

# Table of Contents

## 5000 BHC Inspection Program

<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
5000.0		BHC Inspection Program—General
	5000.0.1	Inspection Reporting Program
	5000.0.2	Policy for Frequency and Scope of Inspections for BHCs
	5000.0.3	Frequency and Scope of Inspection of the Largest BHCs
	5000.0.4	Inspection-Frequency Requirements
	5000.0.4.1	BHCs with No Identified Problems or Special Characteristics
	5000.0.4.2	BHCs Requiring Special Supervisory Attention
	5000.0.4.3	Supervision Procedures for BHCs with Total Consolidated Assets of Less Than \$5 Billion
	5000.0.4.3.1	Holding Companies with Total Consolidated Assets Between \$1 Billion and \$5 Billion
	5000.0.4.3.2	Holding Companies with Total Consolidated Assets of Less Than \$1 Billion
	5000.0.4.4	BHCs with Special Characteristics
	5000.0.4.5	Inspection of Nonbank Subsidiaries of BHCs
	5000.0.4.5.1	On-Site Reviews of Nonbank Subsidiaries
	5000.0.4.5.2	Off-Site Review of Nonbank Activities
	5000.0.4.6	Rating Assignments for Complex and Noncomplex Holding Companies with Total Consolidated Assets of Less Than \$1 Billion
	5000.0.4.6.1	Rating Assignments for Complex Holding Companies with Total Consolidated Assets of Less Than \$1 Billion
	5000.0.4.6.2	Rating Assignments for Noncomplex Holding Companies with Total Consolidated Assets of Less than \$1 Billion
	5000.0.4.6.3	Rating Assignments for Holding Companies with Total Consolidated Assets Between \$1 Billion and \$5 Billion
	5000.0.5	BHCs Exempt from the Prohibitions of Section 4 of the BHC Act
	5000.0.6	Multi-Tier BHC Inspections
	5000.0.6.1	Population of Second-Tiers Suitable for On-Site Inspection
	5000.0.6.2	Frequency Guidelines for Second-Tier BHCs over \$5 Billion
	5000.0.6.3	Frequency Guidelines for Second-Tier BHCs Rated 3, 4, or 5
	5000.0.6.4	Second-Tier Shell BHCs
	5000.0.7	Classification of Assets Involving Out-of-District Nonbank Subsidiaries
	5000.0.8	Interagency Inspection/Examination Agreements
	5000.0.8.1	Interagency Coordination of BHC Inspections and Subsidiary Bank Examinations
	5000.0.8.2	Interagency Agreement to Conduct Concurrent Examinations of Certain BHCs and Their Lead Bank Subsidiaries
	5000.0.8.3	Interagency Policy Statement on Examination Coordination
	5000.0.8.3.1	Primary Supervisory and Coordination Responsibility

<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
	5000.0.8.3.2	Overview of Examination Coordination and Implementation Guidelines
	5000.0.8.3.3	Coordinating the Planning, Timing, and Scope of Examinations and Inspections
	5000.0.8.3.4	Interagency Review of Bank, Nonbank, and Parent-Company Activities
	5000.0.8.3.5	Joint Meetings Between Regulators and Bank or BHC Management
	5000.0.8.3.6	Significant Differences in Agencies' Findings, Conclusions, and Recommendations
	5000.0.8.3.7	Inspection and Examination Reports
	5000.0.8.3.8	Coordinating Information Requests
	5000.0.8.3.9	Coordinating Enforcement Actions
	5000.0.8.3.10	State Banking Departments
	5000.0.9	Policy for Communicating Problems of Supervisory Concern to Management and Boards of Directors
	5000.0.9.1	Introduction
	5000.0.9.2	Meetings with Directors
	5000.0.9.2.1	Criteria for Conducting Meetings
	5000.0.9.3	Communication of Inspection Findings
	5000.0.9.4	Summary of BHC Inspection Findings
	5000.0.10	Summary to Directors of Inspection Findings
	5000.0.11	Completion Standard for Inspection Reports
	5000.0.12	Combined Examination/Inspection Report for BHCs with Lead State Member Banks
5010.0		Procedures for Inspection Report Preparation— Inspection Report References
5010.1		General Instructions to FR 1225
	5010.1.1	Core Section
	5010.1.2	Appendix Section
	5010.1.3	Optional Pages to Be Included in the Core or Appendix Sections
	5010.1.4	Confidential Section for All Inspection Reports
	5010.1.5	General Comments for All Report Pages
5010.2		Cover
5010.3		Page i—Table of Contents
5010.4		Core Page 1—Examiner's Comments and Matters Requiring Special Board Attention
	5010.4.1	Summary of Examiner's Findings
5010.5		Core Page 2—Scope of Inspection and Abbreviations
5010.6		Core Page 3—Analysis of Financial Factors
	5010.6.1	Parent Company

<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
	5010.6.2	Bank Subsidiaries
	5010.6.3	Nonbank Subsidiaries
	5010.6.4	Consolidated
	5010.6.5	General Instructions
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 and Special-Mention Assets and OTRP
	5010.10.1	Classification of Assets
	5010.10.1.1	Substandard Assets
	5010.10.1.1.1	Substandard Classification—Guidelines for an Asset When a Substantial Portion Has Been Charged Off
	5010.10.1.2	Doubtful Assets
	5010.10.1.3	Loss Assets
	5010.10.2	Appraisal of Securities in Bank Examinations
	5010.10.2.1	Investment-Quality Debt Securities
	5010.10.2.2	Sub-Investment-Quality Debt Securities
	5010.10.2.3	Rating Differences
	5010.10.2.4	Split or Partially Rated Securities
	5010.10.2.5	Nonrated Debt Securities
	5010.10.2.6	Foreign Debt Securities
	5010.10.2.7	Treatment of Declines in Fair Value Below Amortized Cost on Debt Securities
	5010.10.2.8	Classification of Other Types of Securities
	5010.10.3	Summary Table of General Debt Security Classification Guidelines
	5010.10.4	Credit-Risk-Management Framework for Securities
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
	5010.13.1	BHCs with Consolidated Assets of \$150 Million or More (Core Page 10—Consolidated Capital Structure (FR 1225))
	5010.13.2	Worksheets
	5010.13.3	BHCs with Less Than \$150 Million in Consolidated Assets (Page—Capital Structure (Lead Bank or Other Bank Subsidiary (FR 1241)))
5010.14		Page—Policies and Supervision

<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
	5010.14.1	Questions to Be Addressed on the Policies and Supervision Report Page
	5010.14.1.1	Level of Control and Supervision Exercised over Subsidiaries
	5010.14.1.2	Loans and Investments of Subsidiaries
	5010.14.1.3	Funds Management and the Adequacy of Existing Policies
	5010.14.1.4	Loan Participations among Subsidiaries
	5010.14.1.5	Dividends and Fees from Subsidiaries
	5010.14.1.6	Risk Evaluation and Control
	5010.14.1.7	Management Information Systems
	5010.14.1.8	Internal Loan Review
	5010.14.2	Discussion and Appraisal of Other Parent Company Policies
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
	5010.20.1	Investment in and Advances to Subsidiaries
	5010.20.2	Investment in and Advances to Subsidiaries (continued)
5010.21		Page—Commercial Paper (Parent)
5010.22		Page—Lines of Credit (Parent)
5010.23		Page—Questions on Commercial Paper and Lines of Credit
	5010.23.1	Appendix A—Commercial-Paper Ratings
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

<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
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
5010.34		<i>Reserved for Future Use</i>
5010.35		Page—Other Supervisory Issues
	5010.35.1	Intercompany Transaction (Question 1)
	5010.35.2	Compensating Balances (Question 2)
	5010.35.3	Intercorporate Income Tax Practices (Question 3)
	5010.35.4	Tie-In Arrangements (Question 4)
	5010.35.5	Insider Transactions (Question 5)
	5010.35.6	Litigation (Question 6)
	5010.35.7	Insurance Program (Question 7)
	5010.35.8	Audit Program (Question 8)
	5010.35.9	Credit Quality Review Program (Question 9)
	5010.35.10	Supervisory Reports (Question 10)
	5010.35.11	Outstanding Commitments to The Board of Governors (Question 12)
5010.36		Page—Extensions of Credit to BHC Officials . . .
5010.37		Interest Rate Sensitivity—Assets and Liabilities
5010.38		Treasury Activities/Capital Markets
5010.39		<i>Reserved for Future Use</i>
5010.40		Confidential Page A—Principal Officers and Directors
5010.41		Confidential Page B—Condition of BHC
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)
	5020.2.1	Level of Control and Supervision Exercised over Subsidiaries (Question 1)
	5020.2.2	Dividends from Subsidiaries (Question 2)
	5020.2.3	Representations Made in Applications to the Board (Question 3)
	5020.2.4	Compensating Balances (Question 4)
	5020.2.5	Management and Other Services Performed for Subsidiaries (Question 5)

<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
	5020.2.6	Intercompany Transactions (Question 6)
	5020.2.7	Insider Transactions (Question 7)
	5020.2.8	Tax Allocation (Question 8)
	5020.2.9	Use of Subsidiary Bank Personnel, or Assets to Sell Credit-Related Life Insurance to the Bank's Customers (Question 9)
	5020.2.10	Tie-In Arrangements (Question 10)
	5020.2.11	Litigation (Question 11)
	5020.2.12	Insurance Program (Question 12)
	5020.2.13	Audit Program (Question 13)
	5020.2.14	Internal Loan Review (Question 14)
	5020.2.15	Accuracy and Timeliness of Reports (Question 15)
	5020.2.16	Outstanding Commitments to the Board of Governors (Question 17)
	5020.2.17	Other Matters Having a Detrimental Impact (Question 18)
5030.0		Procedures for Inspection Report Preparation— BHC Inspection Report Forms
5040.0		Procedures for “Limited-Scope” Inspection Report Preparation—General Instructions—FR 1427
	5040.0.1	Objectives
	5040.0.2	Implementation Guidelines
	5040.0.2.1	Required Report Pages
	5040.0.2.2	Exception Limited-Scope Report Pages
	5040.0.2.2.1	Reasoning for Including “E” Pages
	5040.0.2.3	Optional Limited-Scope Report Pages
	5040.0.3	Limited-Scope Inspection Procedures
	5040.0.4	Limited-Scope Inspection Report Cover (FR 1427)
5050.0		Procedures for “Targeted” Inspection Report Preparation—General Instructions
	5050.0.1	Objectives of a Targeted Inspection
	5050.0.2	Targeted Inspection Report Cover (FR 1428)
5052.0		Targeted MIS Inspection
	5052.0.1	Relevancy and Use of MIS
	5052.0.2	Internal Controls over MIS Integrity
	5052.0.3	MIS Architecture and Planning
	5052.0.4	Inspection Objectives
	5052.0.5	Inspection Procedures
5060.0		Portions of Bank Holding Company Inspections Conducted in Federal Reserve Bank Office
	5060.0.1	Conducting Inspection Activities in Reserve Bank Offices
	5060.0.2	Off- and On-Site BHC Inspection Procedures— Appendix 1
	5060.0.2.1	Activities That Can Be Completed in the Office

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<i>Sections</i>	<i>Subsections</i>	<i>Title</i>
	5060.0.2.2	BHC Inspection Activities That Should Be Conducted On-Site
	5060.0.2.3	Sample Information Request for a Bank Holding Company
	5060.0.3	Procedures for Implementing Off-Site Inspections for Certain Shell BHCs—Appendix 2
	5060.0.3.1	General Procedures for Off-Site Inspections

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### WHAT'S NEW IN THIS REVISED SECTION

*Effective July 2008, this section has been revised to incorporate the guidance found in SR-08-01, "Communication of Examination/Inspection Findings," which provides guidance on written communication of inspection findings. To improve the consistency and clarity of written communications, Federal Reserve staff is to use the prescribed standardized terminology and definitions, to differentiate among (1) Matters Requiring Immediate Attention, (2) Matters Requiring Attention, and (3) Observations. See subsection 5000.0.9.3.*

### 5000.0.1 INSPECTION REPORTING PROGRAM

The BHC inspection report is intended to effectively communicate the result of inspections without compromising the integrity of inspection and reporting procedures. The inspection report serves the needs of several distinct audiences: the BHC (its directors, executive management, and line management), the Federal Reserve Board, the Federal Reserve Bank, and other banking organization regulators (state banking agencies, the OCC, and the FDIC). The inspection report should serve as an effective and efficient vehicle for communicating conclusions, concerns, and recommendations to the principal audience—the BHC's board of directors—without sacrificing to any great extent the needs of the other users. The inspection reporting program operates on the condition that inspection workpapers can be obtained for immediate review by Federal Reserve Bank or Federal Reserve Board staff, when requested.

The presentation within the inspection report is intended to be concise and direct, with the information needed by all audiences found in the core section. The core section contains the report pages, which consist of the "Examiner's Comments and Other Matters Requiring Special Board Attention," "Scope," "Structure and Abbreviations," and "Analysis of Financial Factors," as well as an analysis of asset quality and off-balance-sheet risk and certain other required financial statements and schedules. Supporting schedules are required and added to the core section when an area of concern or a problem is addressed in the report.

One standardized BHC inspection report format, FR 1225, has been designed to meet the

desired objectives of the full-scope report for all organizations, regardless of the structure and complexity of the BHC under inspection. A few report pages, designated FR 1241, are to be used for BHCs that have less than \$150 million in assets. These pages are "Parent Company and Nonbank Assets Subject to Classification," "Bank Subsidiary," "Capital Structure," and "Other Supervisory Issues." The latter two report pages are for the lead bank or other comparable bank subsidiary.

This part of the manual presents policy and procedures for the inspection process, the collection and presentation of data, and the preparation of the resulting analyses in the inspection report. Section 5010.0 corresponds directly to each page of the report (FR 1225). Sections 5020.0 and 5030.0 provide instructions for limited and targeted inspections.

On each report page, instructions are generally organized to state what information is to be presented on the page, the objectives for the information to be presented, the potential source of the information, and how the information is to be presented in the report. Also, the instructions mention other report areas that are affected by material reported on the page.

The examiner is reminded that the instructions in sections 5010, 5020, and 5030 are only a starting point. As such, the instructions focus principally on the collection of information and the presentation in the report of inspection findings. When working on specific functional aspects of the inspection, the examiner should also refer to the appropriate subject heading in this manual.

### 5000.0.2 POLICY FOR FREQUENCY AND SCOPE OF INSPECTIONS FOR BHCs

On October 7, 1985, the Board announced its policy, effective January 1, 1986, to increase the frequency of inspections of BHCs.<sup>1</sup> The policy objectives are to (1) help prevent the development of problems at banking institutions and (2) make more effective the Federal Reserve's ability to identify and resolve problems that develop nonetheless.

1. All financial holding companies are BHCs; hence, the supervisory guidance in this section applies to financial holding companies as well as BHCs.



In general, the policy provides that—

1. the largest and most complex BHCs will be inspected at least annually,
2. the largest BHCs, and those with significant problems, will be inspected semiannually, and
3. as an exception to the general rule, small holding companies with no known problems will be reviewed on a more limited basis.

(See section 5000.0.3 for the parameters of the policy statement.)

Federal Reserve Banks are to intensify their

involvement in the inspection of large organizations and those with significant problems. Greater reliance is to be placed on state examinations or inspections, in the case of smaller organizations. If a state lacks the resources to conduct inspections in accordance with the specifications of the policy or is unwilling to do so, or, in the case of holding companies, lacks authority, the Federal Reserve will conduct the examinations or inspections to the extent needed to meet the specifications. In addition, if a BHC or its state member bank subsidiary indicates its wish to be examined or inspected by its Federal Reserve Bank, that wish should be honored.

### 5000.0.3 FREQUENCY AND SCOPE OF INSPECTIONS OF THE LARGEST BHCs

		<i>Asset size</i>	
<i>Rating</i>	<i>\$10 billion and over</i>	<i>\$5 billion to \$10 billion</i>	
		<i>Complex<sup>4</sup></i>	<i>Noncomplex<sup>5</sup></i>
1 or 2	Full-scope required annually. <sup>1</sup> Additional limited-scope or targeted presumed annually.	Full-scope required annually. Limited-scope <sup>2</sup> or targeted <sup>3</sup> when needed.	Limited-scope required every two years. Additional limited-scope or targeted when needed.
3	Full-scope required annually. One limited-scope or targeted also required annually.		
4 or 5	Full-scope required annually. One limited-scope or targeted also required annually.		

Source: Board policy statement, October 7, 1985.

**Special Characteristics:**

1. BHCs formed to acquire going concerns: inspection to be conducted between the 6th and 18th months of operation, or within 36 months under specific condition, or waived if under \$50 mm with specific conditions.
2. Change in control or de novo BHCs: inspection required within 12 months.
3. BHCs that fail surveillance screen or for which other significant adverse information is received: triggers in-depth off-site review to evaluate need for limited-scope or targeted inspection.

**Notes:**

1. A *full-scope inspection* covers all areas of interest to the Federal Reserve in depth.
2. A *limited-scope inspection* will review all areas of activity covered by a full-scope inspection, but less intensively.
3. *Targeted inspections* will focus intensively on one or two activities.
4. A complex BHC is defined as one with material credit-extending nonbank subsidiaries or debt outstanding to the general public.
5. A noncomplex BHC is without credit-extending subsidiaries and without public debt.

## 5000.0.4 INSPECTION-FREQUENCY REQUIREMENTS

### 5000.0.4.1 BHCs with No Identified Problems or Special Characteristics

Multinational bank holding companies and all others with consolidated assets over \$10 billion are to receive a full-scope inspection annually, which should be coordinated with the examination of the lead bank to the extent possible. Although the inspection of the holding company and the examination of the lead bank need not be commenced simultaneously, they should overlap and rely on financial statements as of the same date, if possible, to facilitate the analysis and presentation of findings to management and directors. A limited-scope or targeted inspection of these companies is also to be conducted between the annual full-scope inspections; the precise timing will be determined by off-site surveillance reports and opportunities to coordinate with the examination of the lead bank. The requirement for a limited-scope or targeted inspection may be waived by the Reserve Bank if, on the basis of the findings of the last full-scope inspection and of the surveillance system, the institution is judged to be in satisfactory condition.

Complex BHCs (defined as companies with nonbank subsidiaries that extend a material amount of credit or companies whose parent has a material amount of debt outstanding to the general public<sup>2</sup>) with consolidated assets of \$15 billion or more receive a full-scope inspection annually. These inspections should be conducted, to the extent possible, in coordination with the examination of the lead bank. All BHCs in this size group should be subject to additional limited-scope or targeted inspections when the Reserve Bank has information that suggests the institution may be developing significant problems.

