

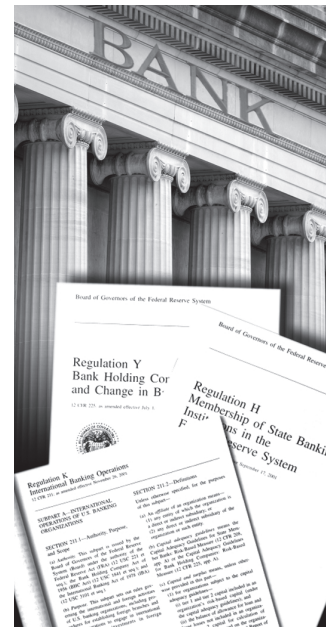
## 5 Supervision and Regulation

*The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions. As the U.S. central bank, the Federal Reserve also has extensive and well-established relationships with the central banks and financial supervisors of other countries, which enables it to coordinate its actions with those of other countries when managing international financial crises and supervising institutions with a substantial international presence.*

The Federal Reserve has responsibility for supervising and regulating the following segments of the banking industry to ensure safe and sound banking practices and compliance with banking laws:

- bank holding companies, including diversified financial holding companies formed under the Gramm-Leach-Bliley Act of 1999 and foreign banks with U.S. operations
- state-chartered banks that are members of the Federal Reserve System (state member banks)
- foreign branches of member banks
- Edge and agreement corporations, through which U.S. banking organizations may conduct international banking activities
- U.S. state-licensed branches, agencies, and representative offices of foreign banks
- nonbanking activities of foreign banks

Although the terms *bank supervision* and *bank regulation* are often used interchangeably, they actually refer to distinct, but complementary, activities. Bank supervision involves the monitoring, inspecting, and examining of banking organizations to assess their condition and their compliance with relevant laws and regulations. When a banking organization within the Federal Reserve's supervisory jurisdiction is found to be noncompliant or to have other problems, the Federal Reserve may use its supervisory authority to take formal or informal action to have the organization correct the problems.



Bank regulation entails issuing specific regulations and guidelines governing the operations, activities, and acquisitions of banking organizations.

## Responsibilities of the Federal Banking Agencies

*The primary supervisor of a domestic banking institution is generally determined by the type of institution that it is and the governmental authority that granted it permission to commence business.*

The Federal Reserve shares supervisory and regulatory responsibilities for domestic banking institutions with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level, and with the banking departments of the various states. The primary supervisor of a domestic banking institution is generally determined by the type of institution that it is and the governmental authority that granted it permission to commence business (commonly referred to as a charter). Banks that are chartered by a state government are referred to as state banks; banks that are chartered by the OCC, which is a bureau of the Department of the Treasury, are referred to as national banks.

The Federal Reserve has primary supervisory authority for state banks that elect to become members of the Federal Reserve System (state member banks). State banks that are not members of the Federal Reserve System (state nonmember banks) are supervised by the FDIC. In addition to being supervised by the Federal Reserve or FDIC, all state banks are supervised by their chartering state. The OCC supervises national banks. All national banks must become members of the Federal Reserve System. This dual federal–state banking system has evolved partly out of the complexity of the U.S. financial system, with its many kinds of depository institutions and numerous chartering authorities. It has also resulted from a wide variety of federal and state laws and regulations designed to remedy problems that the U.S. commercial banking system has faced over its history.

Banks are often owned or controlled by another company. These companies are referred to as bank holding companies. The Federal Reserve has supervisory authority for all bank holding companies, regardless of whether the subsidiary bank of the holding company is a national bank, state member bank, or state nonmember bank.

Savings associations, another type of depository institution, have historically focused on residential mortgage lending. The OTS, which is a bureau of the Department of the Treasury, charters and supervises federal savings associations and also supervises companies that own or control a savings association. These companies are referred to as thrift holding companies.

