for certain shell BHCs. Listed below are general procedures that can be followed in implementing the program for off-site inspections of certain noncomplex shell bank holding companies (NCSBHCS). Sample documents are included that can be used in implementing the program, including examples of correspondence with eligible bank holding companies and a sample first day letter information request form.

5060.0.3.1 General Procedures for Off-Site Inspections

In implementing the program, Reserve banks should conform to the following procedures:

1. Senior management of bank holding companies should be notified before or early in the calendar year if their company qualifies for a full off-site inspection. They should also be informed that they may opt out of the off-site process and that, even if they choose to participate, the Reserve Bank may conduct the inspection on-site if conditions change or if, at some point during the year, examiners will be traveling to the company's vicinity to carry out other activities.

2. When the Reserve Bank is ready to conduct the off-site inspection, the holding company should be contacted by telephone, as well as by letter. An information request form should be attached to the letter.

3. After assigned examiners have reviewed information forwarded by the company, additional information may be requested by telephone or other means if deemed necessary. Once all necessary information has been received, the designated examiners should commence the off-site inspection.

4. Findings of the inspection should be conveyed to company management by telephone or, if the situation requires, at company or Reserve Bank offices.

5. The examiner-in-charge should then complete an inspection report for transmission to the company.

SAMPLE LETTER

Date:

BHC Official
BHC Name
Address

Dear BHC Official:

This year, the Federal Reserve Bank of New York will conduct off-site inspections of certain bank holding companies. Your company will be inspected during 19X0 and presently qualifies for an off-site review by our office.

As part of our off-site program, you will receive an information request form which must be completed and returned to the Reserve Bank. The Reserve Bank will reimburse you for postage expenses. The form requires responses to several questions, as well as submission of copies of certain holding company financial documents. Our examiners will review the information, complete their analysis, and discuss their findings with management, either by telephone conference or, if necessary, at the offices of your bank holding company. Following the off-site review, holding company management will receive a written report which will include the following:

- a description of the scope of the inspection;
- the examiner's presentation of the financial condition and performance of the parent company and the subsidiary bank;
- an evaluation of the company's compliance with laws and regulations; and
- the examiner's comments, conclusions, and recommendations.

We have found that the off-site inspection program has proved attractive to many banking organizations. However, participation is not mandatory. Therefore, if you do not wish to participate, please sign and mail the enclosed form by DATE. We do want to make it clear, however, that while we plan to conduct an off-site review of your company if you accept this proposal, we still may conduct an on-site inspection if conditions change or if examiners are otherwise in your vicinity.

Should you have any questions concerning the off-site inspection program, please contact OFFICE STAFF MEMBER at (800) ___-____, extension ____.

Sincerely,

Officer
Title

Enclosure

SAMPLE RESPONSE FORM

OFF-SITE INSPECTION PROGRAM
FEDERAL RESERVE BANK OF NEW YORK
RESPONSE FORM

We do not wish to participate in the off-site inspection program in 19X0.

Name of Company: ______________________________

City: ______________________________

State: ______________________________

Signed: ____________________

Title: ____________________

SAMPLE LETTER

Date:

BHC Official
BHC Name
Address

Dear BHC Official:

Pursuant to our telephone conversation of (Date), an off-site inspection of (BHC Name), will be conducted by our office. Please respond to each item of the information request form attached and complete the enclosed schedules. Please be aware that all items submitted for review will be retained by our office and not returned to the company. Therefore, it is advisable to submit copies of records rather than originals. Upon receipt of the items requested, we will reimburse your bank holding company for the postage expense.

In order for us to use the off-site program, you must submit a complete response to this information request no later than (Date). If we are unable to satisfactorily resolve any issues arising from your response to this request, or if the information contained in your response is substantially incomplete, we will schedule the company for an on-site inspection.

Upon review of the information submitted, we will contact you to schedule a meeting with our examiners. If you have any questions concerning the inspection process or the preparation of your responses, please contact (Office Staff Member) at (800) ___-____, extension ____.

Sincerely,

Name
Examiner

Enclosures

SAMPLE INFORMATION REQUEST FORM

BHC
OFF-SITE INSPECTION CONDUCTED AS OF
DATE __/__/__

INFORMATION REQUEST FORM

Please submit or provide responses to the following (if non-applicable, answer N/A):

1. Statements for the most recent quarter and the two latest fiscal years:

   A. Parent Company -- Balance Sheet

   B. Parent Company -- Income Statement

   C. Parent Company -- Statement of Changes in Stockholders' Equity

   D. Bank -- Reports of Condition and Income (most recent quarter only)

   E. Reconciliation of the parent company's "Investment in Bank" account to the subsidiary bank's "Stockholders' Equity" as reported in the Reports of Condition

2. The bank's daily statement and income and expense statement dated __/__/X0.

3. Projected cash flow worksheet for the year 19X1 (see attached form).

4. Excerpts from the company's general ledger and subsidiary ledgers containing all significant accounting entries since __/__/__.

5. Detail of any "other assets" or "other liabilities" accounts for the company, as well as "other income" or "other expense" items, presented in financial statements requested above IF the amounts exceed $500.

6. Details on any liabilities, contingent or otherwise, not appearing in the financial statements.

7. A copy of the company's bank statements and its check register and/or cancelled checks issued since __/__/__.

8. A copy of any notes payable and/or receivable of the bank holding company (including a copy of any related loan agreements) if they have been put in place or amended since the last inspection.*

*The last inspection of __(BHC Name)__ was conducted on __(Date)__.