2. SR-02-1 extended the definition of a complex BHC to take into account a number of considerations: the size and structure of the holding company; the extent of intercompany transactions between insured depository institution subsidiaries and the holding company or uninsured subsidiaries of the holding company; the nature and scale of any nonbank 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 (for example, insurance, securities, merchant banking); and whether risk-management processes for the holding company are consolidated. Such a determination is made at least annually on a case-by-case basis.

### 5000.0.4.2 BHCs Requiring Special Supervisory Attention

The inspection frequency of BHCs requiring special supervisory attention is to be determined by both the size and complexity of the organization. The most intensive frequency requirements are directed at BHCs rated RFI/C(D) composite 3, 4, or 5, or whose lead bank subsidiary has been rated CAMELS composite 3, 4, or 5. All BHCs so rated and with consolidated assets of \$5 billion or more are to receive an annual full-scope inspection and a limited-scope or targeted inspection during the interval between full-scope inspections.

### 5000.0.4.3 Supervision Procedures for BHCs with Total Consolidated Assets of Less Than \$5 Billion

#### *5000.0.4.3.1 Holding Companies with Total Consolidated Assets Between \$1 Billion and \$5 Billion*

In accordance with SR-02-1, a full-scope inspection for holding companies with total consolidated assets between \$1 billion and \$5 billion may be satisfied, when appropriate, with a targeted or limited-scope on-site review supplemented by other information sources. A full-scope inspection (which may include a targeted review for the on-site portion) is to be conducted for the *complex holding companies* at least once annually, after which a complete rating is assigned.<sup>3</sup> For the *noncomplex holding companies*, an inspection (which may be targeted or limited in scope) is required at least once every two years, after which a complete rating is assigned. For both complex and non-complex companies in this size group that are rated composite 3, 4, or 5, one full-scope inspection—which under this program may include a targeted review for the on-site portion—plus one limited-scope inspection must be conducted at least annually. The inspection's scope and documentation requirements are governed by the guidance in this manual. The scope and documentation requirements are to be tailored to the risks—in particular, the risks posed to an insured depository institution subsidiary by the holding company's operations or

3. The complete holding company rating would include a composite rating as well as all of the component ratings.

activities—and to the company’s compliance with applicable laws and regulations.

#### *5000.0.4.3.2 Holding Companies with Total Consolidated Assets of Less Than \$1 Billion*

For *complex holding companies*, Reserve Banks can conduct an off-site review of the organization using surveillance results and relevant supervisory, financial, and other information, including correspondence or other communications with bank management and the primary bank supervisor or functional or other regulator. The supervisory cycle will be determined by the examination frequency of the lead depository institution.<sup>4</sup> Surveillance results or other relevant financial and supervisory information may prompt more-frequent reviews and reassignment or confirmation of ratings. If the information obtained off-site from these sources is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a complete holding company RFI/C(D) rating, an on-site review should be conducted. The on-site review should be targeted, as appropriate, to those areas where additional information or analysis is needed to develop the complete holding company rating.

For the *noncomplex holding companies*, where all subsidiary depository institutions have satisfactory composite and risk-management ratings, and where no material outstanding holding company or consolidated issues are otherwise indicated, the Reserve Bank assigns only a composite rating and a risk-management rating to the company, based on the ratings of the lead depository institution. Also, for those noncomplex holding companies 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, the Reserve Bank is to conduct an off-site review of the organization using surveillance results and relevant financial, supervisory, and other information, including correspondence or other communications with bank management and the pri-

mary bank supervisor. If the information obtained off-site from these sources is not sufficient to determine the overall financial condition of the holding company and to assign the composite and risk-management ratings, an on-site review should be conducted. Any on-site review should be targeted, as appropriate, to those areas where additional information is needed to develop the risk-management and composite ratings.

#### *5000.0.4.4 BHCs with Special Characteristics*

BHCs formed to acquire an existing bank are to be inspected to determine their compliance with Federal Reserve regulations and the extent to which they have fulfilled commitments the Board of Governors required of the organization in approving its application. Such inspections should be conducted between the 6th and 18th month after the acquisition; their scope is to be determined by the Reserve Bank. If information available to the Reserve Bank (the most recent examination of the bank, the most recent FR Y-6 and FR Y-9 reports from the holding company, and other pertinent information) indicates that (1) the condition of the bank and BHC is satisfactory, (2) the BHC is fulfilling its commitments to the Board of Governors, and (3) the ratio of the parent’s debt to its proportionate interest in the book value of the subsidiary bank (or banks) is less than 75 percent, then, at the Reserve Bank’s discretion, the inspection may be delayed as long as 36 months after the formation. Moreover, the requirement for an inspection may be waived in the case of a BHC whose bank subsidiary has less than \$50 million in total assets if, in the Reserve Bank’s judgment, (1) the holding company’s financial condition is satisfactory and its commitments to the Board of Governors are being fulfilled and (2) the ratio of the holding company’s debt to its proportionate interest in the book value of the subsidiary bank (or banks) is less than 75 percent.

BHCs that have undergone a change in control and de novo BHCs organized to acquire de novo banks are to receive a full-scope inspection within 12 months following the change in control or formation. A limited-scope or targeted inspection may be conducted in lieu of the full-scope inspection if, in the Reserve Bank’s judgment, the financial condition of the holding company appears satisfactory.

When BHCs fail the surveillance screen or when other information suggests the company has experienced an adverse development, an in-depth, off-site review will be made to deter-

4. The lead depository institution is generally the largest depository institution subsidiary. However, a Reserve Bank may, based on the facts and circumstances of a particular holding company, designate another depository institution as the lead.

mine the need for a limited-scope or targeted inspection.

#### 5000.0.4.5 Inspection of Nonbank Subsidiaries of BHCs

The instructions in this subsection are intended to supplement the guidance in the Board's policy statement regarding the frequency and scope of inspections for BHCs, as set forth above and included with SR-85-28 (October 7, 1985). (See sections 4030.0.2, 5010.6.3, and 5010.31; SR-93-19 (April 13, 1993); and the *Federal Reserve Regulatory Service* at 3–1531.)

##### 5000.0.4.5.1 On-Site Reviews of Nonbank Subsidiaries

Notwithstanding the risk assessment that is to be performed for each nonbank subsidiary (see section 4030.2), an on-site review is required for the following nonbank subsidiaries:<sup>5</sup>

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.*<sup>6</sup>
  - The subsidiary has total assets equal to 10 percent or more of the bank holding company's consolidated tier 1 capital.
  - The subsidiary's total operating revenue equals 10 percent or more of the BHC's consolidated total operating revenue.<sup>7</sup>
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

5. 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.

6. 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.

7. For BHCs, "total operating revenue" is the sum of total interest income and total noninterest income (before extraordinary items).

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) and SR-91-2 (January 31, 1991), dealing with collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). (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.

##### 5000.0.4.5.2 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.<sup>8</sup> When warranted by (1) a deterioration in the condition and performance of nonbank subsidi-

8. For example, combined financial statements of nonbank subsidiaries are submitted to the Board quarterly on Form FR Y-11Q when the nonbank subsidiary is owned or controlled by a BHC with total consolidated assets equal to or greater than \$150 million and—

- the total assets of the nonbank subsidiary are equal to or greater than 5 percent of the top-tier BHC's consolidated tier 1 capital or
- the total operating revenue of the nonbank subsidiary is equal to or greater than 5 percent of the top-tier BHC's consolidated total operating revenue.

"Operating revenue" is defined for this purpose as the sum of total interest income and total noninterest income (before deduction of expenses and extraordinary items).

Annual reports of selected financial data for individual nonbank subsidiaries are also submitted to the Board on Form FR Y-11I. Section 20 subsidiaries submit quarterly financial statements to the Board on the FR Y-20 report.

aries, (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.

#### 5000.0.4.6 Rating Assignments for Complex and Noncomplex Holding Companies with Total Consolidated Assets of Less Than \$1 Billion

The documentation for the ratings and the off-site or on-site review for both complex and noncomplex companies with total consolidated assets of less than \$1 billion should be commensurate with the risk of the company and the nature and scope of issues. At a minimum, this documentation will generally consist of the examination reports for the insured depository institution subsidiaries, a copy of the transmittal letter communicating the ratings to the company, information related to relevant surveillance results, and memoranda supporting any on-site review conducted. All ratings assigned should be 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. If an on-site review is required to assign the ratings, the findings of that review and the assigned ratings should be communicated no later than 120 days after receipt of the lead depository institution examination report. The ratings should be entered into the National Examination Data (NED) system.

##### *5000.0.4.6.1 Rating Assignments for Complex Holding Companies with Total Consolidated Assets of Less Than \$1 Billion*

The Reserve Bank will assign a complete holding company rating, using surveillance results and relevant supervisory, financial, and other information, including correspondence or other communication with bank management and the primary bank supervisor or functional or other regulator.<sup>9</sup> If the information obtained off-site from these sources is not sufficient for the Reserve Bank to determine the overall condition of the company and assign a complete holding company rating, the information must be derived from an on-site review.

##### *5000.0.4.6.2 Rating Assignments for Noncomplex Holding Companies with Total Consolidated Assets of Less Than \$1 Billion*

For noncomplex holding companies with total consolidated assets of less than \$1 billion, where all subsidiary depository institutions have satisfactory composite and risk-management ratings and no material outstanding holding company or consolidated issues are otherwise indicated, the Reserve Bank should assign only a composite rating and a risk-management rating to the company on the basis of the ratings of the lead depository institution. For those holding companies in this asset group 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, the Reserve Bank will conduct its off-site review of the organization using surveillance results and relevant financial, supervisory, and other information, including correspondence or other communications with bank management and the primary bank supervisor. Any on-site review should be targeted, as appropriate, to those areas where additional information is needed to develop the management and composite ratings.

<sup>9</sup> The complete holding company rating would include a composite rating as well as all of the component ratings.

### 5000.0.4.6.3 Rating Assignments for Holding Companies with Total Consolidated Assets Between \$1 Billion and \$5 Billion

All companies with total consolidated assets between \$1 billion and \$5 billion (whether deemed complex or noncomplex) must be assigned a complete holding company rating. The complete holding company rating would include a composite rating as well as all of the component ratings. The ratings must be communicated to the holding company in writing within 60 days of the completion of the inspection; however, Reserve Banks are encouraged to adopt an internal target of 45 days for the processing and mailing of reports for companies rated 3, 4, or 5. (See SR-93-4.)

### 5000.0.5 BHCs EXEMPT FROM THE PROHIBITIONS OF SECTION 4 OF THE BHC ACT

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.

### 5000.0.6 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 for each fully consolidated banking organization (i.e., each top-tier consolidated banking organization). For domestic banking organizations, the responsible Reserve Bank 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 and section 2124.01.2)

### 5000.0.6.1 Population of Second-Tiers Suitable for On-Site Inspection

A second-tier holding company (and other lower tiers) that (1) has assets greater than \$5 billion, (2) irrespective of size, has a financial condition deemed in need of special supervisory attention (BHC or lead bank rated 3, 4, or 5), or (3) is prone to insider or abusive practices would usually warrant an on-site inspection, the preparation of an inspection report, the assignment of a rating, and a presentation of findings to management, as well as the board of directors if the board includes any “outside directors.” To the extent possible, the inspection should be coordinated with that of the top-tier parent holding company.

### 5000.0.6.2 Frequency Guidelines for Second-Tier BHCs over \$5 Billion

It is assumed that a second-tier BHC will be subject to inspection-frequency guidelines that pertain to the top-tier on a consolidated basis. Although top-tier companies greater than

\$10 billion in assets may be subject to a second on-site presence annually, these guidelines are not intended to require a second annual presence for the second-tier company.

### 5000.0.6.3 Frequency Guidelines for Second-Tier BHCs Rated 3, 4, or 5

When a second-tier holding company requires special supervisory attention or is prone to insider or abusive practices, the responsible Reserve Bank may conclude that the second-tier holding company warrants inspection at least as frequently or more frequently than the top-tier holding company. Under such circumstances, it would be appropriate for the second-tier holding company to receive a second presence annually, despite the fact that the top-tier holding company may be inspected less frequently. Problem BHCs acquired as “debts previously contracted” need not be inspected any more frequently than the top-tier company.

### 5000.0.6.4 Second-Tier Shell BHCs

To the extent that the second-tier holding company is strictly a shell without outside directors and no substantive policymaking authority, and to the extent that the records necessary to review its operations and condition are available at the location of the top-tier holding company, the inspection of the second-tier need not be done on-site, but may be done at the top-tier parent location. In either case, if an inspection is conducted, a rating should be assigned to the second-tier holding company.

### 5000.0.7 CLASSIFICATION OF ASSETS INVOLVING OUT-OF-DISTRICT NONBANK SUBSIDIARIES

The classification of assets involving out-of-District nonbank subsidiaries should be performed at the office of the parent company by the RRB when sufficient information is available or could be made available upon request. In adopting the inspection-frequency requirements for selected BHCs (see above), the Board recognized that inspection of nonbank subsidiaries and classification of nonbank assets were an essential part of the inspection process. How-

ever, an on-site inspection of out-of-District nonbank subsidiaries should not be done routinely by the RRB. If the RRB concludes that information necessary to classify assets is available only on-site, or if problems or other material circumstances lead to the conclusion that an on-site inspection is required, the RRB is encouraged to arrange for the local Reserve Bank to undertake on its behalf the inspection or other supervisory activities to take advantage of opportunities to enhance supervisory effectiveness or efficiency. When other Reserve Bank Districts conduct supervisory activities for the RRB, substantial reliance should be placed on the conclusions and ratings recommended by the participating Reserve Bank Districts.

### 5000.0.8 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, OCC, and FDIC) have adopted two policies intended to enhance the interagency supervision of BHCs and their bank and non-bank subsidiaries.

#### 5000.0.8.1 Interagency Coordination of BHC Inspections and Subsidiary Bank Examinations

The first policy was adopted in conjunction with the Federal Financial Institutions Examination Council (FFIEC) and addresses large and problem holding companies and holding companies with deteriorating financial conditions. The policy requires the agencies to coordinate the BHC inspection and the examination of the lead bank subsidiary for—

1. any BHC with consolidated assets in excess of \$10 billion;
2. any BHC or BHC subsidiary lead bank rated composite 4 or 5 (the two lowest rating categories) under the RFI/C(D) bank holding company rating system or the Uniform Rating System for banks; and
3. any BHC or BHC subsidiary lead bank rated composite 3 (the middle of the rating categories) whose financial condition appears to have worsened significantly since the last inspection or examination.

It is recognized that substantial problems

could develop for a holding company as a result of serious difficulties in significant subsidiary banks other than its largest bank, and the policy as adopted affords the agencies the flexibility to conduct coordinated examinations when any bank, regardless of size, has problems warranting supervisory concern. In implementing this aspect of the policy, the agencies will conduct coordinated examinations when any significant bank subsidiary is rated 4 or 5, or when the financial condition of any other subsidiary causes serious concern about that subsidiary's impact on the condition of the holding company or any other banking affiliate.

#### 5000.0.8.2 Interagency Agreement to Conduct Concurrent Examinations of Certain BHCs and Their Lead Bank Subsidiaries

The second policy implements a program to conduct an annual concurrent examination by the Federal Reserve and the OCC or FDIC of holding companies with consolidated assets greater than \$1 billion and their lead bank subsidiaries. The major provisions of this program are as follows:

1. The agencies will conduct concurrent examinations of certain BHCs and their lead bank subsidiaries, as well as any other subsidiary or subsidiaries as appropriate. Concurrent examinations are defined as the performance of certain on-site examination activities by examiners from the agencies on a simultaneous or coordinated basis to enhance cooperation, minimize potential duplication, and reduce burden on banking institutions. Concurrence does not necessarily require coincidence of beginning and closing dates of bank and holding company examinations. The geographical location of the lead bank shall determine the district bank and regional office responsible for coordination of examination logistics of all involved subsidiaries.
2. The banking organizations to which this program will apply will be mutually agreed upon by the director of the Division of Banking Supervision and Regulation (FRS) and the senior deputy comptroller for bank supervision (OCC) for holding companies with lead national bank subsidiaries, and by the director of the Division of Banking Supervision and Regulation (FRS) and the director of the Division of Bank Supervision (FDIC) for holding companies with lead state-chartered nonmember bank subsidiaries. These banking organizations will be specified in a list prepared jointly by the FRS and OCC for holding companies with lead national banks, and by the FRS and FDIC for holding companies with lead state-chartered nonmember banks.
3. In general, this program will apply to holding companies whose lead bank subsidiaries are national or state-chartered nonmember banks and whose consolidated holding company assets are equal to or exceed \$1 billion. However, the program may be applied to other holding companies upon the agreement of the FRS, OCC, and FDIC.
4. In general, banking organizations included in the program will be examined annually, although each agency reserves the right not to participate in an examination due to resource constraints or other supervisory imperatives.
5. The agencies will mutually agree on the division and sharing of work assignments and routines for concurrently examining the holding company and the bank, with the goal of minimizing unnecessary overlap, duplication, and burden on the banking organization. In general, the division of examination duties will be based on the locus of primary statutory examination and supervisory responsibility but will recognize that in some areas the agencies have common supervisory interests and needs for information.
6. Findings, conclusions, recommendations, reports, and transmittal letters pertaining to examinations of the holding company or subsidiaries included in the program should be provided to or discussed with the district bank and regional office of the other agency responsible for coordination of the concurrent examinations before being forwarded to management or directors of the holding company or bank (or banks).
7. Each district bank and regional office receiving examination information from the other agency should promptly inform the other agency of any major findings, conclusions, or recommendations with respect to which the receiving agency substantially disagrees.
8. Before forwarding examination results to management or directors, every effort should be made to resolve significant differences



between the district bank and regional office concerning major examination findings, conclusions, and recommendations.