The FDIC insures the deposits of banks and savings associations up to certain limits established by law. As the insurer, the FDIC has special exami-

nation authority to determine the condition of an insured bank or savings association for insurance purposes.

Table 5.1 summarizes the supervisory responsibilities of the Federal Reserve and other federal banking agencies.

Table 5.1

**Federal supervisor and regulator of corporate components of banking organizations in the United States**

Component	Supervisor and regulator
Bank holding companies (including financial holding companies)	FR
Nonbank subsidiaries of bank holding companies	FR/Functional regulator <sup>1</sup>
National banks	OCC
State banks	
Members	FR
Nonmembers	FDIC
Thrift holding companies	OTS
Savings banks	OTS/FDIC/FR
Savings and loan associations	OTS
Edge and agreement corporations	FR
Foreign banks <sup>2</sup>	
Branches and agencies <sup>3</sup>	
State-licensed	FR/FDIC
Federally licensed	OCC/FR/FDIC
Representative offices	FR

**NOTE:** FR = Federal Reserve; OCC = Office of the Comptroller of the Currency; FDIC = Federal Deposit Insurance Corporation; OTS = Office of Thrift Supervision

1. Nonbank subsidiaries engaged in securities, commodities, or insurance activities are supervised and regulated 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 (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 subsidiary engaged in commodity activities regulated by the Commodity Futures Trading Commission.

2. Applies to direct operations in the United States. Foreign banks may also have indirect operations in the United States through their ownership of U.S. banking organizations.

3. The FDIC has responsibility for branches that are insured.

## Federal Financial Institutions Examination Council

To promote consistency in the examination and supervision of banking organizations, in 1978 Congress created the Federal Financial Institutions Examination Council (FFIEC). The FFIEC is composed of the chairpersons of the FDIC and the National Credit Union Administration, the comptroller of the currency, the director of the OTS, and a governor of the Federal Reserve Board appointed by the Board Chairman. The FFIEC's purposes are to prescribe uniform federal principles and standards for the examination of depository institutions, to promote coordination of bank supervision among the federal agencies that regulate financial institutions, and to encourage better coordination of federal and state regulatory activities. Through the FFIEC, state and federal regulatory agencies may exchange views on important regulatory issues. Among other things, the FFIEC has developed uniform financial reports for federally supervised banks to file with their federal regulator.

*The main objective of the supervisory process is to evaluate the overall safety and soundness of the banking organization.*

### Supervisory Process

The main objective of the supervisory process is to evaluate the overall safety and soundness of the banking organization. This evaluation includes an assessment of the organization's risk-management systems, financial condition, and compliance with applicable banking laws and regulations.

The supervisory process entails both on-site examinations and inspections and off-site surveillance and monitoring. Typically, state member banks must have an on-site examination at least once every twelve months. Banks that have assets of less than \$250 million and that meet certain management, capital, and other criteria may be examined once every eighteen months. The Federal Reserve coordinates its examinations with those of the bank's chartering state and may alternate exam cycles with the bank's state supervisor.

The Federal Reserve generally conducts an annual inspection of large bank holding companies (companies with consolidated assets of \$1 billion or greater) and smaller bank holding companies that have significant non-bank assets. Small, noncomplex bank holding companies are subject to a special supervisory program that permits a more flexible approach that relies on off-site monitoring and the supervisory ratings of the lead subsidiary depository institution. When evaluating the consolidated condition of the holding company, Federal Reserve examiners rely heavily on the results of the examination of the company's subsidiary banks by the primary federal or state banking authority, to minimize duplication of efforts and reduce burden on the banking organization.

## Risk-Focused Supervision

With the largest banking organizations growing in both size and complexity, the Federal Reserve has moved towards a risk-focused approach to supervision that is more a continuous process than a point-in-time examination. The goal of the risk-focused supervision process is to identify the greatest risks to a banking organization and assess the ability of the organization's management to identify, measure, monitor, and control these risks. Under the risk-focused approach, Federal Reserve examiners focus on those business activities that may pose the greatest risk to the organization.