SAMPLE INFORMATION REQUEST FORM—Continued

- 2 -

9. A copy of any agreements originating since the last inspection between the company and the bank, between stockholders, or between the bank holding company and the stockholders.

10. A list of changes of specific services performed by the holding company for the bank or for any other company since the last inspection. Also indicate the method for computing fees, provide copies of any relevant agreements, and provide documentation supporting any management/service fee assessments.

11. For any changes to the parent company's investments in stocks of companies OTHER THAN subsidiaries, a list of the (1) date of acquisition/sale, (2) number of shares acquired/sold, (3) resulting percentage ownership, and (4) nature of business engaged in by the subject company.

12. A copy of any internally prepared reports of problem loans and nonperforming assets for the banking organization.

13. A list of any stock issuances or redemptions by the company since the last inspection, including the issue/redemption date and price. Also, list all stockholders and their percentage interest in the holding company as of __/__/__.

14. A statement of the date and amount of any capital injections into the bank since the last inspection.

15. A copy of the minutes of all shareholders'/directors' meetings for the company held since the last inspection.

16. For each director of the holding company, provide his or her (1) date of birth, (2) date first elected to the board, (3) position in the bank holding company, (4) position in the bank, (5) principal occupation if different than bank or bank holding company officer, (6) ownership percentage in other financial institutions, and (7) positions in other financial institutions.

17. A statement of any material litigation affecting the company or the bank.

18. A list of all tax transactions since __/__/__. These transactions would include those between the bank and the holding company as well as any transactions with the tax authorities. (See attached example.)

19. A copy of the last two years' federal and state income tax returns, including any amendments.

20. A copy of your accountant's workpapers showing the calculation of the holding company tax benefit or liability for the last two years.

SAMPLE INFORMATION REQUEST FORM—Continued

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21. If the parent company filed for a tax loss carryback in the last two years, provide documents filed with the IRS and related prior-year tax returns.

22. A copy of the tax sharing agreement between the bank holding company and its bank subsidiary if amended or redated since the last inspection.

23. The date of the last IRS audit of the bank holding company's tax returns, an identification of the tax periods covered in the audit, and an indication of whether any assessments or refunds remain unsettled.

24. A copy of the bank's current year budget and operating projections, if available.

25. If the subsidiary bank maintains a correspondent balance at any creditor bank of the holding company, copies of (1) the monthly analysis of the account provided by the correspondent for the last 12 months, (2) any agreement whereby the loan to the holding company is contingent on the subsidiary bank maintaining such a balance, and (3) an explanation if the balances maintained by the subsidiary bank exceed the level required for services received.

26. If any Employee Stock Ownership Plan (ESOP) owns stock in the holding company, provide copies of (1) the ESOP plan and trustee agreement; (2) the ESOP's current balance sheet; (3) the independent appraisal used to determine the value of the holding company stock purchased by the ESOP; (4) any note payable, security agreement, loan agreement, and guarantees. Also provide (1) the date the plan was accepted by the IRS; (2) a description of the ESOP's current investments, including the date they were purchased and their cost; (3) the names of the individuals who have the power to vote the ESOP's stock; (4) a list of individuals having the power to make investments for the ESOP; and (5) a list of the beneficiaries of the ESOP.

27. Copies of the articles of incorporation and by-laws for the bank holding company, if amended since the last inspection.

28. If the holding company is selling insurance, list the (1) licensed agents employed by the company; (2) compensation received by each agent; (3) method for determining compensation; (4) a description of how customers of the bank are informed that they are not obligated to purchase insurance from the holding company in order to obtain credit; and (5) a breakdown of insurance accounts receivable, past due more than 90 days.

SAMPLE INFORMATION REQUEST FORM—Continued

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29. If the subsidiary bank is providing the holding company with either personnel or facilities for the sale of insurance or any noninsured investment products, a statement indicating whether the subsidiary bank is reimbursed for its expenses. If the bank is reimbursed, a description of the method used to determine such amounts. Indicate when this reimbursement method was approved by the respective boards of directors.

30. If the holding company is involved in the sale of any non-insured investment products such as annuities or mutual funds, describe the program including any arrangements that involve the use of third-party brokers. If the holding company receives any share of the related commissions or lease income or if employees of the holding company or a nonbank subsidiary of the holding company are involved in the program, please describe.

31. Copies of the dividend policies of the holding company and the subsidiary bank. If no written policy exists, provide a description of the methods used to determine the amount of dividends paid by the bank holding company or any of its subsidiaries.

32. The dates and amounts of dividends paid by the subsidiary bank since the last quarter-end.

33. A description of any changes made to the holding company's audit and/or credit review programs.

34. Details of any directors and officers liability insurance maintained by the organization or indemnification provisions adopted by the bank or bank holding company.

35. For banker's blanket bond and excess fidelity bond coverage, please provide (1) name of surety; (2) form number; (3) primary and excess amount of coverage; (4) expiration date; (5) name of insured; (6) an indication of whether all officers and employees of the holding company, bank, and any nonbank subsidiaries are covered; (7) the date the insurance coverage was last approved by the bank holding company's board of directors and the bank's board of directors; and (8) a description of how insurance premiums are allocated among the entities of the organization.

36. Details of any significant transactions since __/__/__ not already described in responses to the above questions.