9. Significant differences that cannot be resolved by examiners or officials at the regional office-district level should be referred to the director of the Division of Banking Supervision and Regulation (FRS) and the senior deputy comptroller for bank supervision (OCC) for ultimate resolution, in the case of a holding company and its lead national bank. Cases that involve significant differences at the regional office-district level with regard to a holding company and its lead state-chartered nonmember bank will be referred to the director of the Division of Banking Supervision and Regulation (FRS) and the Director of the Division of Bank Supervision (FDIC) for ultimate resolution. If major differences cannot be resolved, the agencies may proceed with the transmission of examination findings and conclusions to management, according to each agency's existing procedures.
10. Reasonable efforts should be made by the agencies to hold joint or combined final interviews and meetings with the management or directors of the holding company and the bank subsidiaries to discuss significant supervisory issues involving examination results. In the ordinary course, the district bank (FRS) would initiate meetings with the holding company, and the regional offices (OCC and FDIC) would initiate meetings with the national or state-chartered nonmember bank subsidiaries, respectively. If such meetings are not appropriate or feasible, each agency should inform the other agency in advance of any plans to meet with management or directors of the holding company or bank to discuss significant supervisory matters, and the other agency should be given the opportunity to attend such meetings or send a representative. If the other agency does not attend or send a representative, significant results of the meetings should be transmitted to that agency.
11. This agreement is intended to foster cooperation and is not meant by the exclusion of other arrangements to preclude other reasonable efforts or cooperative arrangements to strengthen interagency coordination and consistency.
12. Nothing in this agreement precludes or prohibits the agencies from examining any

entity for which the agency has statutory examination authority, or from taking timely supervisory action against any entity for which the agency has statutory supervisory authority.

### 5000.0.8.3 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.)

#### 5000.0.8.3.1 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
FDIC	state nonmember banks
OTS	thrift holding companies and savings associations
FRB	parent BHCs, nonbank subsidiaries of BHCs, the consolidated BHC, 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.

### *5000.0.8.3.2 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.

### *5000.0.8.3.3 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

### *5000.0.8.3.4 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.

### *5000.0.8.3.5 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.

### *5000.0.8.3.6 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.

### *5000.0.8.3.7 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.

#### *5000.0.8.3.8 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.

#### *5000.0.8.3.9 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.

#### *5000.0.8.3.10 State Banking Departments*

The agencies will endeavor to coordinate with state banking departments, when appropriate and feasible.

### **5000.0.9 POLICY FOR COMMUNICATING PROBLEMS OF SUPERVISORY CONCERN TO MANAGEMENT AND BOARDS OF DIRECTORS**

#### **5000.0.9.1 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
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.

#### **5000.0.9.2 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.

#### *5000.0.9.2.1 Criteria for Conducting Meetings*

##### **5000.0.9.2.1.1 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. SR-02-1 stipulates that 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 rat-

ing, 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.<sup>10</sup> 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.)

#### 5000.0.9.2.1.2 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.

#### 5000.0.9.2.1.3 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<sup>11</sup> or is about to become a problem institution if existing conditions deteriorate. 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;
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.

For BHCs with consolidated assets of less than \$500 million, the Reserve Banks, effective March 30, 1995 (SR-95-19), were provided the discretion to have senior supervision or examination staff represent the Reserve Bank in meetings with the directors of banks and BHCs. Conference calls with directors may be made in

10. 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.

11. 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. (See section 4070.0.9.)

place of on-site meetings for these BHCs when considered appropriate and if an on-site meeting was held following the previous inspection.

### 5000.0.9.3 Communication of Inspection Findings

An important part of the inspection of banking organizations is the communication of findings to the directors and senior management. Inspection findings may be communicated in writing through formal reports, through letters summarizing the results of targeted reviews or a roll-up (consolidation) of those reviews or through some combination thereof, depending upon the size and complexity of the organization. These written communications are generally directed to the board of directors, an executive-level committee, or senior management, as appropriate.

To be effective, the communication of inspection findings must be (1) written in clear and concise language, (2) prioritized based upon importance, and (3) focused on any significant matters that require attention. In addition, written communications to a board of directors should clarify whether the action must be taken directly by the board or whether the action may be delegated by the board even though the board would continue to be held accountable.

To improve the consistency and clarity of written communications, the Federal Reserve uses standardized terminology to differentiate among

- *Matters Requiring Immediate Attention*, matters arising from the inspection that the Federal Reserve is requiring a banking organization to address immediately;
- *Matters Requiring Attention*, matters that are important and that the Federal Reserve is expecting a banking organization to address over time; and
- *Observations*, matters that are informative, advisory, or suggest a means of improving performance or management of the operations of the organization.

*Matters Requiring Immediate Attention* (MRIA) encompass the highest priority concerns and include matters that have the potential to pose significant risk to the organization's safety and soundness or that represent significant instances of noncompliance with laws and regulations. These concerns must be addressed

immediately by the board of directors or senior management. The action required to address the concern may be a single, short-term event, such as injecting capital, or it may involve the development of an action plan with remedial actions identified within a specified timeframe. All MRIAs must specify a timeframe for completion. The key element is that action to address the concern must begin immediately.

*Matters Requiring Attention* (MRA) have a lower priority than MRIAs, but nonetheless are matters that, based upon current information, must be addressed over time to preclude a significant issue. While issues giving rise to MRAs must be addressed to ensure the long-term operation of the organization in a safe and sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs. Nevertheless, communications must also specify a timeframe for MRAs. At least initially, the supervisory team or the institution (when appropriate) may set an imprecise timeframe because the organization may first need to complete preliminary planning. Timeframes for MRAs are likely to become more precise over time or as circumstances change. The key distinction between MRIAs and MRAs is the immediacy with which the board of directors or senior management must begin and accomplish remediation.<sup>12</sup>

Reserve Banks must formally communicate MRIAs and MRAs to the organization in writing through an inspection report or a letter summarizing the results of a target review or a roll-up of such reviews. When included in a safety and soundness inspection report, MRIAs and MRAs should be noted on the page discussing Matters Requiring Attention. 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.

*Observations* may be communicated within the body of the reports or conveyed informally to the organization. For example, Observations related to enhancement to funds-management policies or practices could be included in the segment on Liquidity Risk Management or discussed with appropriate management personnel.

Communications must specify a timeframe in which the banking organization must complete the action. The expected timeframe for address-

12. For examples and more information on the use of the terms: Matters Requiring Immediate Attention, Matters Requiring Attention, and Observations, see SR-08-01, and in particular, its attachment.

ing MRAs is generally short, and may be “immediate.” In the case of safety-and-soundness findings, corrective actions should be completed within an examination cycle. Supervisory staff should work with senior bank management on the timeframe; however, safety and soundness compliance risk concerns will remain a priority. For MRAs that are necessary to preserve or restore the viability of a banking organization, the timeframe should take into account potential loss to the Federal Deposit Insurance Corporation and whether a delay in action will increase the potential for loss or the cost of resolution.

Communications must also specify a timeframe for MRAs. The timeframe, at least initially, may be imprecise because the organization may first need to complete preliminary planning. The supervisory team may establish the timeframe; however, in some instances, it may be appropriate to request that the institution set forth a reasonable timeframe, subject to supervisory staff concurrence. Timeframes for MRAs are likely to become more precise over time or as circumstances change. Timeframes that span more than one examination cycle for safety-and-soundness issues should include precise or estimated interim targets or thresholds.

Reserve Banks are encouraged to include descriptions of the three categories of findings in the document communicating findings. Regardless of whether a finding is an MRA or MRA, the communication should be clear as to whether the board of directors or senior management is accountable for implementing remedial action.

#### 5000.0.9.4 Summary of BHC Inspection Findings

In the following situations, the Federal Reserve Banks will provide special written reports summarizing the results of the inspection findings to BHCs (see SR-85-28):

1. An organization is rated composite 3, 4, or 5 (except for organizations rated composite 3 or 4 when a written summary report was provided on a preceding inspection (see SR-95-12); when the organization has been taking actions to comply fully with the provisions of that report; and when, in the examiner’s judgment, no good purpose would be served by issuing another summary report).
2. An organization is rated composite 1 or 2 but is showing signs of a significant deterioration in condition or an apparent violation of law.

Examiners in these and other cases may decide to issue summaries to board members when the summaries will prove constructive in resolving potential or actual problems.

The inspection report page, “Examiner’s Comments and Other Matters Requiring Special Board Attention,” may serve as the full text of the summary report to directors and should be written with that purpose in mind. The discussion on the page (and thus in the summary report) should focus on identified problems of the organization rather than its strengths. Problems should be presented in a succinct and unmistakably clear manner. The types of actions to be taken by the directors and management to address these problems should be specifically noted. Institutions rated 4 or 5 are to be told they are “problem” institutions that warrant “special supervisory attention.” Institutions rated 3 are to be informed that their condition is not satisfactory, that they are subject to more-than-normal supervision, and that they may become “problems” if their weaknesses are not addressed adequately.

The summary report will be sent directly to the banking organization’s management for their distribution to each director. The transmittal letter to the banking organization is to state that the report is a summary of identified problems and contemplated supervisory actions and is to request that management distribute the report to each director. The letter is to state further that each director should read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management is to keep on file copies of the statements signed by the directors but is to destroy all but a file copy of the summaries themselves.

To provide the directors with prior notice of the deficiencies to be discussed, the directors’ summary report is to be completed and distributed before any Reserve Bank meeting with the board of directors. Reserve Banks should also make every effort to distribute the complete examination or inspection report to management before meeting with directors.

5000.0.10 SUMMARY TO DIRECTORS OF INSPECTION FINDINGS

# SUMMARY TO DIRECTORS OF INSPECTION FINDINGS

Prepared by the  
Federal Reserve Bank

\_\_\_\_\_

For the Board of Directors of

\_\_\_\_\_

\_\_\_\_\_

Inspection Conducted As of



This summary is the property of the Board of Governors of the Federal Reserve System and is furnished to members of the board of directors of the bank holding company inspected 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. Under no circumstances should the holding company, or any of its directors, officers, or employees disclose or make public in any manner the report or any portion thereof. In reviewing this summary, it should be kept in mind that an inspection is not the same as an audit report.

**THIS SUMMARY SHOULD BE HELD IN STRICTEST CONFIDENCE**

5000.0.10 SUMMARY TO DIRECTORS OF INSPECTION FINDINGS—  
Continued

## Summary Signature Page

The attached summary of an inspection of \_\_\_\_\_ completed on \_\_\_\_\_, has been prepared to assist members of the board of directors of the bank holding company in fulfilling their fiduciary responsibilities. As a member of the board you are urged to review this summary and the inspection report as soon as possible.

As an elected member of the holding company's board of directors, you have a duty to ensure that the organization is operated in a safe and sound manner. You may be held liable for losses caused by your failure to supervise properly the affairs of the holding company. It is suggested that you review one or more of the publications that explain the functional and legal responsibilities of a director.

Congress has placed great emphasis on the role of holding company directors and officers by passing legislation allowing regulatory authorities to use "cease and desist" actions against individuals, to assess civil money penalties, and even to remove an officer or director demonstrating willful or continuing disregard for safety and soundness considerations.

This summary is the property of the Board of Governors of the Federal Reserve System and is furnished to members of the board of directors of the bank holding company inspected 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. Under no circumstances should the holding company, or any of its directors, officers, or employees disclose or make public in any manner the report or any portion thereof. In reviewing this summary, it should be kept in mind that an inspection is not the same as an audit report. After reviewing this summary, please sign below and return this entire document to the bank holding company.

I have received and read the attached summary of the inspection of \_\_\_\_\_ by the Federal Reserve Bank of \_\_\_\_\_ conducted as of \_\_\_\_\_.

\_\_\_\_\_  
S/director

\_\_\_\_\_  
Date



5000.0.10 SUMMARY TO DIRECTORS OF INSPECTION FINDINGS—  
Continued

Summary of Inspection Findings

### 5000.0.11 COMPLETION STANDARD FOR INSPECTION REPORTS

Inspection reports issued by the Federal Reserve must be completed and mailed within 60 calendar days, beginning with the day following the examiner's exit meeting. This standard applies to all inspections, regardless of the complexity of the BHC. For BHCs rated 3, 4, or 5, Reserve Banks are encouraged to follow an internal target of 45 calendar days for processing and mailing reports. When reports are issued jointly with other state banking agencies, this standard may be extended at the discretion of the senior management at the Reserve Bank. (See SR-93-4.)

### 5000.0.12 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,<sup>13</sup> 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 section 6000 of the *Commercial Bank Examination Manual* and sections 5010.0 to 5010.43 of this 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<sup>14</sup> numbers, and must clearly indicate that the report is a combined report.

13. 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.

14. Research, Statistics, Supervision and Regulation, and Discount and Credit (RSSD)

# Procedures for Inspection Report Preparation (Inspection Report References)

Section 5010.0

<i>Manual Section No.</i>	<i>Report Page No.</i>	<i>Report Page Title</i>
FR 1225:		
5010.2		Cover
5010.3	i.	Table of Contents
5010.4	1.	Examiner's Comments and Matters Requiring Special Board Attention
5010.5	2.	Scope and Abbreviations of Inspection
5010.6	3.	Analysis of Financial Factors
5010.7	4.	Audit Program
5010.8	5.	Parent Company Comparative Balance Sheet
5010.9	6.	Parent Company Comparative Statement of Income and Expenses
5010.10	7.	Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems
5010.11	8.	Consolidated Comparative Balance Sheet
5010.12	9.	Comparative Consolidated Statement of Income and Expenses
5010.13		Consolidated Capital Structure
5010.14		Policies and Supervision
5010.15		Violations
5010.16		Other Matters
5010.17		Classified Assets and Capital Ratios of Subsidiary Banks
5010.18		Organization Chart
5010.19		History and Structure
5010.20		Investment in and Advances to Subsidiaries
5010.21		Commercial Paper
5010.22		Lines of Credit
5010.23		Commercial Paper/Lines of Credit (including questions)
5010.24		Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)
5010.25		Statement of Changes in Stockholder's Equity
5010.26		Income from Subsidiaries (Fiscal and Interim)
5010.27		Cash Flow Statement (Parent) (including questions) <sup>1</sup>
5010.28		Parent Company Liquidity Position
5010.29		Parent Company and Nonbank Assets Subject to Classification
5010.30		Bank Subsidiaries
5010.31		Nonbank Subsidiaries
5010.32		Nonbank Subsidiary Financial Statements
5010.33		Fidelity and Other Indemnity Insurance
5010.34		(Reserved for future use)
5010.35		Other Supervisory Issues
5010.36		Extensions of Credit to Bank Holding Company Officials and Their Related Interests and Investments in and Loans on Stock or Obligations of Their Related Interests
5010.37		Interest Rate Sensitivity—Assets and Liabilities
5010.38		Treasury Activities/Capital Markets
5010.40	A	Principal Officers and Directors
5010.41	B	Condition of the Bank Holding Company
5010.42	C	Liquidity and Debt Information
5010.43	D	Administrative and Other Matters

1. This page is required to be included in the inspection report for bank holding companies with consolidated assets in excess of \$1 billion or those companies that have substantive fixed charges or debt outstanding, as well as selected others at the option of the Reserve Bank.

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<i>Manual Section No.</i>	<i>Report Page No.</i>	<i>Report Page Title</i>
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FR 1241:

5010.13		Capital Structure (lead bank subsidiary)
5020.1		Bank Subsidiary
5020.2		Other Supervisory Issues

The full-scope report is designed to be used as a minimum standard in reporting the results of a bank holding company inspection. The report to be provided to the bank holding company consists of a core section and an appendix section, the latter consisting of certain required financial statements. Supporting schedules are added to the core or appendix sections when an area of concern or problem is addressed. Such schedules provide detailed information relevant to a particular activity area.

The core section contains a table of contents, a summary of the scope of the inspection, and a page that presents the examiner's comments and discusses matters requiring special Board attention. The core section should also contain an analysis of financial factors, including an assessment of the quality of assets and a complete analysis of the bank holding company's RFI/C(D) components. Specifically, the core section is made up of the pages described in the following subsections.

### 5010.1.1 CORE SECTION

The inspection report format contains the following pages in the core section:

<i>Page no.</i>	<i>Page title</i>
	Standard Report Cover
i.	Table of Contents
1.	Examiner's Comments and Matters Requiring Special Board Attention
2.	Scope of Inspection and Abbreviations
3.	Analysis of Financial Factors
4.	Audit Program

### 5010.1.2 APPENDIX SECTION

The appendix section will consist of a mandatory section that presents the following financial statements for the organization:

1. Parent Company Comparative Balance Sheet
2. Parent Company Comparative Statement of Income and Expenses
3. Consolidated Comparative Balance Sheet
4. Consolidated Comparative Statement of Income and Expenses

Bank holding company inspections should be conducted as of the latest fiscal quarter. All financial statements should be presented as of the most recent calendar quarter. The dollar amounts are reported in thousands.

Financial statements prepared by the bank holding company may be used to meet the appendix requirements, provided the statements are prepared in accordance with generally accepted accounting principles and are, in the examiner's judgment, suitably detailed, clear, and accurate. Any adjustments to any financial statements made by the examiner should be footnoted. Any other supporting schedules or visual aids (for example, graphs or charts) can be included in the core section to communicate or support the examiner's findings. Percentages should be rounded to the nearest tenth of 1 percent, unless finer detail is necessary.

### 5010.1.3 OPTIONAL PAGES TO BE INCLUDED IN THE CORE OR APPENDIX SECTIONS

#### Supporting Report Pages for All Inspections

The listed optional supporting report pages are to provide support to the core or appendix section of the report.<sup>1</sup> They will normally be sequenced as listed below. If a problem area is cited within the core section, the respective typed supporting report pages need to be included to support the critical comments. The optional supporting pages listed are to be included by the examiner in the report when they convey signifi-

1. "Supporting report pages" refers to information gathered in essentially the same format as when the page is being prepared by the examiner for inclusion in the report. However, certain supporting information may not provide sufficient value to address an area of concern in the report but should be retained in workpaper form to provide evidential matter for the inspection report. For example, the Statement of Changes in Stockholders' Equity may be summarized in an audit report or may be included with the company's audited annual financial statements. The examiner would review the statement to conclude whether the information is reliable and complete and that it agrees with the respective balances reported in the inspection report. A photocopy of the information could be used to provide evidence of the examiner's review, including any related notes.

cant findings in the core section or when they support the discussion in the core section with an appendix page. If appropriate standardized report pages do not exist to address a particular area of concern, the relevant analytical support can be included on the “Other Matters” page as part of the inspection report. Any or all supporting report pages and workpapers should be available to be forwarded immediately to Board staff, if requested.