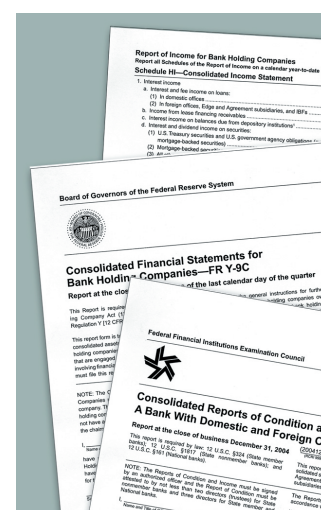
## Supervisory Rating System

The results of an on-site examination or inspection are reported to the board of directors and management of the bank or holding company in a report of examination or inspection, which includes a confidential supervisory rating of the financial condition of the bank or holding company. The supervisory rating system is a supervisory tool that all of the federal and state banking agencies use to communicate to banking organizations the agency's assessment of the organization and to identify institutions that raise concern or require special attention. This rating system for banks is commonly referred to as CAMELS, which is an acronym for the six components of the rating system: capital adequacy, asset quality, management and administration, earnings, liquidity, and sensitivity to market risk. The Federal Reserve also uses a supervisory rating system for bank holding companies, referred to as RFI/C(D), that takes into account risk management, financial condition, potential impact of the parent company and nondepository subsidiaries on the affiliated depository institutions, and the CAMELS rating of the affiliated depository institutions.<sup>1</sup>

## Financial Regulatory Reports

In carrying out their supervisory activities, Federal Reserve examiners and supervisory staff rely on many sources of financial and other information about banking organizations, including reports of recent examinations and inspections, information published in the financial press and elsewhere, and the standard financial regulatory reports filed by institutions.

1. The risk-management component has four subcomponents that reflect the effectiveness of the banking organization's risk management and controls: board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. The financial-condition component has four subcomponents reflecting an assessment of the quality of the banking organization's capital, assets, earnings, and liquidity.



The financial report for banks is the Consolidated Reports of Condition and Income, often referred to as the Call Report. It is used to prepare the Uniform Bank Performance Report, which employs ratio analysis to detect unusual or significant changes in a bank's financial condition that may warrant supervisory attention. The financial report for bank holding companies is the Consolidated Financial Statements for Bank Holding Companies (the FR Y-9 series).

The number and type of report forms that must be filed by a banking organization depend on the size of the organization, the scope of its operations, and the types of activities that it conducts either directly or through a subsidiary. The report forms filed by larger institutions that engage in a wider range of activities are generally more numerous and more detailed than those filed by smaller organizations.

*The Federal Reserve plays a significant role in promoting sound accounting policies and meaningful public disclosure by financial institutions.*

### **Off-Site Monitoring**

In its ongoing off-site supervision of banks and bank holding companies, the Federal Reserve uses automated screening systems to identify organizations with poor or deteriorating financial profiles and to help detect adverse trends developing in the banking industry. The System to Estimate Examinations Ratings (SEER) statistically estimates an institution's supervisory rating based on prior examination data and information that banks provide in their quarterly Call Report filings. This information enables the Federal Reserve to better direct examiner resources to those institutions needing supervisory attention.

### **Accounting Policy and Disclosure**

Enhanced market discipline is an important component of bank supervision. Accordingly, the Federal Reserve plays a significant role in promoting sound accounting policies and meaningful public disclosure by financial institutions. In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act, emphasizing the importance of financial institution accounting, auditing, and control standards. In addition, the Sarbanes-Oxley Act of 2002 seeks to improve the accuracy and reliability of corporate disclosures and to detect and address corporate and accounting fraud. Through its supervision and regulation function, the Federal Reserve seeks to strengthen the accounting, audit, and control standards related to financial institutions. The Federal Reserve is involved in the development of international and domestic capital, accounting, financial disclosure, and other supervisory standards. Federal Reserve examiners also review the quality of financial institutions' disclosure practices. Public disclosure allows market participants to assess the strength of individual institutions and is a critical element in market discipline.

## Umbrella Supervision and Coordination with Other Functional Regulators

In addition to owning banks, bank holding companies also may own broker-dealers engaged in securities activities or insurance companies. Indeed, one of the primary purposes of the Gramm–Leach–Bliley Act (GLB Act), enacted in 1999, was to allow banks, securities broker-dealers, and insurance companies to affiliate with each other through the bank holding company structure. To take advantage of the expanded affiliations permitted by the GLB Act, a bank holding company must meet certain capital, managerial, and other requirements and must elect to become a “financial holding company.” When a bank holding company or financial holding company owns a subsidiary broker-dealer or insurance company, the Federal Reserve seeks to coordinate its supervisory responsibilities with those of the subsidiary’s functional regulator—the Securities and Exchange Commission (SEC) in the case of a broker-dealer and the state insurance authorities in the case of an insurance company.

The Federal Reserve’s role as the supervisor of a bank holding company or financial holding company is to review and assess the consolidated organization’s operations, risk-management systems, and capital adequacy to ensure that the holding company and its nonbank subsidiaries do not threaten the viability of the company’s depository institutions. In this role, the Federal Reserve serves as the “umbrella supervisor” of the consolidated organization. In fulfilling this role, the Federal Reserve relies to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the company’s bank, securities, or insurance subsidiaries.

## Anti-Money-Laundering Program

To enhance domestic security following the terrorist attacks of September 11, 2001, Congress passed the USA Patriot Act, which contained provisions for fighting international money laundering and for blocking terrorists’ access to the U.S. financial system. The provisions of the act that affect banking organizations were generally set forth as amendments to the Bank Secrecy Act (BSA), which was enacted in 1970.

The BSA requires financial institutions doing business in the United States to report large currency transactions and to retain certain records, including information about persons involved in large currency transactions and about suspicious activity related to possible violations of federal law, such as money laundering, terrorist financing, and other financial crimes. The BSA also prohibits the use of foreign bank accounts to launder illicit funds or to avoid U.S. taxes and statutory restrictions.



The Department of the Treasury maintains primary responsibility for issuing and enforcing regulations to implement this statute. However, Treasury has delegated to the federal financial regulatory agencies responsibility for monitoring banks' compliance with the BSA. The Federal Reserve Board's Regulation H requires banking organizations to develop a written program for BSA compliance. During examinations of state member banks and U.S. branches and agencies of foreign banks, Federal Reserve examiners verify an institution's compliance with the recordkeeping and reporting requirements of the BSA and with related regulations, including those related to economic sanctions imposed by Congress against certain countries, as implemented by the Office of Foreign Assets Control.

### **Business Continuity**

After September 11, 2001, the Federal Reserve implemented a number of measures to promote the continuous operation of financial markets and to ensure the continuity of Federal Reserve operations in the event of a future crisis. The process of strengthening the resilience of the private-sector financial system—focusing on organizations with systemic elements—is largely accomplished through the existing regulatory framework. In 2003, responding to the need for further guidance for financial institutions in this area, the Federal Reserve Board, the OCC, and the SEC issued the “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.” The paper sets forth sound practices for the financial industry to ensure a rapid recovery of the U.S. financial system in the event of a wide-scale disruption that may include loss or inaccessibility of staff. Many of the concepts in the paper amplify long-standing and well-recognized principles relating to safeguarding information and the ability to recover and resume essential financial services.

### **Other Supervisory Activities**

The Federal Reserve conducts on-site examinations of banks to ensure compliance with consumer protection laws (discussed in chapter 6) as well as compliance in other areas, such as fiduciary activities, transfer agency, securities clearing agency, government and municipal securities dealing, securities credit lending, and information technology. Further, in light of the importance of information technology to the safety and soundness of banking organizations, the Federal Reserve has the authority to examine the operations of certain independent organizations that provide information technology services to supervised banking organizations.