The designated optional supporting report pages are—

Policies and Supervision  
 Summary of Consolidated-Classified and Special-Mention Assets, and Other Transfer-Risk Problems  
 Consolidated Capital Structure  
 Capital Structure (lead bank subsidiary)  
 Treasury Activities/Capital Markets  
 Violations  
 Other Matters  
 Classified Assets and Capital Ratios of Subsidiary Banks<sup>2</sup>  
 Organization Chart  
 History and Structure  
 Investment in and Advances to Subsidiaries  
 Commercial Paper (Parent)  
 Lines of Credit (Parent)  
 Commercial Paper/Lines of Credit (Parent) (including questions)  
 Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)  
 Statement of Changes in Stockholders’ Equity  
 Income from Subsidiaries (Fiscal and Interim)  
 Cash Flow Statement (Parent) (including questions)<sup>3</sup>  
 Parent Company Liquidity Position  
 Parent Company and Nonbank Assets Subject to Classification  
 Bank Subsidiaries  
 Nonbank Subsidiaries  
 Nonbank Subsidiary Financial Statements  
 Fidelity and Other Indemnity Insurance  
 Other Supervisory Issues  
 Extensions of Credit to Bank Holding Company Officials and Their Related

Interests and Investments in and Loans on Stock or Obligations of Their Related Interests  
 Interest Rate Sensitivity—Assets and Liabilities

In addition to the FR 1225 report pages, a few replacement report pages are designated as FR 1241 pages. The following pages were designed to be used for smaller bank holding companies having less than \$150 million in assets:

Capital Structure (lead bank subsidiary)  
 Bank Subsidiary  
 Other Supervisory Issues

#### 5010.1.4 CONFIDENTIAL SECTION FOR ALL INSPECTION REPORTS

The confidential section for bank holding company inspection reports is reserved for confidential comments that will be limited to staff of the Federal Reserve System. The confidential section of the inspection report will consist of the following pages:

<i>Page</i>	<i>Page title</i>
A.	Principal Officers and Directors
B.	Condition of the Bank Holding Company
C.	Liquidity and Debt Information
D.	Administrative and Other Matters

Discussion in the confidential section should be kept to a minimum. As much information as possible should be incorporated in other sections of the report that are available to the bank holding company. The complete analysis of the holding company organization (that is, bank holding company RFI/C(D) components) is to appear in the front of the report on the “Analysis of Financial Factors” page. The information reported on the confidential pages should be printed on yellow paper.

#### 5010.1.5 GENERAL COMMENTS FOR ALL REPORT PAGES

The specified format of the report pages should be used whenever possible, but when flexibility is necessary, additions and limited deletions can be made. Examiners are required to include in the core section only a relatively small number

2. Included if assets are classified or written up as required.

3. This page is required to be included in the inspection report for bank holding companies with consolidated assets in excess of \$1 billion or those companies that have substantive fixed charges or debt outstanding, as well as select other organizations at the option of the Reserve Bank.

of report pages and, in the appendix section, only financial statements for the organization. These pages will normally be sequenced as listed previously. At the same time, examiners have the discretion to decide whether to include other standard pages in a report and whether to include them in the core or the appendix sections. This choice should be made on the basis of whether the content of the page will highlight a significant inspection finding (in which case, the finding should be included in the core section) or whether the content will provide support for comments offered in the core section (in which case, the finding should ordinarily be placed in the appendix section).<sup>4</sup> Given the discretion being accorded examiners to tailor reports to accurately convey inspection findings, reports prepared for large and small companies alike should be prepared to achieve that objective.

Another important objective is to avoid excessive length in the report, particularly in the open section. Including comments that may provide directors and management with information of marginal importance or including information that repeats findings and conclusions from different pages of the report diverts the reader's attention from the areas of concern that

must be corrected.<sup>5</sup> In addition, reports should be understandable and readable. A further objective is for examiners to determine precisely what should be conveyed in their reports to boards of directors and management and then to present that information in clear and concise language.

All reports are to be on 8½- by 11-inch paper and bound on the left margin. Responses to questions should be provided below the last question in the section or, if necessary, on an additional page. Do not repeat the question in the response. Indicate the question number in the response.

All credit-extending nonbank subsidiaries will be subject to asset classification. The examiner should recommend that management maintain a loan-loss reserve that is adequate to offset 100 percent of assets classified loss and still have a balance sufficient to absorb normal unidentified, unanticipated future losses from operations. The examiner and BHC management should consider the guidance provided in section 2065.2 on the determination of an adequate level for the allowance for loan and lease losses. Examiners should also review the organization's loan-loss history to determine trends and to help evaluate the adequacy of the existing reserve.

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4. If a problem area is cited within the core section, inclusion of the listed and typed supporting report pages will be necessary to support the critical comments.

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5. While brevity is an important goal, examiners should note that, when an enforcement action is contemplated, the inspection report must fully support the proposed provisions of the enforcement document.

The official name, location, and the RSSD ID number of the bank holding company being inspected is to be provided. Also provide the dates the inspection commenced and concluded as well as the inspection date. The cover includes a notice that its content is strictly confidential.

The cover must include the official seal of the Board of Governors of the Federal Reserve Sys-

tem. It may also include the names and seals of the Reserve Bank and the state bank supervisory agency that participated in the inspection as part of a cooperative inspection agreement. The cover must also include a reference to the Board's rule pertaining to confidential supervisory information made available to supervised financial institutions and financial institution supervisory agencies, which is 12 C.F.R. 261.20.



FR 1225-Cover  
(Revised 7/08)



# REPORT OF BANK HOLDING COMPANY INSPECTION

Name: \_\_\_\_\_ Inspection Commenced: \_\_\_\_\_

Location: \_\_\_\_\_ Inspection Concluded: \_\_\_\_\_

RSSD ID Number: \_\_\_\_\_ 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 dis-

close 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

# Procedures for Inspection Report Preparation (Page i—Table of Contents)

## Section 5010.3

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The table of contents indicates the report pages included in the report and the sequential numbering of pages within the report. All pre-numbered Core Section inspection report pages are included in each table of contents along with any other supporting report pages. Supporting report pages will be numbered sequentially in FR 1225, starting with page number “11”.

If included, individual subsidiaries may be

listed with their respective page numbers, or they may be grouped such as “Nonbank Subsidiaries” with a page reference such as “26–26c” to indicate the number of such subsidiaries. At the bottom of the page, insert the commencement date of the previous inspection followed by the date of the financial statements in parentheses.

# Procedures for Inspection Report Preparation (Core Page 1—Examiner’s Comments; Matters Requiring Special Board Attention) Section 5010.4

## WHAT’S NEW IN THIS REVISED SECTION

*Effective July 2008, this section has been revised to incorporate and reference the guidance found in SR-08-01, “Communication of Examination/Inspection Findings,” which may involve the preparation of this inspection report page or section (continuous flow reporting). To improve the consistency and clarity of written communications, Federal Reserve staff is to use the prescribed standardized terminology and definitions, to differentiate among (1) Matters Requiring Immediate Attention, (2) Matters Requiring Attention, and (3) Observations.*

### 5010.4.1 SUMMARY OF EXAMINER’S FINDINGS

The report page or section (continuous flow reporting) is to include a summary of the examiner’s findings relating to—

1. violations,
2. criticisms,
3. special comments,
4. matters requiring special board attention, and
5. recommendations.

In addition, it will include the RFI/C(D) component ratings (see SR-04-18 and section 4070.0.2.3). Component ratings for the current inspection and the two prior inspections will be reported at the top of the page, as illustrated below (see SR-96-26).

## Bank Holding Company RFI/C(D) Rating System

Inspection rating for:	Current inspection	Prior inspection	Prior inspection
Date:	09-03-X7	10-19-X6	8-22-X5
[R]isk management	2	2	2
[F]inancial condition	2		
[I]mpact	2		
[C]omposite rating	2	2	2
[D]epository institution(s)	2		

This listing should be followed by the uniform definition of the assigned ratings. The uniform definitions of the component and subcomponent ratings assigned need not be included in reports; however, they should be made available to management and directors upon request.

When a combined examination/inspection report format is used, similar matrices for each component and subcomponent rating assigned should be included in the report. Numeric ratings should also be included on the pages of reports that discuss findings related to the components and subcomponents.

The purpose of the report page or section is to communicate to the holding company’s board of directors and its management the examiner’s views on the overall condition of the company, significant problems that have been identified in the inspection, and actions the company’s board of directors and management need to take to correct the company’s problems and strengthen its condition. The comments should summarize only material concerns, criticisms, analyses, or violations, referring the reader to an appropriate optional report page for additional detail. The use of subcaptions to identify and separate the areas subject to comment is encouraged.

The comments are generally written on an exception basis. Avoid laudatory comments. The examiner may, however, comment on improvements initiated by management.

Items suitable for discussion within the

“Examiner’s Comments and Matters Requiring Special Board Attention” report page include, but are not limited to—

1. policies and supervision of subsidiaries,
2. earnings,
3. cash flow or liquidity,
4. level of classified assets,
5. adequacy of capital,
6. borrowings,
7. condition of subsidiaries,
8. violations of the Bank Holding Company Act and Regulation Y,
9. violations of section 23A or section 23B of the Federal Reserve Act and other statutes,
10. fees and dividends being paid to the parent by subsidiaries,
11. audit function, and
12. information that serves as an alternative to issuing a separate Summary to Directors of Inspection Findings.

Any substantive recommendations contained elsewhere in the inspection report should be presented briefly in the core page “Examiner’s Comments and Matters Requiring Special Board Attention.” A summary comment relative to the adequacy of the BHC’s oversight of its subsidiaries may be provided. Any comments that refer specifically or indirectly to details presented elsewhere in the report should be consistent with that information. All inspection report pages entitled “Examiner’s Comments and Matters Requiring Special Board Attention” will be written to accomplish these objectives: give an overall assessment of the condition of the company, discuss significant problems, and specify needed corrective action. See the subsection 5000.0.9.3 on the “Communication of Inspection Findings.” To achieve consistency and clarity in written communications, Federal Reserve staff is to use prescribed standardized terminol-

ogy and definitions, to differentiate among (1) Matters Requiring Immediate Attention (MRIAs), (2) Matters Requiring Attention (MRAs), and (3) Observations. (See also SR-08-01.)

The Matters Requiring Board Attention report page or section should label the comments therein as being either MRIAs, MRAs, or Observations. As a general rule, examiners should expect fewer MRIAs or MRAs in stronger organizations than in weaker ones. However, the presence of MRIAs or MRAs does not preclude a strong or satisfactory rating. For example, while correction of any violation of law is essential, the presence of inadvertent violations that do not expose the organization to significant risk (such as insufficient Federal Reserve stock shortly after a capital injection or a technical exception) would not preclude a strong rating if all other factors supported that rating. Conversely, the presence of a large number of inspection findings that give rise to MRIAs or MRAs that represent a threat to the safety and soundness of the organization or that signify an elevated consumer compliance risk exposure would generally preclude a satisfactory rating and may require consideration of an enforcement action. For institutions between these extremes, examiners should determine the impact of MRIAs and MRAs on ratings and assess the need for an enforcement action by considering the severity of these weaknesses and their relative importance in light of all the factors influencing the assessment of the organization. The Federal Reserve examiner’s use of this common terminology is designed to enhance the focus and efficiency of communicating supervisory expectations and overseeing their implementation.

In cases of composite ratings of 3, 4, and 5, the text of this page will also be used for the summary report. The signature of the examiner-in-charge should appear below the comments.

# Procedures for Inspection Report Preparation (Core Page 2— Scope of Inspection and Abbreviations) Section 5010.5

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The scope of the inspection describes generally the coverage parameters of the inspection. When determining the scope of the inspection, the examiner must consider the Board's policy statement on the examination and inspection of state member banks and bank holding companies (October 7, 1985, S-2493). See sections 5000.0.7 to 5000.0.9.

The scope generally includes a presentation of the following:

- the purpose for the inspection
- which subsidiaries were inspected on-site and which were done from the parent's location
- the depth of inspection coverage<sup>1</sup>
- an identification of the peer group(s) and the bank holding companies used for comparison with the bank holding company being inspected
- the source of information regarding the administration of policies and the supervision over subsidiaries

- comments as to the extent examiners relied on internal classification systems or classifications of other bank regulatory agencies
- the senior officers with whom the overall inspection findings were discussed
- the sources upon which the examiner based his conclusions and/or recommendations

The opening paragraph of the scope should include authority under which the inspection was conducted (section 5(c) of the Bank Holding Company Act of 1956, as amended), and may include the dates the inspection commenced and closed, and the date(s) of financial statements used as the basis for the inspection.

In brief paragraphs, the examiner should also indicate what minute books were read, which nonbank subsidiaries were examined, what size loans were reviewed in credit-extending subsidiaries, with whom corporate policies were discussed, and to what extent banking subsidiaries were reviewed.

The report page will also include explanations of abbreviations used in the report. Generally, abbreviations familiar to the BHC should be used. However, efforts should be made to incorporate at least a part of the name into the abbreviation as opposed to relying strictly on initials which tend to become confusing. Also, it is desirable that abbreviations of bank subsidiaries include the word "bank" to distinguish them from the parent company and/or nonbank subsidiaries with similar names.

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1. This includes a statement as to the percentage of loans reviewed in each credit-extending nonbank subsidiary, without consideration to statistical sampling or any form of extrapolation. The ratio will include loans actually reviewed by Federal Reserve examiners divided by total loans in each nonbank subsidiary. When different categories of loans are housed in a nonbank subsidiary, it may be relevant to provide a breakdown by percentage of loans reviewed for each category of loans, further segregated by current and delinquent categories. See SR-90-26.

The “Analysis of Financial Factors” page presents a complete financial analysis of the components (nonconfidential bank holding company RFI/C(D) comments) of the holding company—parent, bank subsidiaries, nonbank subsidiaries, and consolidated (as applicable). The page is supported and followed by parent and consolidated financial statements, information on consolidated asset quality, and consolidated capital ratios. See the 4000 sections for specific information on analyzing financial factors.

The analysis serves the informational needs of both senior management of the holding company and the supervisory authorities by presenting positive and negative factors affecting the condition of the major components and the consolidated company. The analysis helps to identify problems or potential problems and measures the holding company’s ability to be a source of financial strength to its subsidiaries. Therefore, the “Analysis of Financial Factors” page is considered one of the most important parts of the report.

The information for the analysis is available from discussions with management; financial-statement data within the report; published statements, such as the SEC Form 10-K; and unpublished information that is sometimes available from the officer in charge of finance, the treasurer, or the comptroller.

### 5010.6.1 PARENT COMPANY

For the parent company, present an analysis of each of the financial factors in narrative form. Tables may be used to support the narrative analysis.

The analysis of the parent should include a discussion of the following: debt structure (with indications of how debt proceeds are used), debt/equity ratios (with comparisons to previous years), sufficiency of cash flow, sources and stability of income, interest coverage, dividend-payout ratios, classifications of parent company assets, changes in dividend policy, comparisons of the actual levels and results to the respective peer group, and a conclusion about whether the holding company is considered to be a source of financial strength to its subsidiaries.

Within the analysis of the parent, the examiner should also include comments on whether dividend payments to stockholders have been reasonable, considering the parent’s leveraged position, debt servicing, cash flow, and capital

needs. The examiner should describe how dividend policy is formulated and what the policy is. See the Board’s policy on cash-dividend payments in section 2020.5.1.

Dividends paid by 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. The examiner will need to conclude and discuss in the report whether dividend assessments of any subsidiary are excessive. The examiner can draw conclusions about excessive dividends from discussions with management about dividend policies and from information that may be contained elsewhere in the report, such as—

1. peer-group averages,
2. the condition and capitalization of each subsidiary,
3. the type of subsidiary (credit-extending subsidiaries need more capitalization than service subsidiaries),
4. the bank holding company’s reasons for extracting proportionately more or less from each subsidiary,
5. past policy and payments, and
6. compliance with regulatory policy and guidelines.

### 5010.6.2 BANK SUBSIDIARIES

A summary write-up should be prepared for each bank subsidiary comprising 10 or more percent of the bank holding company’s consolidated assets or for bank subsidiaries evidencing material financial deficiencies or other characteristics that should be brought to the attention of the bank holding company’s board of directors.<sup>1</sup> These write-ups should summarize noteworthy examiner comments from the open section of the latest reports of examination of the subsidiary bank(s) and should comment on any actions taken to correct significant weaknesses or violations. The summary should also include an analysis of the level and trend of earnings

1. In determining the subsidiary banks that require write-ups, examiners should be mindful of the effect that the cross-guarantee provisions of FIRREA can have on nontroubled bank subsidiaries.

and classified assets and of the adequacy of capital (for example, tier 1, total capital, and leverage ratios).

For the other bank subsidiaries, the examiner should provide an overall summary that includes the number of subsidiaries, by composite rating; an overall analysis of the level and trend of earnings; classified assets; capital (that is, capital adequacy); and any other financial-analysis indicators.

### 5010.6.3 NONBANK SUBSIDIARIES

The examiner should present an analysis of the condition and an analysis of the risk assessment of nonbank subsidiaries. The analyses presented within this report page should support the I component of the RFI/C(D) rating without making the reader refer to other report pages.

Because of the number of nonbank subsidiaries a bank holding company may have, it may not be possible or reasonable to discuss the condition, risk assessment, and impact of each nonbank subsidiary on the BHC's banking and other depository institution subsidiaries. The analysis presented on this page should, therefore, be based on the combined performance of the nonbanking activities. However, if the company has significant or troubled credit-extending nonbank subsidiaries, individual analyses of each of these subsidiaries should be included.

The analysis of nonbank subsidiaries should include information on these subsidiaries' financial condition, including the level, trend, and quality of earnings; composition of the loan portfolio; level and trend of classified, past-due, and nonperforming assets; and adequacy of the loan-loss reserve, capital, financial management of debt-to-equity ratios, and funds management. The combined risk assessment should address the 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. (See SR-93-19.) Conclude with a general statement on the condition and overall risk assessment of the nonbank subsidiaries.

### 5010.6.4 CONSOLIDATED

Present an analysis of the consolidated balance sheet, including levels and trends of debt; the adequacy of capital (tier 1, total capital, and leverage ratios); growth in loans, assets, and liabilities; and peer-group comparisons. Also present an analysis of the consolidated earnings trends, asset quality, and the adequacy of valuation reserves. Such analysis should include comments on performance results based on net interest margins, return on average assets, return on average equity, factors influencing earnings, and peer-group comparisons. Include a statement on the condition of the company, including its reliance on interest-sensitive funds and its ability to borrow additional short- or long-term funds or to issue new capital stock.