### **Enforcement**

If the Federal Reserve determines that a state member bank or bank holding company has problems that affect the institution's safety and soundness



or is not in compliance with laws and regulations, it may take a supervisory action to ensure that the institution undertakes corrective measures. Typically, such findings are communicated to the management and directors of a banking organization in a written report. The management and directors are then asked to address all identified problems voluntarily and to take measures to ensure that the problems are corrected and will not recur. Most problems are resolved promptly after they are brought to the attention of an institution's management and directors. In some situations, however, the Federal Reserve may need to take an informal supervisory action, requesting that an institution adopt a board resolution or agree to the provisions of a memorandum of understanding to address the problem.

If necessary, the Federal Reserve may take formal enforcement actions to compel the management and directors of a troubled banking organization, or persons associated with it, to address the organization's problems. For example, if an institution has significant deficiencies or fails to comply with an informal action, the Federal Reserve may enter into a written agreement with the troubled institution or may issue a cease-and-desist order against the institution or against an individual associated with the institution, such as an officer or director. The Federal Reserve may also assess a fine, remove an officer or director from office and permanently bar him or her from the banking industry, or both. All final enforcement orders issued by the Board and all written agreements executed by Reserve Banks are available to the public on the Board's web site.

### **Supervision of International Operations of U.S. Banking Organizations**

The Federal Reserve also has supervisory and regulatory responsibility for the international operations of member banks (that is, national and state member banks) and bank holding companies. These responsibilities 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 and agreement corporations, which are specialized institutions used for international and foreign business;
- authorizing foreign investments of member banks, Edge and agreement corporations, and bank holding companies and regulating the activities of foreign firms acquired by such investors; and
- establishing supervisory policy and practices regarding foreign lending by state member banks.

Under federal law, U.S. banking organizations generally may conduct a wider range of activities abroad than they may conduct in this country.

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The Board has broad discretionary powers to regulate the foreign activities of member banks and bank holding companies so that, in financing U.S. trade and investments abroad, U.S. banking organizations can be fully competitive with institutions of the host country. U.S. banks also may conduct deposit and loan business in U.S. markets outside their home states through Edge and agreement corporations if the operations of the corporations are related to international transactions.

The Federal Reserve examines the international operations of state member banks, Edge and agreement corporations, and bank holding companies principally at the U.S. head offices of these organizations. When appropriate, the Federal Reserve will conduct an examination 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 foreign-country supervisor.

### **Supervision of U.S. Activities of Foreign Banking Organizations**

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. When Congress enacted the International Banking Act of 1978 (IBA), it created a federal regulatory structure for the activities of foreign banks with U.S. branches and agencies. The IBA 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.

The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) increased the Federal Reserve's supervisory responsibility and authority over the U.S. operations of foreign banking organizations and eliminated gaps in the supervision and regulation of foreign banking organizations. The FBSEA amended the IBA to require foreign banks to obtain Federal Reserve approval before establishing branches, agencies, or commercial lending company subsidiaries in the United States. An application by a foreign bank to establish such offices or subsidiaries generally may be approved only if the Board determines that the foreign bank and any foreign-bank parents engage in banking business outside the United States and are subject to comprehensive supervision or regulation on a consolidated basis by their home-country supervisors. The Board may also take into account other factors, such as whether the home-country supervisor has consented

to the proposed new office or subsidiary, the financial and managerial resources of the foreign bank, the condition of any existing U.S. offices, the bank's compliance with U.S. law, the extent of access by the Federal Reserve to information on the foreign bank from the bank and its home-country supervisor, and whether both the foreign bank and its home-country supervisor have taken actions to combat money laundering. The Board's prior approval is also required before a foreign bank may establish a representative office and, in approving the establishment of such an office, the Board takes the above-mentioned standards into account to the extent deemed appropriate.

The FBSEA also increased the responsibility and the authority of the Federal Reserve to regularly examine the U.S. operations of foreign banks. Under the FBSEA, all branches and agencies of foreign banks must be examined on-site at least once every twelve months, although this period may be extended to eighteen months if the branch or agency meets certain criteria. Supervisory actions resulting from examinations may be taken by the Federal Reserve alone or with other agencies. Representative offices are also subject to examination by the Federal Reserve.

The Federal Reserve coordinates the supervisory program for the U.S. operations of foreign banking organizations with the other federal and state banking agencies. Since a foreign banking organization may have both federally 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 carrying out their supervisory responsibilities, the Federal Reserve and other U.S. supervisors rely on two supervisory tools: SOSA rankings and ROCA ratings. SOSA (the Strength of Support Assessment) is the examiners' assessment of a foreign bank's ability to provide support for its U.S. operations. The ROCA rating is an assessment of the organization's U.S. activities in terms of its risk management, operational controls, compliance, and asset quality.

Under the Bank Holding Company Act and the IBA, the Federal Reserve is also responsible for approving, reviewing, and monitoring the U.S. nonbanking activities of foreign banking organizations that have a branch, agency, commercial lending company, or subsidiary bank in the United States. In addition, such foreign banks must obtain Federal Reserve approval to acquire more than 5 percent of the shares of a U.S. bank or bank holding company.

### **Supervision of Transactions with Affiliates**

As part of the supervisory process, the Federal Reserve also evaluates transactions between a bank and its affiliates to determine the effect of the transactions on the bank's condition and to ascertain whether the transac-

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tions are consistent with sections 23A and 23B of the Federal Reserve Act, as implemented by the Federal Reserve Board's Regulation W. Since the GLB Act increased the range of affiliations permitted to banking organizations, sections 23A and 23B play an increasingly important role in limiting the risk to depository institutions from these broader affiliations. Among other things, section 23A prohibits a bank from purchasing an affiliate's low-quality assets. In addition, it limits a bank's loans and other extensions of credit to any single affiliate to 10 percent of the bank's capital and surplus, and it limits loans and other extensions of credit to all affiliates in the aggregate to 20 percent of the bank's capital and surplus. Section 23B requires that all transactions between a bank and its affiliates be on terms that are substantially the same, or at least as favorable, as those prevailing at the time for comparable transactions with nonaffiliated companies. The Federal Reserve Board is the only banking agency that has the authority to exempt any bank from these requirements. During the course of an examination, examiners review a banking organization's intercompany transactions for compliance with these statutes and Regulation W.

### **Regulatory Functions**

As a bank regulator, the Federal Reserve establishes standards designed to ensure that banking organizations operate in a safe and sound manner and in accordance with applicable law. These standards may take the form of regulations, rules, policy guidelines, or supervisory interpretations and may be established under specific provisions of a law or under more general legal authority. Regulatory standards may be either restrictive (limiting the scope of a banking organization's activities) or permissive (authorizing banking organizations to engage in certain activities). (For a complete list of Federal Reserve regulations, see appendix A.)

In many cases, the Federal Reserve Board's regulations are adopted to implement specific legislative initiatives or requirements passed by Congress. These statutory provisions may have been adopted by Congress to respond to past crises or problems or to update the nation's banking laws to respond to changes in the marketplace. For example, in response to the savings and loan crisis and financial difficulties in the banking industry in the late 1980s and early 1990s, Congress enacted several laws to improve the condition of individual institutions and of the overall banking industry, including the Competitive Equality Banking Act of 1987; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and the Federal Deposit Insurance Corporation Improvement Act of 1991. These legislative initiatives restricted banking practices, limited supervisors' discretion in dealing with weak banks, imposed new regulatory requirements—including prompt corrective action—and strengthened supervisory oversight overall.