### 5010.6.5 GENERAL INSTRUCTIONS

The examiner should make certain that—

1. the figures and comments related to the parent are consistent with the various parent company financial statements;
2. the analysis of bank subsidiaries is consistent with data included on the "Bank Subsidiaries" and the "Classified Assets and Capital Ratios of Subsidiary Banks" pages;
3. the analysis of nonbank subsidiaries is consistent with data on the "Nonbank Subsidiary," "Nonbank Subsidiary Financial Statements," and "Nonbank Company Assets Subject to Classification" report pages;
4. the consolidated analysis is consistent with information presented throughout the report, primarily with the consolidated financial statements and the unaffiliated borrowings on the "Liquidity and Debt Information" confidential page C;
5. all names are the same as those on the "Scope and Abbreviations" core page 2, the "Organization Chart" page, and other report pages and tables; and
6. all debt figures agree with the unaffiliated borrowings of the "Liquidity and Debt Information" confidential page C.

This page presents the adequacy of the internal audit program, the effectiveness and quality of the overall audit program, and the BHC's relationship with its external auditor. See section 2060.1 for related information.

The examiner's review of the BHC's internal audit program will establish whether the program is adequate to effectively audit the BHC's operations regularly. It will also help determine whether the audit function provides the directors with sufficient information on the corporation's conditions and operations. The review will allow the examiner to determine the external auditor's role and relationship with the internal auditor.

The information on the audit program is available from the auditor, audit committee, the audit staff, and the internal audit reports. Information on the external auditor should be available from the management letter, the internal auditor, and the audit committee minutes.

Comments on the internal audit program may include an appraisal of the effectiveness of the program at meeting the frequency guidelines for auditing subsidiaries, information on the recipients of audit reports, and the party to whom the auditor is responsible. The examiner's comments on the external auditor may include the name of the firm, the scope of the audit, the degree of interface with the internal auditors, any "qualified opinion" submitted by the independent auditors in certifying the most recent years' financial statements, and any pertinent comments regarding relations with the directors' audit committee. The comments should conclude with an appraisal of the quality and effectiveness of the overall audit program.

The following is a list of suggested questions for the internal auditor in developing comments for this section:

#### 5010.7.1 INTERNAL AUDITOR

1. How is the audit staff organized? To whom do they report?
2. What are the educational backgrounds and experience of the staff?
3. What is the size of the staff and the length of time that most of the staff have been in audit? Is the staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor? Is the department used as a training ground for other departments?
4. What is the schedule for the audit of banking and nonbanking subsidiaries and for particular departments therein?

5. Are copies of audit programs and reports available for the Federal Reserve's review?

6. Are audit programs coordinated with and workpapers reviewed by outside accountants?

7. Are qualified EDP auditors on the staff?

Although more information is obtained through interviews with the auditor, as opposed to receiving responses to written questions, these questions represent a general framework on which the conversation may develop.

#### 5010.7.2 EXTERNAL AUDITORS

1. Have independent public accountants audited the bank holding company's consolidated financial statements for the FR Y-6 annual report if the BHC's consolidated assets exceed \$500 million or more?

2. Does the external auditor work with the internal auditor in establishing the scope and frequency of audits?

3. In addition to performing some of the basic functions of the internal auditor, did the external auditor review the internal auditing program to assess its scope and adequacy?

4. When the BHC does not have sufficient earnings to employ an internal audit staff, yet the complexities of the organization necessitate the need for an audit, has an external auditor been engaged for this purpose?

5. Does the external auditor have the ability to conduct surprise audits and sufficient flexibility for establishing the scope of the audits and in making recommendations on internal control changes?

6. Have the BHC's insured depository institutions furnished their independent auditors with the required call reports, memorandums of understanding, written agreements, and other designated supervisory information required by section 7(a) of the FDIC Act (see section 2060.1.1)?

The comments detailed on this report must be consistent with summarized comments on the Policies and Supervision page and the Other Supervisory Issues page (item 8). Any noteworthy deficiencies in the audit program may be included on the Examiner's Comments and Matters Requiring Special Board Attention, core page 1, at the examiner's discretion.



The comparative balance sheet presents the composition of the parent company's balance sheet as to assets, liabilities, and capital and should be representative of the functions and activities of the company. The comparative balance sheet allows the reader to compare changes in accounts on a line-by-line basis from one period to another. It aids and gives written support to the financial analysis.

The parent company balance sheets may be requested in the officer's questionnaire or may be obtained from the accounting department. Fiscal statements can also be found in the most recent SEC Form 10-K and the FR Y-6 and Y-9 LP.

The detail on the most recent balance sheet accounts should be reconciled to subsidiary ledgers or a detailed trial balance. The statements should be adjusted to reflect generally accepted accounting principles. Adjustments should be footnoted. The statements should be presented in four columns with two interims and two fiscals except for year-end inspections when only two fiscals are required. The presentation should be (from left to right) current interim period, prior interim period, current fiscal, and prior fiscal. The statement may be formatted like the FR Y-9 LP.

The parent company comparative balance sheet should have specific detail or schedules supporting balance-sheet accounts and amounts as follows.

1. Show investments in and advances to subsidiaries as separate accounts, with separate subtotals for banks and nonbanks.
2. Provide supplementary schedules on the "Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)" page showing a breakdown of accounts not detailed in the report, such as marketable securities, CDs, and other investments when considered appropriate or when the account exceeds 25 percent of total footings.
2. Break out goodwill and other intangibles from "Other Assets" or "Investments in Subsidiaries," and detail on the "Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)" page.
3. Break out "other real estate owned" from "Other Assets," and detail on the "Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)" page.

4. "Other Assets" and "Other Liabilities" should be broken down and detailed on the "Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)" page if any item in the account is considered significant.

5. Mandatory convertible debt instruments should be shown separate from subordinated capital notes and debentures and detailed on the unaffiliated borrowings on the "Liquidity and Debt Information" confidential page "C."

6. Stockholder's equity should contain the following categories, as applicable: common stock, perpetual preferred stock, limited life preferred stock, capital surplus, retained earnings (undivided profits), reserves for contingencies and other capital reserves. Limited life preferred stock should be shown separate from stockholders' equity. For all capital stock issues indicate in a footnote the par value and the number of shares authorized and outstanding for each period. If there is more than one type of stock, indicate the voting rights, preferential dividend rights, and conversion rights, where applicable.

The examiner should make certain that the—

1. investments in subsidiaries equals the investments detailed on the "Investment in and Advances to Subsidiaries" page,
2. advances to subsidiaries equals advances detailed on the "Investment in and Advances to Subsidiaries" page,
3. commercial paper total equals the commercial paper totals detailed on the Commercial Paper (Parent) page and the "Liquidity and Debt Information" confidential page "C,"
4. total of short-term and long-term debt equals the same totals for unaffiliated borrowings on the "Liquidity and Debt Information" confidential page "C,"
5. "Other Assets" and any other accounts detailed on the "Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)" page reconciles to the corresponding items on the page (the "Contingent Liabilities and Schedule of Balance-Sheet Accounts Not Detailed Elsewhere (Parent)" page may show only significant items in the categories without totals), and
6. parent's equity accounts equal those on the "Statement of Changes in Stockholder's Equity" and on the "Consolidated Comparative Balance Sheet" page.

# Inspection Report Preparation (Appendix Page 6—Comparative Statement of Income and Expenses (Parent))

## Section 5010.9

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The comparative income statement presents income of the parent available to satisfy expense requirements. It also can be an indicator of the structure of services and activities provided at the parent level.

The purpose of the statement is to determine—

- the levels and types of intercompany income,
- that the sources of external income are consistent with authorized activities,
- the changes in corporate policy via changes in intercompany income, and
- that the types and levels of the parent's expenses are appropriate for the parent's activities.

All statements of income and expenses should be requested in the officer's questionnaire. Fiscal information can be found in the holding company's annual report to shareholders, FR Y-6, and/or SEC Form 10-K. Interim results are generally requested from the corporation's accounting or comptroller department.

Two interims and two fiscals should be presented unless the inspection is as of fiscal year-end, when only two fiscals are required. The report page should show all significant categories of operating income and expense. A supplementary schedule should be provided breaking down any category of other income or expense

that equals or exceeds 25 percent of its respective total.

If possible, insurance commission income is to be shown net of premiums collected, and, when available, commissions should be broken down to show those directly related to credit extended within the bank holding company organization. The various income components from internal and external sources need to be detailed separately to allow cross checking with the "Income from Subsidiaries" pages.

Equity in undistributed earnings of subsidiaries should be listed below net operating income to derive "net income." Where applicable, show separately the equity in undistributed earnings of subsidiary banks and nonbanks.

The examiner should make certain that—

- dividends, interest, management, and service fees and equity in undistributed earnings of subsidiaries equal the totals on the "Income from Subsidiaries" pages and
- net income equals the amounts reported on the "Statement of Changes in Stockholders' Equity (Parent)" and "Comparative Statement of Income and Expense (Consolidated)" pages. In those cases where the figures do not agree, the difference should be footnoted and detail should be provided for the difference.

# Inspection Report Preparation (Appendix Page 7—Consolidated Classified & Special-Mention Assets & OTRP) Section 5010.10

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Classified assets, off-balance-sheet transactions, and other transfer-risk problems (OTRP) are summarized by organizational level, whether at the parent company, banking subsidiaries, or nonbank subsidiaries, and compared with valuation reserves established to absorb known and potential losses. For banking subsidiaries, the classified items are derived from the most recent federal and state examinations for the individual bank subsidiaries.

Report the classification, reserve, noncurrent, and loan/lease-level ratios as detailed on the report page. The ratio of consolidated classified assets to tier 1 capital should be included. The “continued” page should contain comments regarding the sources of information and methods used by the examiner for determining consolidated asset quality.

For the parent company, the classification totals should be broken down into the major asset categories (for example, “Loans,” “Other Real Estate,” and “Other Assets”). The lead bank subsidiary’s classification should be broken out along with any other bank that has classified assets representing 20 percent or more of total consolidated classified assets. The assets of a nonbank credit-extending subsidiary should be broken out if the nonbank subsidiary had classifications greater than 5 percent of consolidated classified assets or other large problem credits or classified assets.

There may be occasions when one or more subsidiary banks may not have been subject to an asset-quality review by a bank supervisory agency within the last two years, which impedes the bank holding company examiner from making an accurate judgment on the company’s asset quality. The examiner may accept the internal criticized assets of the bank holding company *only if* the internal system was tested by the examiner and deemed to be valid. Generally, such testings should be conducted as necessary in order to make an informed judgment on consolidated asset quality. Comments should be provided about whether the examiner was able to rely on information depicting asset quality or that such information was not available.

Classification totals of off-balance-sheet transactions, if any, should be broken out separately and summarized for each level of the organization (parent company, bank subsidiaries, and nonbank subsidiaries).

The source for reporting classified asset totals should be stated (FRB, OCC, FDIC, internal operations, or internal audit review) along with

the respective as-of date. As an alternative, classified asset totals may be listed for individual bank and nonbank subsidiaries. The purpose of preparing this summary is to—

1. determine the amount and degree of risk and potential loss associated with on- and off-balance-sheet transactions and activities (This is accomplished by summarizing the amount of classified assets and losses and other potential losses that may result from on- and off-balance-sheet activities, including off-balance-sheet risk and transfer risk at the consolidated organizational level, as well as the general composition of such potential losses at the parent company, bank subsidiaries, or nonbank subsidiaries);
2. analyze ratio trends in consolidated asset quality for the current and previous two inspections;
3. determine the extent to which such classified assets and off-balance-sheet risk influence the overall financial condition of the consolidated organization;
4. determine the adequacy of reserves (The page alerts management about the need for increasing the valuation reserve accounts);
5. disclose problem assets and off-balance-sheet transactions requiring management’s attention;
6. show in summary form all classifications and criticisms assigned by examiners in determining asset quality and the adequacy of respective reserves; and
7. aid in the identification of existing and potential problems in the banks that may have an overall effect on the bank holding company.

The information for the report page is derived from two other completed pages or workpapers, “Parent Company and Nonbank Assets Subject to Classification” and “Classified Assets and Capital Ratios of Subsidiary Banks.” The information is obtained by determining the collectibility or forced-sale value of assets or potential losses that may arise from certain on- and off-balance-sheet transactions. For banks, the information is to be generated from bank examination reports that are available at the Reserve Bank. (The holding company may have copies of the open sections of the reports.)

Investments in and advances to bank and

nonbank credit-extending subsidiaries by the parent are not to be classified. The examiner may, however, classify the parent's investments in and advances to non-credit-extending nonbank subsidiaries. For additional information on classifying an investment to a non-credit-extending subsidiary, see section 4070.0.

The use of abbreviations for the subsidiaries within narrative comments, as presented on the "Scope and Abbreviations" core page 2, is permissible. The examiner may comment on and analyze lending policies, documentation, collection procedures, and past-due volume in the aggregate. Such comments should be consistent with comments in other report pages and workpapers.

The examiner should provide comments on the adequacy of the valuation reserves and any recommendations to management to provide for additional loan-loss provisions. The examiner should also recommend that management maintain a level of loan-loss reserves that is adequate to offset 100 percent of assets classified loss and still have a balance sufficient to absorb normal unidentified, unanticipated future losses from operations.

*Weighted classified assets* includes 100 percent of loss, 50 percent of doubtful, 20 percent of substandard, and, when applicable, value impaired (net of adjusted transfer-risk reserve). It is appropriate to comment on weighted classified assets on the "Analysis of Financial Factors" core page 3.

*Noncurrent loans and leases* refers to the end-of-period dollar amount of loans and lease-financing receivables past due 90 days or more and still accruing, plus those carried in nonaccrual status, as reported for each loan category. This report page should not be included in the core section of the report for one-bank holding companies. For those bank holding companies, the examiner will include the classifications on the "Parent Company and Nonbank Assets Subject to Classification" and the "Bank Subsidiaries" report pages when assets are classified or written up as required.

The examiner should make certain that the aggregate classifications and reserve amounts agree with those reported for the parent, the banking subsidiaries, and the nonbank subsidiaries on the "Parent Company and Nonbank Assets Subject to Classification" and the "Classified Assets and Capital Ratios of Subsidiary Banks" pages or workpapers. If classifications are discussed on the "Examiner's Comments

and Matters Requiring Special Board Attention" page, the totals should be confirmed.

### 5010.10.1 CLASSIFICATION OF ASSETS

The Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts<sup>1</sup> (the uniform agreement), as revised June 15, 2004, 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.) The revised uniform agreement amends the examination procedures that were established in 1938 and then revised and issued on July 15, 1949, and May 7, 1979. The uniform agreement's classification of loans remains unchanged from the 1979 revision. The classification categories are designated as Substandard, Doubtful, and Loss. The June 15, 2004, uniform agreement changes the classification standards applied to banks' (and bank holding companies') holdings of debt securities by—

1. eliminating the automatic classification of sub-investment-grade debt securities when a banking organization has developed an accurate, robust, and documented credit-risk management framework to analyze its securities holdings;
2. conforming the uniform agreement to current generally accepted accounting principles by basing the recognition of depreciation on all available-for-sale securities on the bank's determination as to whether the impairment of the underlying securities is "temporary" or "other than temporary";
3. eliminating the preferential treatment given to defaulted municipal securities;
4. clarifying how examiners should address securities that have two or more different ratings, split or partially rated securities, and nonrated debt securities;
5. identifying when examiners may diverge from conforming their ratings to those of the rating agencies; and
6. addressing the treatment of Interagency Country Exposure Review Committee ratings.

The uniform agreement's classification categories also apply to the classification of assets held

1. The statement was issued 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 (the agencies).

by the subsidiaries of banks and bank holding companies. *Although the classification categories for bank and bank holding company assets and assets held by their subsidiaries are the same, the classification standards may be difficult to apply to the classification of certain subsidiary assets because of differences in the nature and risk characteristics of the assets.* Despite the differences that may exist between assets held directly by a bank or bank holding company and those held by its subsidiaries, the standards for classifying investment securities are to be applied directly to securities held by a bank or bank holding company and its subsidiaries.

### 5010.10.1.1 Substandard Assets

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or 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 bank will sustain some loss if the deficiencies are not corrected.

#### *5010.10.1.1.1 Substandard Classification—Guidelines for an Asset When a Substantial Portion Has Been Charged Off*

In some cases, credit-extending subsidiaries with loans to financially troubled borrowers have charged off substantial portions of these credits. Consistent with long-standing supervisory practice, the evaluation of each extension of credit should be based on the fundamentals of the particular credit. That is, the evaluation of each credit should be based on the borrower's (or the collateral's) current and stabilized cash flow, earning and debt-service capacity, financial performance, net worth, guarantees, and future prospects and on other factors relevant to the borrower's ability to service and retire its debt.

Based on the consideration of all relevant financial factors, the evaluation may indicate that a credit has well-defined weaknesses that jeopardize repayment in full but that a portion of the loan may be reasonably assured of repayment. When a charge-off has been taken in a sufficient amount so that the remaining recorded balance of the loan is being serviced (based on reliable sources of cash flow) and is reasonably assured of repayment, this remaining recorded

balance would generally be classified no more severely than substandard.<sup>2</sup> Consistent with long-standing classification guidelines, a Substandard classification of the remaining recorded balance would only be appropriate when well-defined weaknesses continue to be present in the credit. For example, when the remaining recorded balance of an asset is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be classified. (See SR-91-18.) This approach would generally be appropriate when an organization maintains sufficient controls over its lending function and maintains adequate current documentation to support the credit analysis of the loan. This classification approach could not be used for loans for which the loss exposure cannot be reasonably determined, for example, loans collateralized by properties subject to environmental hazards. This approach would also not be justified when sources of repayment are considered unreliable.

### 5010.10.1.2 Doubtful Assets

An asset classified Doubtful has all the weaknesses inherent in one classified Substandard. However, it has 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.

### 5010.10.1.3 Loss Assets

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 that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

2. The accrual/nonaccrual status of the loan must continue to be determined in accordance with the glossary to the current Call Report or bank holding company reporting instructions. Thus, while these partially charged-off loans may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the report guidance are met.

## 5010.10.2 APPRAISAL OF SECURITIES IN BANK EXAMINATIONS

In an effort to streamline the examination process and achieve as much consistency as possible, examiners will use the published ratings provided by nationally recognized statistical ratings organizations (NRSROs) as a proxy for the supervisory classification definitions. Examiners may, however, assign a more- or less-severe classification for an individual security, depending on a review of applicable facts and circumstances.

### 5010.10.2.1 Investment-Quality Debt Securities

Investment-quality debt securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating categories provided by NRSROs and includes unrated debt securities of equivalent quality.

Because investment-quality debt securities do not exhibit weaknesses that justify an adverse classification rating, examiners will generally not classify them. However, published credit ratings occasionally lag demonstrated changes in credit quality and examiners may, in limited cases, classify a security notwithstanding an investment-grade rating. Examiners may use such discretion, when justified by credit information the examiner believes is not reflected in the rating, to properly reflect the security's credit risk.

### 5010.10.2.2 Sub-Investment-Quality Debt Securities

Sub-investment-quality debt securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes debt securities, including hybrid equity instruments (for example, trust preferred securities), in grades below the four highest rating categories; unrated debt securities of equivalent quality; and defaulted debt securities.

To reflect asset quality properly, an examiner may in limited cases “pass” a debt security that is rated below investment quality. Examiners

may use such discretion when, for example, the institution has an accurate and robust credit-risk-management framework and has demonstrated, based on recent, materially positive credit information, that the security is the credit equivalent of investment grade.

### 5010.10.2.3 Rating Differences

Some debt securities may have investment-quality ratings by one (or more) rating agencies and sub-investment-quality ratings by others. Examiners will generally classify such securities, particularly when the most recently assigned rating is not investment quality. However, an examiner has discretion to “pass” a debt security with both investment-quality and sub-investment-quality ratings. The examiner may use that discretion if, for example, the institution has demonstrated through its documented credit analysis that the security is the credit equivalent of investment grade.

### 5010.10.2.4 Split or Partially Rated Securities.

Some individual debt securities have ratings for principal but not interest. The absence of a rating for interest typically reflects uncertainty regarding the source and amount of interest the investor will receive. Because of the speculative nature of the interest component, examiners will generally classify such securities, regardless of the rating for the principal.

### 5010.10.2.5 Nonrated Debt Securities

The agencies expect institutions holding individually large nonrated debt security exposures, or having significant aggregate exposures from small individual holdings, to demonstrate that they have made prudent pre-acquisition credit decisions and have effective, risk-based standards for the ongoing assessment of credit risk. Examiners will review the institution's program for monitoring and measuring the credit risk of such holdings and, if the assessment process is considered acceptable, generally will rely on those assessments during the examination process. If an institution has not established independent risk-based standards and a satisfactory process to assess the quality of such exposures, examiners may classify such securities, including those of a credit quality deemed to be the equivalent of subinvestment grade, as appropriate.

Some nonrated debt securities held in investment portfolios represent small exposures relative to capital, both individually and in aggregate. While institutions generally have the same supervisory requirements (as applicable to large holdings) to show that these holdings are the credit equivalent of investment grade at purchase, comprehensive credit analysis subsequent to purchase may be impractical and not cost effective. For such small individual exposures, institutions should continue to obtain and review available financial information, and assign risk ratings. Examiners may rely on the bank's internal ratings when evaluating such holdings.

#### 5010.10.2.6 Foreign Debt Securities

The Interagency Country Exposure Review Committee (ICERC) assigns transfer-risk ratings for cross-border exposures. Examiners should use the guidelines in this uniform agreement rather than ICERC transfer-risk ratings in assigning security classifications, except when the ICERC ratings result in a more severe classification.

#### 5010.10.2.7 Treatment of Declines in Fair Value Below Amortized Cost on Debt Securities

Under generally accepted accounting principles (GAAP), an institution must assess whether a decline in fair value<sup>3</sup> below the amortized cost

of a security is a “temporary” or an “other-than-temporary” impairment. When the decline in fair value on an individual security represents “other-than-temporary” impairment, the cost basis of the security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be reflected in current-period earnings. If an institution's process for assessing impairment is considered acceptable, examiners may use those assessments in determining the appropriate classification of declines in fair value below amortized cost on individual debt securities.

Any decline in fair value below amortized cost on defaulted debt securities will be classified as indicated in the table below (section 5010.10.3). Apart from classification, for impairment write-downs or charge-offs on adversely classified debt securities, the existence of a payment default will generally be considered a presumptive indicator of “other-than-temporary” impairment.

#### 5010.10.2.8 Classification of Other Types of Securities

Some investments, such as certain equity holdings or securities with equity-like risk and return profiles, have highly speculative performance characteristics. Examiners should generally classify such holdings based on an assessment of the applicable facts and circumstances.

3. As currently defined under GAAP, the fair value of an asset is the amount at which that 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 are the best evidence of fair value and must be used as the basis for measuring fair value, if available.

### 5010.10.3 SUMMARY TABLE OF GENERAL DEBT SECURITY CLASSIFICATION GUIDELINES

The following table outlines the uniform classification approach the agencies will generally use when assessing credit quality in debt securities portfolios:

<i>Type of security</i>	<i>Classification</i>		
	<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>
Investment-quality debt securities with “temporary” impairment	—	—	—
Investment-quality debt securities with “other-than-temporary” impairment	—	—	Impairment
Sub-investment-quality debt securities with “temporary” impairment <sup>1</sup>	Amortized cost	—	—
Sub-investment-quality debt securities with “other-than-temporary” impairment, including defaulted debt securities	Fair value	—	Impairment

Note. Impairment is the amount by which amortized cost exceeds fair value.

1. For sub-investment-quality available-for-sale (AFS) debt securities with “temporary” impairment, amortized cost rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value, is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities. Under GAAP, unrealized

gains and losses on AFS debt securities are excluded from earnings and reported in a separate component of equity capital. In contrast, these unrealized gains and losses are excluded from regulatory capital. Accordingly, the amount classified Substandard on these AFS debt securities, i.e., amortized cost, also excludes the balance-sheet adjustment for unrealized losses.

The general debt security classification guidelines do not apply to private debt and equity holdings in a small business investment company or an Edge Act corporation. The uniform agreement does not apply to securities held in trading accounts, provided the institution demonstrates through its trading activity a short-term holding period or holds the security as a hedge for a customer’s valid derivative contract.

appropriate pre-acquisition credit due diligence by qualified staff that grades a security’s credit risk based on an analysis of the repayment capacity of the issuer and the structure and features of the security. It also involves the ongoing monitoring of holdings to ensure that risk ratings are reviewed regularly and updated in a timely fashion when significant new information is received.

### 5010.10.4 CREDIT-RISK-MANAGEMENT FRAMEWORK FOR SECURITIES

When an institution has developed an accurate, robust, and documented credit-risk-management framework to analyze its securities holdings, examiners may choose to depart from the above general debt security classification guidelines in favor of individual asset review in determining whether to classify those holdings. A robust credit-risk-management framework entails

The credit analysis of securities should vary based on the structural complexity of the security, the type of collateral, and external ratings. The credit-risk-management framework should reflect the size, complexity, quality, and risk characteristics of the securities portfolio; the risk appetite and policies of the institution; and the quality of its credit-risk-management staff, and should reflect changes to these factors over time. Policies and procedures should identify the extent of credit analysis and documentation required to satisfy sound credit-risk-management standards.



This Core report page is to present the consolidated balance sheet as of the financial statement date, the comparable date for the previous year, and the last two fiscal year-end statements. When the inspection is conducted at fiscal year-end, only two fiscal year-end statements need be presented. The comparative statement allows the reader to analyze any changes in asset, liability, and capital structure and to determine the condition of the consolidated organization on the specified dates.

The financial statements should be requested in the officer's questionnaire. Fiscal financial statements can also be obtained from the FR Y-6, FR Y-9, the SEC Form 10-K, and published reports to shareholders.

The balance sheets should be presented in columnar form with the current interim first, prior interim period, current fiscal and prior fiscal. They may be formatted like the FR Y-9.

In preparing the comparative balance sheet, the following should be done.

1. Gross loans should be shown and then netted of unearned discount and reserve for loan losses.

2. Federal funds sold and securities purchased under resale agreements may be shown as one amount or separately, depending on how the company prepares its statements. Similar treatment should be given to federal funds purchased and securities sold under repurchase agreements on the liability side.

3. Total deposits should be broken down or footnoted to show interest-bearing and noninterest-bearing deposits in domestic and foreign offices.

4. Mandatory convertible debt instruments should be shown separate from subordinated capital notes and debentures and detailed on the "Liquidity and Debt Information" Confidential Page "C."

5. Stockholder's equity should be detailed using the following categories, as applicable: common stock, perpetual preferred stock, capital surplus, retained earnings (undivided profits), and reserves for contingencies and other capital reserves.

The amount of total consolidated debt should agree with unaffiliated debt for the current period on the "Liquidity and Debt Information" Confidential page "C." Any exceptions should be footnoted.

Equity capital should agree with the individual components shown on the "Statement of Changes in Stockholders' Equity (Parent)" page for the respective periods and with stockholders' equity on the "Parent Company Comparative Balance Sheet" Core page 5. Any exceptions should be footnoted.

Figures used in the analysis on the "Analysis of Financial Factors" Core page 3 and the "Capital Structure (Consolidated)" pages should agree with this statement.

# Inspection Report Preparation (Appendix Page 9—Comparative Consolidated Statement of Income and Expenses) Section 5010.12

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This report page is to present a *consolidated* statement of income and expense as of the financial statement date, the comparable date for the previous year, and the last two fiscal year-end statements. When the inspection is conducted at fiscal year-end, only two fiscal year-end income and expense statements need be presented. The statement aids the reader in an analysis of corporate earnings performance on a consolidated basis and provides the ability to further analyze changes in income and expense accounts from one period to another.

Statements of income and expenses should be requested in the officer's questionnaire. Statements for fiscal periods can also be obtained from the FR Y-6, FR Y-9, the SEC Form 10-K and published reports to stockholders.

The statement of income and expenses should be presented in columnar form with the current interim first, prior interim period, current fiscal,

and prior fiscal. They may be formatted like the FR Y-9.

Any detail available that breaks down "interest income" for the most recent fiscal year into components should be presented either on the statement as a footnote or on a supplemental page, the "Comparative Statement of Income and Expenses (Consolidated)" page, if considered appropriate by the examiner.

Provisions for loan losses should be shown as a line item and not grouped in "other expenses." "Other income" and "other expenses" should be broken down to provide additional detail at the discretion of the examiner.

Net income should normally agree with net income of the parent on the "Comparative Statement of Income and Expenses (Parent)" page and the "Statement of Changes in Stockholders' Equity (Parent)" page. Footnote differences.

The risk-based capital guidelines apply on a consolidated basis to bank holding companies with consolidated assets of \$150 million or more. For these BHCs, the designated FR 1225 report page will be used. For BHCs with consolidated assets of less than \$150 million, the risk-based capital guidelines apply on a bank-only basis unless (a) the parent holding company is engaged in nonbank activity involving significant leverage (e.g. engaged in significant off-balance sheet activity); or (b) the parent company has a significant amount of outstanding debt that is held by the general public. For BHC with total assets of less than \$150 million the Capital Structure (FR 1241) report page is used.

### 5010.13.1 BHCS WITH CONSOLIDATED ASSETS OF \$150 MILLION OR MORE— [CORE PAGE 10—CONSOLIDATED CAPITAL STRUCTURE (FR 1225)]

The consolidated capital structure report page summarizes the various components of the BHC risk-based capital ratios. Two report pages are provided to allow for risk-based capital computations during transition and at year-end 1992 for final implementation. The pages provide the various limitations for the respective components of Tier 1 and Tier 2 capital. For both report pages, the first page summarizes "Total Qualifying Capital" comprised of Tier 1 and Tier 2 capital, adjusted for investments in unconsolidated financing subsidiaries and reciprocal holdings of capital.

Tier 1 capital consists of permanent core capital elements (common equity, noncumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interest in the equity of consolidated subsidiaries). Tier 1 capital is derived by subtracting goodwill from the sum of Tier 1 capital elements.

Tier 2 capital consists of: (a) a limited amount of the allowance for loan and lease losses; (b) auction rate perpetual preferred stock plus any cumulative perpetual preferred stock exceeding its Tier 1 limitation; (c) perpetual debt, mandatory convertible securities, and other hybrid capital instruments; (d) long-term perpetual preferred stock; and (e) limited amounts of term subordinated debt, intermediate-term preferred stock, and unsecured long-term debt issued prior to March 12, 1988.

For Tier 2 capital, the amount of mandatory

convertible securities that have the proceeds of common or perpetual preferred stock dedicated to retire or redeem them should be treated as term subordinated debt subject to the established limit of 50 percent of Tier 1 capital. Mandatory convertible securities, net of the perpetual preferred or common stock dedicated to redeem or retire the issues, are included within Tier 2 on an unlimited basis. Tier 2 capital may not exceed Tier 1 capital.

Investments in unconsolidated financial subsidiaries and reciprocal holdings of capital are subtracted from the combined total of Tier 1 and Tier 2 capital to determine the amount of total qualifying capital.

Core page 10-1 provides a summary of risk weighted on- and off-balance sheet assets, adjusted (reduced) for the excess of the allowance for loan and lease losses not included in Tier 2 capital and the allocated transfer risk reserve (ATRR). In addition, it provides a comparative peer and historical summary of risk-based capital ratios, growth rates, and dividend payout ratios.

Core page 10-2 provides a summary comments section to discuss any pertinent aspects of the institution's capital structure not evident from the schedule.

The information on the capital structure page will give support to the examiner's evaluation of the bank holding company's capital adequacy. The most convenient method to obtain the information is to request it in the officer's questionnaire, or through direct contact with the accounting department.

The amounts on the risk-based capital schedules should be shown as of the same date as the "Consolidated Comparative Balance Sheet" of the inspection report. Refer to the Risk-based Capital Guidelines in Appendix A of Regulation Y and Manual sections 4060.3 and 4060.4 for a discussion of the Capital Adequacy Guidelines and the minimum risk-based capital and leverage ratios for BHCs.

Use the instructions and guidance found on the report page and worksheets. When completing the supplementary capital section, insert the aggregate amount of each component in the space provided. If more than one issue of a particular Tier 2 capital component is outstanding, a range of rates should be shown in the appropriate space, giving the lowest and the highest rates paid.

Comments under the Risk-based Capital schedule should include:

- Any unusual terms and conditions relating to issues of supplementary capital that the examiner feels should be mentioned;
- An indication of whether a subsidiary bank's equity represents the proceeds from the issuance of parent debt (double leverage);
- A presentation or description of risk-based capital components for statutory purposes if there is a violation for which the statutory definition is relevant.
- A situation whereby the levels of risk warrant significantly higher risk-based capital ratios than the minimums.

The amounts of Tier 1 and Tier 2 used in this analysis of consolidated risk-based capital on the "Analysis of Financial Factors" page should be consistent with the amounts on this page.

### 5010.13.2 WORKSHEETS

In addition to the report pages, BHC Risk-Based Capital Calculation Worksheets have been developed for examiner use with year-end 1992 final implementation. The worksheets are to be

retained with the examiner's workpapers. If the bhc generated data was validated by the examiner and accepted to support or partially substitute for the computation of the elements, it should also be retained with the worksheets. The worksheets provide more detail as to the composition of core capital elements and supplementary capital elements. In addition, the footnotes provide more detailed explanations of the various components than are found on the actual report pages.

### 5010.13.3 BHCS WITH LESS THAN \$150 MILLION IN CONSOLIDATED ASSETS—[PAGE—CAPITAL STRUCTURE (LEAD BANK OR OTHER BANK SUBSIDIARY (FR 1241)]

The FR 1241 report page is used primarily for the lead bank. Report pages have been developed for year-end 1992 final implementation. The report pages are nearly identical to those used for state member bank examinations (FR 1460). If there is no one lead bank, the report pages should be prepared for each comparable lead bank.

This report page provides a summary of the policies formulated by the board of directors by which active management supervises holding company operations. The objective is to determine whether there are adequate formal policies developed and supervised, either directly through the board of directors, or by a delegation of the authority, for the parent company and its subsidiaries. Another objective is to evaluate management's performance in carrying out those policies for the entire organization. These policies aid in giving insight into the operations of the holding company. The policies should ensure that all statutory and regulatory requirements are met and that proper controls (management information systems) are in place to minimize risk. Examiners should encourage BHCs to develop formal written policies on all items presented.

The report page is to provide an analysis of the adequacy of supervision exercised by the holding company over its subsidiaries, and policies concerning intercompany relationships. Also included is a discussion of deficiencies in the policy-making process, any noncompliance with existing policies, and the plans for correcting any deficiencies.

In the officer's questionnaire, the examiner may request some of the information pertaining to policies. Insight into policies may also be gained by reviewing the holding company's annual reports to stockholders and through discussions with management. If the holding company does not have any formal written policies, the organization's operating procedures should be discussed with officers responsible for the various areas.

Compliance with policies may be determined by reviewing recent internal and external audit reports, recent bank examinations, and discussions with management at the subsidiary level, and by conducting tests to determine the extent of compliance with policies. Discussions with management are necessary to obtain a thorough understanding of management and supervisory practices, policy-development techniques, the degree to which management information is utilized to monitor subsidiaries, and overall management philosophy.

The policies should be summarized as succinctly as possible in narrative form. If the holding company has no formal policies the examiner may use an introductory statement indicating that comments were derived from discussions with senior management. Absence of any formal policies may require the examiner to make

a recommendation on the "Examiner's Comments" Core page 1 that the holding company strongly consider the establishment of formal written policies in order to supervise its subsidiaries more effectively.

This report page should address existing policies and the level of control and supervision exercised over subsidiaries. How effectively policies are carried out should be shown in the respective sections of the report. Where policies result in violations of law or regulation, comments should be made on the "Examiner's Comments" Core page 1 and detailed on the "Violations" page. If any policy is considered inconsistent with safe and sound banking practices, the matter should be presented on Core page 1 and detailed elsewhere in the report.

Comments on policies that are on other pages in the report should be consistent with this report page. Those comments and report pages are:

1. Dividends and fees from subsidiaries—on the "Statement of Changes in Stockholder's Equity," "Income from Subsidiaries," and the "Cash Flow Statement (Parent)" pages.
2. Dividends paid to shareholders—on the "Statement of Changes in Stockholder's Equity," and the "Cash Flow Statement (Parent)."
3. Budgeting and tax planning—on the "Other Supervisory Issues" page.
4. Internal audit—on the "Audit Program" page.
5. Insider transactions—on the "Extensions of Credit to BHC Officials" page.

#### 5010.14.1 QUESTIONS TO BE ADDRESSED ON THE POLICIES AND SUPERVISION REPORT PAGE

##### 5010.14.1.1 Level of Control and Supervision Exercised over Subsidiaries

1. Do subsidiaries operate autonomously? What is the degree of overlap between BHC and bank management?
2. Who sets major policies of the corporation?
3. How does the holding company monitor the operations of its subsidiaries (reports, directors, etc.)?
4. Are the subsidiaries involved in formulating the holding company's budget and tax plan-

ning? How is the holding company's budget developed and at what corporate level is income tax planning coordinated?