More recently, Congress has adopted other laws to respond to the growing integration of banking markets, both geographically and functionally, and the increasing convergence of banking, securities, and insurance activities. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 significantly reduced the legal barriers that had restricted the ability of banks and bank holding companies to expand their activities across state lines. In 1999, Congress passed the GLB Act, which repealed certain Depression-era banking laws and permitted banks to affiliate with securities and insurance firms within financial holding companies.

## Acquisitions and Mergers

Under the authority assigned to the Federal Reserve by the Bank Holding Company Act of 1956 as amended, the Bank Merger Act of 1960, and the Change in Bank Control Act of 1978, the Federal Reserve Board maintains broad authority over the structure of the banking system in the United States.

The Bank Holding Company Act assigned to the Federal Reserve primary responsibility for supervising and regulating the activities of bank holding companies. Through this act, Congress sought to achieve two basic objectives: (1) to avoid the creation of a monopoly or the restraint of trade in the banking industry through the acquisition of additional banks by bank holding companies and (2) to keep banking and commerce separate by restricting the nonbanking activities of bank holding companies. Historically, bank holding companies could engage only in banking activities and other activities that the Federal Reserve determined to be closely related to banking. But since the passage of the GLB Act, a bank holding company that qualifies to become a financial holding company may engage in a broader range of financially related activities, including full-scope securities underwriting and dealing, insurance underwriting and sales, and merchant banking. A bank holding company seeking financial holding company status must file a written declaration with the Federal Reserve System, certifying that the company meets the capital, managerial, and other requirements to be a financial holding company.

### ***Bank Acquisitions***

Under the Bank Holding Company Act, a firm that seeks to become a bank holding company must first obtain approval from the Federal Reserve. The act defines a *bank holding company* as any company that directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of the voting shares of a bank; controls in any manner the election of a majority of the directors or trustees of a bank; or is found to exercise a controlling influence over the management or policies of a bank. A bank holding company must obtain the approval of the Federal

Reserve before acquiring more than 5 percent of the shares of an additional bank or bank holding company. All bank holding companies must file certain reports with the Federal Reserve System.

When considering applications to acquire a bank or a bank holding company, the Federal Reserve is required to take into account the likely effects of the acquisition on competition, the convenience and needs of the communities to be served, the financial and managerial resources and future prospects of the companies and banks involved, and the effectiveness of the company's policies to combat money laundering. In the case of an interstate bank acquisition, the Federal Reserve also must consider certain other factors and may not approve the acquisition if the resulting organization would control more than 10 percent of all deposits held by insured depository institutions. When a foreign bank seeks to acquire a U.S. bank, the Federal Reserve also must consider whether the foreign banking organization is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor.

*The Federal Reserve is responsible for changes in the control of bank holding companies and state member banks.*

#### **Bank Mergers**

Another responsibility of the Federal Reserve is to act on proposed bank mergers when the resulting institution would be a state member bank. The Bank Merger Act of 1960 sets forth the factors to be considered in evaluating merger applications. These factors are similar to those that must be considered in reviewing bank acquisition proposals by bank holding companies. To ensure that all merger applications are evaluated in a uniform manner, the act requires that the responsible agency request reports from the Department of Justice and from the other approving banking agencies addressing the competitive impact of the transaction.

#### **Other Changes in Bank Control**

The Change in Bank Control Act of 1978 authorizes the federal bank regulatory agencies to deny proposals by a single "person" (which includes an individual or an entity), or several persons acting in concert, to acquire control of an insured bank or a bank holding company. The Federal Reserve is responsible for approving changes in the control of bank holding companies and state member banks, and the FDIC and the OCC are responsible for approving changes in the control of insured state nonmember and national banks, respectively. In considering a proposal under the act, the Federal Reserve must review several factors, including the financial condition, competence, experience, and integrity of the acquiring person or group of persons; the effect of the transaction on competition; and the adequacy of the information provided by the acquiring party.