5. Describe the intermediate and long-term strategic planning process and whether the subsidiaries are integrated into a consolidated planning process. Does the consolidated plan include the minimum elements discussed in section 2010.4 of this manual? Is the plan effective and is it consistently applied?

6. How is the internal audit of subsidiaries performed?

- Does an audit team audit each subsidiary on a periodic basis?
- What is the frequency of the audit cycle?
- To whom does the audit department report?
- Is there an audit committee of directors?

7. Is the control and supervision of subsidiaries deficient?

#### 5010.14.1.2 Loans and Investments of Subsidiaries (See sections 2010.2 and 2010.3.)

1. Does the parent company's policies address the minimum elements of a lending policy as listed and described in section 2010.2 of this manual?

2. Does each subsidiary have its own loan policy or does the holding company establish policy for all subsidiaries? Are lending policies considered adequate and is there general compliance?

3. Does each subsidiary handle its own investment portfolio or are investments managed at the holding company level? Are investment policies adequate and is there general compliance? Are investment-authorization procedures adequately detailed to prevent circumvention of investment-policy directives?

4. Does the holding company have a credit review team or is credit review handled by each subsidiary?

5. Does the BHC have a policy establishing limits on consolidated concentrations of credit?

#### 5010.14.1.3 Funds Management and the Adequacy of Existing Policies (See section 2010.1.)

1. Does the parent-company management have policies in place to prevent funding prac-

tices that put at risk the welfare of the subsidiary banks or the consolidated organization?

2. Does the parent company maintain for itself and its subsidiaries policies that provide guidance and controls for funding practices?

3. To what extent do the subsidiaries follow the funding policies and how effective are they in reducing risk to the entire organization?

4. At a minimum, do the parent company's funding policies address:

a. Capitalization levels for bank subsidiaries, the nonbank subsidiaries, and the consolidated organization as to whether the policy for:

- Bank and consolidated capital are consistent with the Board's capital adequacy guidelines;
- Nonbank capital includes maintaining the capital level at industry standards;
- The holding company specifies the desired range of capital for each entity, and the measures that should be taken in the event that capital falls below that level;
- The parent company specifies the degree of double leverage that it is willing to accept;
- Each entity specifies the method for calculating dividends?

b. Asset/liability management including interest rate sensitivity matching, maturity matching, and the use of interest rate futures and forwards and other financial derivative instruments?

c. How nonbank subsidiaries fund their activities?

#### 5010.14.1.4 Loan Participations Among Subsidiaries (See sections 2010.2 and 2020.2.)

1. Under what circumstances are loans participated?

2. Who determines the type of loans that may be participated? Does the BHC have policies in that regard? Are credit standards included in the lending policy for purchased loan participations and does the policy require complete loan documentation.

3. Does the lending policy place limits on the amount of loans purchased from any one source and does it place an aggregate limit on such loans?

4. Are low-quality loans allowed to be participated?

### 5010.14.1.5 Dividends and Fees From Subsidiaries

1. What is the policy for assessing dividends from subsidiaries?
2. Does the policy take into account statutory and regulatory restrictions on bank dividends as well as subsidiary asset quality, earnings, the ability to service debt and growth prospects?
3. What is the policy for determining fees charged to subsidiaries in relation to management and other services rendered?
4. Are service fee arrangements supported by contracts and are the subsidiaries actually receiving the services?
5. Are the fees charged to subsidiaries reasonable and justifiable in relation to the fair market value of the services provided? If no market exists for the services provided, are fees based on their cost plus a reasonable profit? Has the BHC directly or indirectly through other subsidiaries burdened its banking subsidiaries with excessive fees or unreimbursed charges to fund its debt service, dividend payments or support of other subsidiaries?

### 5010.14.1.6 Risk Evaluation and Control

1. Has the bank holding company formalized policies and procedures in identifying, evaluating, and controlling risk?
2. What has management done to limit its risk exposure in relationship to the amount of the organization's capital, or earnings?
3. Do audit procedures include a determination as to whether management's risk evaluation and control procedures are being followed as prescribed?
4. Has the bank holding company taken steps to identify and control its exposure to losses resulting from contingent liabilities and off-balance sheet activities such as standby letters of credit, interest rate swaps, foreign exchange contracts, currency swaps, options, securities lending and borrowing, insider transactions, and commitments to lend?

### 5010.14.1.7 Management Information Systems

1. How effective and timely are the parent company's policies and procedures with respect to its management information systems as to:

- Audit
- Budget
- Reporting
- Insurance

2. Does the board of directors receive sufficient information about key areas of its operations?

### 5010.14.1.8 Internal Loan Review

1. Is an internal loan review program in existence for bank and/or nonbank subsidiaries? If no program exists, does the size and complexity of the organization warrant implementation of a formal process?
2. Will the internal loan review procedures adequately identify deteriorations in credits, loans that do not comply with written loan policies and loans with technical exceptions in a timely manner?
3. Is the loan review function independent of the loan approval function, with written findings reported to a board committee or senior management committee not directly involved in lending?
4. Are the quality and size of the internal loan review staff sufficient in relation to the organization's size and complexity?
5. Are the scope and frequency of the loan review procedures adequate?

## 5010.14.2 DISCUSSION AND APPRAISAL OF OTHER PARENT COMPANY POLICIES

Another parent company policy that should be discussed and appraised, in addition to those listed on the "Policies and Supervision" page is the Consolidated Planning Process whereby the subsidiaries are integrated into a consolidated plan. See Manual section 2010.4.

This report page is used to present information on all violations discussed in the inspection report. The objective of the report page is to bring violations to the attention of the board of directors for corrective action and to alert the supervisory agencies to the need for supervisory attention.

The information reported should center on violations by the holding company uncovered during the course of the inspection and those that are discovered through a review of reports filed with supervisory authorities. Information on violations by the subsidiary bank(s) in its dealings with the holding company or affiliates may be obtained from the most recent bank examination reports or uncovered during the holding company inspection.

This page should include all BHC and non-bank subsidiary violations of the Act, Regulation Y, Section 23A and 23B violations of the Federal Reserve Act, and other applicable statutes and regulations. A complete write-up is necessary if the violation is not detailed on another page (including the date of the violation or transaction, a description of the transaction or act, the reason for the violation, the amount of the transaction, and the amount of any potential or actual loss). When the information is presented elsewhere, a brief summary and a reference to that page is sufficient.

Violations of the holding company should be presented first, followed by the nonbank subsidi-

aries and then bank subsidiaries. Bank violations not involving the holding company or non-bank subsidiaries should not be detailed here.

If violations of sections 23A and 23B of the Federal Reserve Act (transactions with holding company affiliates) are disclosed in a subsidiary bank's examination report or during the inspection of the holding company, comments should be limited to a brief summary on the "Violations" page with a reference to the intercompany transaction(s) on the "Other Supervisory Issues" page. This latter page will contain additional detail on the violation. (Note: only bank subsidiaries can be cited for the violations of sections 23A and 23B of the Federal Reserve Act although the violation may have resulted from holding company actions). The examiner may also criticize management on the "Examiner's Comments" Core page 1 of the inspection report for causing the bank to be in violation of sections 23A and 23B provisions.

Apparent violations should be presented on the "Other Matters" page, and may be presented on the "Examiner's Comments" page if considered appropriate by the examiner. Violations will be reviewed on a case by case basis for possible follow-up administrative action(s).

Violations must be presented in brief on the "Examiner's Comments" page referring the reader elsewhere for detail. The examiner should ensure that information contained on these related pages is consistent.



This page presents nonconfidential information or issues which would not be suitable for presentation on any other page in the report. BHC plans may be discussed here in order to anticipate any regulatory or supervisory considerations. *Apparent* violations are also presented here and may be referred to on “Examiner’s Comments” page or on other report pages at the examiner’s discretion. BHC plans for future activities may be presented.

The information might be derived from minutes of the corporation and/or subsidiaries, discussions with management, and examiner observations during the inspection.

Other information that may be summarized can include:

1. Corporate plans (debt or equity issues, acquisitions, sale of assets). Be certain management has no objection to the reference to these plans. Otherwise, present such information on page C;

2. Any unfunded pension liabilities;

3. Overall condition of corporate records; and

4. Any other comments deemed appropriate by the examiner and not noted elsewhere in the report.

Any reference that involves dollar amounts, ratios, or other information contained in schedules or comments elsewhere in the report should be cross-checked.

# Procedures for Inspection Report Preparation (Page—Classified Assets and Capital Ratios of Subsidiary Banks) Section 5010.17

This report page provides a summary of asset classifications and capital ratios as of the most recent federal and state examinations for the individual bank subsidiaries. The objective of the page is to aid in the identification of existing or potential problems in the banks which may have an overall effect on the holding company.

The information is to be derived from bank examination reports which are available at the Reserve Bank. (The holding company may have copies of the open sections of the reports.)

The banks are to be listed in the same order as they appear on the Organization Chart or Investments in and Advances to Subsidiaries report pages. Total assets or total average assets should be shown as presented in the examination report. Do not adjust total assets by adding back valuation reserves.

For bank holding companies, tier 1 capital includes common equity and qualifying cumulative and noncumulative perpetual preferred stock, less goodwill and other designated intangible assets. Common stockholders equity includes common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign-currency translation, net of any treasury stock, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values.

Qualifying cumulative perpetual preferred stock is limited within tier 1 to 25 percent of the common stockholders equity and minority interest. Total capital includes tier 1 plus tier 2 capital.

Weighted classified assets includes 100 percent of loss, 50 percent of doubtful, and 20 percent of substandard and value-impaired (when applicable), net of allocated transfer risk reserves (ATRR).<sup>1</sup> It is appropriate to comment on weighted classified assets on the Analysis of Financial Factors page.

When determining supervisory asset-quality ratings (the [A]sset rating in "CAMELS") for the BHC's subsidiary banks, an asset-quality ratio is used based on a comparison of weighted classified assets to tier 1 capital (as defined for leverage purposes) plus the allowance for loan

and lease losses. Examiners should use this ratio and the accompanying benchmarks in conjunction with all the other factors normally evaluated when assessing asset quality for each institution.

The allowance for loan and lease losses is defined as the bank's total ALLL. The ALLL is *not* subject to the 1.25 percent limitation on supplementary capital elements for this calculation (that is, all of the ALLL is included in the denominator of the ratio).

The ratio of these assets to tier 1 capital plus the allowance for loan and lease losses is then compared to the existing asset-quality benchmark table to determine the asset-quality rating.

## Asset-Quality Table

<i>Asset-Rating Ranges</i>	<i>Asset-Quality Ratio</i>
1	under 5%
2	5% to 15%
3	15% to 30%
4	30% to 50%
5	over 50%

Examiners should use the asset-quality table and other pertinent factors, including loan policies, credit administration, portfolio concentrations, and past-due levels, to determine the final asset-quality rating. While individual bank ratios may change slightly, depending on the amount of cumulative preferred stock, mandatory convertible debt, and other supplementary elements, the change in the ratio itself should not result in a change in the bank's asset-quality rating.

This page should not be prepared for one-bank holding companies. The examiner may show this data on the Bank Subsidiaries page. However, the examiner may use this page to reflect successive examination data for several years to indicate trends. The examination dates should be cross-checked to those shown on the Bank Subsidiaries page.

1. See SR-92-2 regarding the treatment of value-impaired classifications for asset-quality purposes.

This report page presents an organization chart, giving a schematic description of the structure of the organization, the intercompany relationships and the degree of control of subsidiaries.

An organization chart provided by the holding company for various regulatory filings may be used, with revisions made for new or divested subsidiaries. The information required below may simply be added to the existing chart.

The organization chart may be pictorial (box format) or linear (listing format). The parent should be presented at the head of the page. Banks should be presented individually in the same area. Nonbanks should be presented individually in the same area (if possible).

Each subsidiary should be shown by its official name; however, there is no need to indicate the address unless necessary to distinguish identity. Subsidiaries of banks and second tier nonbank subsidiaries may be omitted or shown at the examiner's discretion. Abbreviated charts should be so footnoted.

Abbreviations used throughout the report should be presented on the "Structure and Abbreviations" Report page and also on the

bottom of this page or following the chart. Generally, abbreviations familiar to the BHC should be used. However, efforts should be made to incorporate at least a part of the name into the abbreviation as opposed to relying strictly on initials which tend to become confusing. Also, it is desirable that abbreviations of bank subsidiaries include the word "Bank" to distinguish them from the parent company and/or nonbank subsidiaries with similar names.

Indicate the percentage of ownership to the nearest tenth of one percent and include directors' qualifying shares. Where all, or nearly all of the subsidiaries are wholly-owned, detail the exceptions and provide a footnote to the effect that unless shown, ownership is 100 percent.

The names and/or abbreviations shown on the organization chart are to be consistently used throughout the report (for example, the "Income from Subsidiaries," "Investment in and Advances to Subsidiaries," and the "Nonbank Subsidiary" and the "Bank Subsidiary" pages).

Where applicable, the order established on this page should be used in all tables of the report.

The report page provides an abbreviated history of the organization including name changes, acquisitions, mergers, reorganizations and divestitures. The objective is:

1. To present the chronological development of the bank holding company.
2. To list nonbank activities engaged in by the parent company and its subsidiaries.
3. To provide a measure of size relative to competing institutions.

The information that is included in this report page may be obtained from documents filed with the Federal Reserve System. For lines 1 through 3, refer to reports filed with the FRB such as the registration statement and FR Y-6. In response to item 3, one bank holding company formed before December 31, 1970, first became subject to the Act on December 31, 1970, with the passage of the 1970 Amendments to the Act. A multibank company formed between 1956 and December 31, 1970, became subject to the Act on the date of controlling its second subsidiary bank. All BHCs formed after December 31, 1970, became subject to the Act

on the date of controlling their first bank subsidiary. For response to item 4, history is available in applications to FRB and in public documents such as annual reports to stockholders and SEC Form 10-K. For additional information contact the corporate secretary.

Comments responding to item 4 are to be in narrative and/or list form and should include:

1. The present number of banking subsidiaries, the percent of State deposits on an aggregate basis and size ranking in the State. For a money-center holding company, also provide its ranking on a national basis.
2. The date and outline of any acquisitions, mergers, reorganizations, or name changes.
3. A list and brief description of activities in which the nonbanking subsidiaries are engaged.
4. A discussion of any permanent or limited grandfather rights, and any plans for divestment of shares or termination of nonbank activities.

The activities shown on this page should be consistent with those shown on the nonbank subsidiary pages.

# Procedures for Inspection Report Preparation (Page— Investment in and Advances to Subsidiaries) Section 5010.20

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## 5010.20.1 INVESTMENT IN AND ADVANCES TO SUBSIDIARIES

This schedule details the parent's financial relationships with its subsidiaries. It will be used to support comments or analyses in other sections of the report, or to clarify answers to the questions on the continued page, "Investment In etc.—continued."

The objectives of the report page are:

1. To determine the percent of the parent's assets comprised of investments in and advances to each subsidiary.
2. To help determine the dependency of subsidiaries on advances from parent.

The parent's investments in and advances to each subsidiary are usually detailed in ledgers maintained by the accounting department. Each subsidiary is listed individually beginning with banks, providing subtotals for banks and non-banking subsidiaries.

The investment in each subsidiary is to include any related unamortized goodwill. Provide a "total" in the "investment" column. From this total subtract the aggregate unamortized goodwill in all subsidiaries and detail the "goodwill" on the "Contingent Liabilities" page.

Totals for investments and advances should agree with the "Comparative Balance Sheet" page. The Parent's investment should be equal to its proportionate interest in each subsidiary's equity as presented in financial statements on the "Nonbank Subsidiary Financial Statement and Condition" and the "Bank Subsidiaries" pages plus any unamortized goodwill. Parent's advances should also equal "loans from parent" as detailed on the "Nonbank Subsidiary Financial Statement and Condition" and the "Bank Subsidiaries" pages.

## 5010.20.2 INVESTMENT IN AND ADVANCES TO SUBSIDIARIES (continued)

For this continuation page, the answers to questions 1 through 6 provide information on the funding of subsidiaries.

The objectives of each question are as follows:

*Question 1*—To determine the amount of goodwill in the investment in each subsidiary.

*Question 2*—To determine if the parent "forgave" the indebtedness of any of its subsidiaries which might indicate an inability to service its debt properly or other financial difficulties in the subsidiary.

*Question 3*—To determine the extent of the parent's borrowings invested as equity since the last inspection. The subsidiary's enlarged capital base might provide additional debt capacity.

*Question 4*—To determine if the advances are on a preferential rate basis, to help in analyzing the subsidiary's earnings proficiency.

*Question 5*—To determine if there is any difficulty in the subsidiary regarding its ability to service its debt properly.

*Question 6*—To determine if the parent lends its credit and debt capacity to its subsidiary and to aid in the analysis of the parent's contingent liabilities.

The answers to all questions should be verified against company records and discussed with the comptroller, the treasurer or the finance officer. Details on some questions can come from company's latest SEC Form 10-K or the annual report to stockholders. All questions should be answered; if not applicable, so state. It is not necessary to repeat the question when answering.

Any guarantees should also be included as contingent liabilities.

Commercial paper is a source of funds for the parent and its subsidiaries. This schedule presents the maturity and placement of commercial paper in use in the parent's operations and/or for back-up to the commercial paper. The page is required if the parent issues commercial paper.

The objectives of this report page are:

1. To summarize the extent of the parent's use of commercial paper and its ability to continue the use of this funding tool.
2. To help determine the overall liquidity position of the parent company.
3. To determine the volatility of commercial paper issued, including average turnover rate.
4. To determine whether any subsidiary bank is providing compensating balances for the benefit of the parent or nonbank affiliate.

The information required in the schedule should be requested in the officer's questionnaire or can be obtained from the accounting or treasurer's departments and verified with the general ledger. If at all possible, the data should be as of the financial statement date. (An alternate date is acceptable for the Maturity Schedule but should be specified.) The schedule should also be prepared for each nonbanking subsidiary which issues its own commercial paper.

The total commercial paper should equal amounts on "Parent Company Comparative Balance Sheet" (Core Page 5) and the confidential "Liquidity and Debt Information" page C, unless an alternate date is used.

Lines of credit are a source of funds for the parent and its subsidiaries. This schedule presents the lines of credit available for the parent's operations and/or for back-up to commercial paper.

The purpose of the report page is to be able to determine the degree of use of the lines of credit and the availability of these lines to back-up commercial paper borrowings. It is also intended to help determine the overall liquidity position of the parent company.