## Formation and Activities of Financial Holding Companies

As authorized by the GLB Act, the Federal Reserve Board's regulations allow a bank holding company or a foreign banking organization to become a financial holding company and engage in an expanded array of financial activities if the company meets certain capital, managerial, and other criteria. Permissible activities for financial holding companies include conducting securities underwriting and dealing, serving as an insurance agent and underwriter, and engaging in merchant banking. Other permissible activities include those that the Federal Reserve Board, after consulting with the Secretary of the Treasury, determines to be financial in nature or incidental to financial activities. Financial holding companies also may engage to a limited extent in a nonfinancial activity if the Board determines that the activity is complementary to one or more of the company's financial activities and would not pose a substantial risk to the safety or soundness of depository institutions or the financial system.

*A key goal of banking regulation is to ensure that banks maintain sufficient capital to absorb reasonably likely losses.*

## Capital Adequacy Standards

A key goal of banking regulation is to ensure that banks maintain sufficient capital to absorb reasonably likely losses. In 1989, the federal banking regulators adopted a common standard for measuring capital adequacy that is broadly based on the risks of an institution's investments. This common standard, in turn, was based on the 1988 agreement "International Convergence of Capital Measurement and Capital Standards" (commonly known as the Basel Accord) developed by the Basel Committee on Banking Supervision. This committee, which is associated with the Bank for International Settlements headquartered in Switzerland, is composed of representatives of the central banks or bank supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

The risk-based capital standards require institutions that assume greater risk to hold higher levels of capital. Moreover, these standards take into account risks associated with activities that are not included on a bank's balance sheet, such as the risks arising from commitments to make loans. Because they have been accepted by the bank supervisory authorities of most of the countries with major international banking centers, these standards promote safety and soundness and reduce competitive inequities among banking organizations operating within an increasingly global market.

Recognizing that the existing risk-based capital standards were in need of significant enhancements to address the activities of complex bank-

ing organizations, the Basel Committee began work to revise the Basel Accord in 1999 and, in June 2004, endorsed a revised framework, which is referred to as Basel II. Basel II has three “pillars” that make up the framework for assessing capital adequacy. Pillar I, minimum regulatory capital requirements, more closely aligns banking organizations’ capital levels with their underlying risks. Pillar II, supervisory oversight, requires supervisors to evaluate banking organizations’ capital adequacy and to encourage better risk-management techniques. Pillar III, market discipline, calls for enhanced public disclosure of banking organizations’ risk exposures.

### **Financial Disclosures by State Member Banks**

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Federal Reserve administers these requirements and has adopted financial disclosure regulations for state member banks that are substantially similar to the SEC’s regulations for other public companies.

### **Securities Credit**

The Securities Exchange Act of 1934 requires the Federal Reserve to regulate the extension of credit used in connection with the purchase of securities. Through its regulations, the Board establishes the minimum amount the buyer must put up when purchasing a security. This minimum amount is known as the margin requirement. In fulfilling its responsibility under the act, the Federal Reserve limits the amount of credit that may be provided by securities brokers and dealers (Regulation T) and the amount of securities credit extended by banks and other lenders (Regulation U). These regulations generally apply to credit-financed purchases of securities traded on securities exchanges and certain securities traded over the counter when the credit is collateralized by such securities. In addition, Regulation X prohibits borrowers who are subject to U.S. laws from obtaining such credit overseas on terms more favorable than could be obtained from a domestic lender.

In general, compliance with the Federal Reserve’s margin regulations is enforced by several federal regulatory agencies. The federal agencies that regulate financial institutions check for Regulation U compliance during examinations. The Federal Reserve checks for Regulation U compliance on the part of securities credit lenders not otherwise regulated by federal agencies. Compliance with Regulation T is verified during examinations of broker-dealers by the securities industry’s self-regulatory organizations under the general oversight of the SEC.