The information required in the schedule should be requested in the officer's questionnaire or can be obtained from the accounting or treasurer's departments and verified with the general ledger. If at all possible, the data should be as of the financial statement date.

The exact names and locations of line banks should be shown in the "Lines of Credit" section and totals calculated for the dollar amount

columns. If a BHC has an extensive number of line banks, the detail for each line of credit may be eliminated at the discretion of the examiner with aggregate amounts and ranges included in the appropriate columns. In this instance, the total number of line banks involved and a general comment as to geographic distribution should be included.

If any subsidiary bank maintains compensating balances on behalf of the parent, the examiner should place an asterisk in the column and determine that the bank is compensated so that it does not incur a loss of income. Any resulting loss of income should be commented upon. See Manual sections 2020.4 and 2080.1.

The total lines of credit in use should equal amounts reported on "Parent Company Comparative Balance Sheet" (Core page 5) and the confidential "Liquidity and Debt Information" page C.

The answers to questions 1 through 13 should provide information about the quality of the commercial paper and the procedures for its issuance. They should also discuss funding involving the issuance of commercial paper backed by lines of credit. Examiners should refer to sections 2080.05 and 2080.1 before completing this report page.

The purpose of the report page is—

1. to determine the quality of commercial paper and to appraise the company's ability to raise additional funds in the marketplace;
2. to determine how the proceeds from commercial paper sales will be used;
3. to decide whether the use of commercial paper is in keeping with statutory requirements and regulatory requirements such as those of the Securities and Exchange Commission (SEC);
4. to determine whether the use of commercial paper satisfies liquidity needs (see section 2080.1);
5. to determine if policies in the commercial-paper funding system are safe and sound;
6. to determine if backup sources of funds are available and adequate to meet the liquidity needs of the parent; and
7. to address the examiner's concerns about commercial paper policies, controls, and marketing methods.

The information needed to complete this report page is usually available from the holding company's investment or funds-management department. It may also be obtained through discussions held with management responsible for the holding company's funding program. The information may also be available from rating agencies and in contractual agreements with lending banks.

Question 1 asks for any changes in the commercial paper rating that may show a changing financial condition. See appendix A of this section, which lists rating indicators used by commercial paper rating companies. Determine the cause for any change in the rating.

Bank holding companies with lower credit ratings may issue commercial paper by obtaining credit enhancements. Such credit support may be obtained from letters of credit (LOC paper) or a surety bond issued by an insurance company having a high credit rating (called credit-supported commercial paper). Bank holding company commercial paper with a lower

credit rating can also be backed by other high-quality assets serving as collateral (called asset-backed commercial paper), thus allowing the bank holding company to enter the market as an issuer. (See section 2128.03 for inspection guidance about such commercial paper enhancements.)

Question 1 further instructs the examiner to report the range of current rates paid on all commercial paper. By presenting the range of current rates paid on different maturities of commercial paper, the examiner can compare rates paid with those of the bank holding company's peers. This will aid in determining the "marketplace's" impression of the company's condition, as reflected by the rates the company must pay to attract funds.

The yields on commercial paper track those of other money market instruments. Like U.S. Treasury bills, a commercial paper instrument is a discount instrument. Because of exposure to credit risk, the yields on commercial paper are usually higher than those of U.S. Treasury bills. As in the case of Treasury bills, interest on commercial paper is computed on a 360-day year. Treasury bills, in contrast to commercial paper, are exempt from state and local taxes and are more liquid than commercial paper.

When responding to question 2, if any subsidiary sells commercial paper for its own use or for the parent, indicate why the bank holding company chooses to structure its funding in this way. For example, a commercial finance non-bank subsidiary of a bank holding company was authorized by the Board to underwrite (purchase) and deal in (resell or place with institutional investors) commercial paper as agent for the issuers (see section 3600.21.1). A section 20 subsidiary also can underwrite and deal in, or act as riskless principal in the placement of, commercial paper, if authorized by the Board by order.

A parent company could issue commercial paper directly or through a broker. The examiner therefore needs to be aware of the difference between direct paper and dealer paper. Direct paper is sold by the issuing firm directly to investors without using a securities dealer or an intermediary. Direct-paper issuers generally require continuous funds and therefore find it more cost-effective to establish their own sales force to sell their commercial paper directly to investors. In the case of *dealer-placed commer-*



*cial paper*, the issuer uses the services of a securities firm to sell its commercial paper.

If the subsidiary's name is similar to the parent's, note whether an investor can tell, by its name or through other means, that the issue is associated with the parent.

With regard to question 3, the commercial paper specimen should clearly state that it *is not* an FDIC-insured obligation of any bank subsidiary. (See section 2080.1.)

The minimum round lot in commercial paper transactions is usually \$100,000, although some issuers sell commercial paper in denominations as low as \$25,000. With regard to question 4, bank holding companies generally should not sell commercial paper in denominations of less than \$25,000. This is to ensure that the commercial paper instrument is suitable for investment by sophisticated investors as opposed to the general public. Commercial paper investors are typically institutional investors.

Rollover 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 (270 days) maturity standard. SEC staff, however, has issued no-action letters for commercial paper master-note agreements.<sup>1</sup> These agreements allow eligible investors to make daily purchases and withdrawals (subject to a \$25,000 minimum) as long as the maturity of the note and each investor's interest therein

do not exceed nine months. Such master-note agreements may allow prepayment by the issuer any time, or upon demand of the investor.

Commercial paper and commercial paper master-note agreements can result in a potential source of funding mismatch from the use of what is commonly called "deposit sweeps." This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts). Such agreements allow these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company.

In view of the extremely short-term maturity of these sweep arrangements, banking organizations should be advised to exercise great care when investing the proceeds. Appropriate uses of the proceeds of such deposit-sweep arrangements are limited to 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. (See also sections 2080.05 and 2080.1 when reviewing commercial paper activities.)

Concerning question 5, investing in the bank holding company's commercial paper by a subsidiary bank's trust department is generally regarded as self-dealing and a violation of trust regulations, absent express written authority and the consent of all of the trust's beneficiaries. Bank holding company examiners finding such trust department holdings should discuss the matter in detail with Reserve Bank trust examiners or the Board's Trust Activities Section, Division of Banking Supervision and Regulation.

In response to question 6, the examiner should indicate the use of the proceeds and whether such use is considered long-term or short-term. (See also sections 2080.05 and 2080.1.)

Question 7, on concentration of holdings, is intended to aid in determining if any party can exert influence on the bank holding company due to its commercial paper holdings. If any individual, organization, or industry holds more than 10 percent of the commercial paper, indicate if the holder(s) exerts any influence on the bank holding company's management.

In response to question 8, if there is any indication of difficulty in refinancing commercial paper at maturity, discuss this in significant detail. Indicate the reasons for the difficulty, the problems it poses for management, and management's plans to rectify those problems. This is a particularly sensitive issue because of the financial exposure that could be created by an inability to refinance.

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1. A master note is a negotiated agreement or contract (negotiated as to size, maturity, and price) between a borrower and investor that permits the investor to place cash, up to a stated amount, with the borrower over a designated period of time. Such unsecured credit agreements (no note is actually issued, only an agreement is signed at the beginning of the arrangement) are limited to borrowers with the highest credit ratings and large investment institutions.

Master notes have characteristics similar to those of a revolving-credit arrangement. The outstanding amount allowed may vary daily but is limited by a stated cap imposed by the issuer. Investors in such agreements control the amount invested in the note on the basis of the amount of surplus cash that is on hand. Either party can terminate the agreement with only 24 hours' notice. In reality, it is a longer-term funding vehicle because the parties generally are interested in maintaining a long-term relationship.

Unlike commercial paper, master notes are indirectly accessible to a wider array of investors. Investment firms group investments from small investors with investments made by a few large institutional investors and place the funds in master notes. The master note, unlike commercial paper, avoids the task of writing daily individual tickets for each customer. Disadvantages of the master note are the potential for daily variation in the amount invested and the potential for sudden redemption.

Question 9 is intended to aid in determining the degree to which the bank holding company can rely on its line banks. Lines that have not been confirmed in writing or for which no contractual obligation exists are less certain to be available than those that are confirmed and contractual.

As question 10 implies, lines of credit are often specifically established solely to back up commercial paper borrowings. Such lines impart a measure of security to the bank holding company. Evaluate the adequacy of the total amount of these lines in relation to the volume of outstanding commercial paper.

In asking about systematic rotation, question 11 is intended to help the examiner determine if the bank holding company routinely uses the proceeds from a line of credit to pay off another, and whether the bank holding company has ever been in an aggregate nonborrowing position

during a given year. If the bank holding company routinely and continuously relies on its ability to repay its lines with other line borrowings, discuss the potential effects on the bank holding company's ability to service its debt properly.

Question 12 asks for information on reciprocal lines that reveals the relationship between the lender and the bank holding company. A line's reciprocity may have a bearing on the degree to which the borrower may rely on the lender.

Question 13 is intended to help the examiner evaluate the relationship between the parent and its nonbank subsidiary. In those cases in which a subsidiary is authorized to borrow directly on the parent's lines, the examiner should evaluate the parent's internal controls and management information systems for supervising the subsidiary's borrowings.

### 5010.23.1 APPENDIX A—COMMERCIAL PAPER RATINGS

Rating Notations by Commercial Paper Rating Companies* (Highest- to Lowest-Quality Rating)			
Rating Company†			
Standard and Poor's	Moody's	Duff and Phelps	Fitch
<i>Investment grade:</i>			
A-1/A1+	Prime-1 (P-1)	Duff-1 (D 1-1/1+)	F-1/F-1+
A-2	Prime-2 (P-2)	Duff-2 (D-2)	F-2
A-3	Prime-3 (P-3)	Duff-3 (D-3)	F-3
<i>Non-investment grade:</i>			
B	NP (Not prime)	Duff-4 (D-4)	F-S
C (Doubtful)			
<i>In default:</i>			
D		Duff-5 (D-5)	D

\*The definition of ratings varies by rating agency.

†This list of rating companies is for the examiner's information only. The list is not an endorsement of these companies by the Federal Reserve.

Listed on this page are any material assets and liabilities (actual and contingent) not detailed on the parent company's balance sheet or other schedules in the report. Contingencies include guarantees, lease or loan commitments, letters of credit, interest rate swaps, futures and forwards transactions and pending litigation.

The purpose of this report page is:

1. To determine the extent of the parent's potential obligations and the related strain on its financial capacity resulting from contingencies.

2. To determine the quality of "Other Assets." These assets are subject to evaluation and classification, if appropriate. "Other Assets" is sometimes found to include assets acquired in violation of section 4 of the Act (particularly section 4(c)(2)).

3. To detail "Other Liabilities" which may indicate external funding relationships otherwise not presented.

The information should be derived directly from the BHC's financial statements and the board of directors' and executive committee's

minutes. Management should be asked to verify and explain any contingent liabilities. A review of all "Other Assets" and "Other Liabilities" in the general ledger and subsidiary ledgers should be conducted and analyzed for appropriate types and amounts of accounts. Suspense accounts should be aged, particularly if shown as a net amount.

If there are no contingent liabilities state "None reported." Normally only items appearing on the balance sheet as of inspection date will be listed. If prior periods' items are listed, columns with dates corresponding to those on the balance sheet should be used.

Refer to Manual section 5010.8 for guidelines on presentation of details of "Other Assets" or "Other Liabilities."

The parent's guarantees on the "Investment In and Advances To Subsidiaries" page should be included as contingent liabilities. "Other Assets" and "Other Liabilities" totals should reconcile to the line items on the "Parent Company Comparative Balance Sheet" page.

## Procedures for Inspection Report Preparation (Page—Statement of Changes in Stockholders' Equity (Parent)) Section 5010.25

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The reconciliation of capital accounts provides a summary of transactions which have caused changes in each of the equity accounts for the periods indicated. There should be no charges against paid-in capital that are properly chargeable to income.

The report page is used to record and analyze changes in stockholders' equity and to determine the effects on the financial condition of the holding company.

The information should be requested in the officer's questionnaire. Sources for prior periods include the FR Y-6, FR Y-9 LP, the annual and quarterly reports to stockholders, previous reports of inspection and the SEC Form 10-K. Current period changes can be obtained from the corporation's accounting or comptroller's department.

The presentation should begin with the last two fiscal years and include the most recent year-to-date interim. The column heading "Capital Stock" can include common and preferred

stock. However, it is necessary to distinguish the type and amount which can be accomplished by using (C) and (P), for common and preferred, beside the amounts. An appropriate legend can be inserted in the column heading.

Net income reported should agree with that reported on the "Comparative Statement of Income and Expenses (Parent)" and the "Comparative Statement of Income and Expenses (Consolidated)" pages. If net income reported on this page does not agree with the income on a consolidated basis (i.e. differences caused by minority interests), include a footnote to explain the reason for the differences.

Balances at year-end and interim period should agree with accounts on the "Parent Company Comparative Balance Sheet" and the "Comparative Statement of Income and Expense (Consolidated)" pages. Footnote and explain any differences.

These “Interim” and “Fiscal” pages can be used when the parent receives income from more than one subsidiary, or where it is needed to support comments or analyses in other sections of the report. Both the “Interim” and “Fiscal” pages should be included in the report when this situation is applicable. From the data on these two pages, the examiner is able to analyze the contribution to overall earnings made by each of the subsidiaries. The schedule also reflects the extent of the parent’s upstreaming income from its subsidiaries.

The purpose of these report pages is:

1. To determine the relative share of the individual subsidiary’s contribution to the holding company operation;
2. To analyze the dividend payout ratio and to compare payouts between subsidiaries;
3. To determine the proportion of each subsidiary’s income paid to the parent as fees; and
4. To determine the degree of interest coverage on advances to subsidiaries.

For the interim and fiscal periods, some items can be obtained from the parent’s income statement and from the BHC’s workpapers show-

ing eliminations on the consolidating income statement. Additional information can be obtained from the holding company’s accounting department or comptroller.

The banks should be presented first, then nonbanks. Subtotals should be provided.

The dividend payout ratio is calculated by dividing total dividends by net income after taxes and securities transactions. Show an average payout ratio for banks and nonbanks, respectively, and an overall payout ratio. Do not show negative percentages.

5. Fees as a percentage of the subsidiary’s operating income is calculated using total operating income before expenses. No subtotals for banks and nonbanks are required.

Equity in undistributed earnings, dividends, interest and total fees should equal that reported for each period on the “Comparative Statement of Income and Expenses (Parent)” page. For wholly-owned subsidiaries, the sum of the “Equity in Undistributed Earnings” and “Dividends” columns should equal its net income for the related period.

The analysis is performed and the statement is completed for BHCs with consolidated assets in excess of \$1 billion, or when substantial fixed charges exist or debt is outstanding, when required by the Reserve Bank. This statement indicates the results of the parent's management of its cash position and identifies major sources of working capital and areas of disbursement. The statement also presents the cash earnings of the parent company. The cited ratios measure the parent company's ability to meet its fixed obligations and the ability of the residual earnings to cover common stock dividends. When combined with an analysis of the parent company's cash income sources from subsidiaries, it serves as a partial basis for determining the parent company's debt servicing capacity, and thus an assessment of its leverage. In addition, projected cash flow information aids in the analysis of the BHC's ability to properly service its debt.

Only items affecting cash should be shown. The "Next Fiscal Year" column completion is optional at the examiner's discretion if the inspection occurs early in the current year (i.e. the inspection is in January 19X6 and thus would require the data through the end of 19x7).

The objective of the report page is:

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 transactions which may adversely affect the financial stability of the parent;
5. To discuss parent company deficit cash flows provided by its own operations.
6. To discuss any parent company borrowings needed to sustain dividend payments to shareholders;
7. To discuss the scope for increasing cash flow to the parent company; and
8. To discuss 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.

The information may be requested in the

officer's questionnaire and a copy of the "Cash Flow Statement (Parent)" page may be included with the questionnaire.

To complete the page refer to the holding company's cash receipts and disbursements journal and its general ledger and income statement(s). Also refer to any cash flow and income projections prepared by the organization.

The statement should be verified and reconciled, to the extent possible, to the BHC's published statements. Any additional items not provided for in the preprinted statement can be separately listed in an appropriate space.

Any dividends considered unreasonable should be discussed in the comments section. Dividends paid with funds derived from new borrowings should be discussed in detail.

Any significant cash flow transactions should be discussed. Refer to section 4010 for examples of such transactions.

If shortfalls exist, discuss on the "Cash Flow Statement (Parent)" page. For example, if the parent has a deficit cash flow provided by its own operations (as is often the case), discuss how the parent offsets (or plans to offset) the deficit. If the question is not applicable, state "NA."

If the BHC must incur additional debt in order to sustain its dividend payments to shareholders, discuss this in detail on the "Cash Flow Statement (Parent)" page.

To the extent that the accrual method of accounting is used, income and expense items should agree with the figures on the "Comparative Statement of Income and Expenses (Parent)," and between balance sheet periods, the "Statement of Changes in Stockholder's Equity (Parent)" pages and the "Income from Subsidiaries" for the fiscal year are as follows:

1. Dividends, and management and service fees from subsidiaries should agree with those on the "Comparative Statement of Income and Expenses (Parent)" and the "Income from Subsidiaries" pages;
2. Interest income should agree with the amounts reported on the "Comparative Statement of Income and Expenses (Parent)" and the "Income from Subsidiaries" pages;
3. Interest expense should agree with the amounts reported on the "Comparative Statement of Income and Expenses (Parent)" page;
4. Salaries and employee benefits should be the same as those reported on the "Comparative

Statement of Income and Expenses (Parent)” page; and

5. Dividend payments made by the parent should agree with those reported on the “Statement of Changes in Stockholder’s Equity (Parent)” page.

Other increases and decreases in cash which

should agree with changes in balance sheet items on the “Parent Company Comparative Balance Sheet” page are:

1. Increases in borrowed funds;
2. Decreases or increases in advances to subsidiaries; and
3. Debt retirement or reductions.

The Parent Company Liquidity Position page is prepared for bank holding companies with consolidated assets in excess of \$1 billion and those with substantial debt outstanding, as well as select others at the option of the Reserve Bank. The report schedule provides a structured analysis of all assets and liabilities within predetermined remaining maturity categories. The schedule is designed to place emphasis on remaining maturing assets and liabilities of less than one year.

When the schedule is initially completed, the examiner is provided with an indication of whether the parent company has an adequate cushion of short-term liquid assets within the 0 to 30 days and the 0 to 90 days categories to cover short-term liabilities, or whether a pattern of short-term funding gaps exist. Following adjustments, if any, to maturing assets or liabilities, the resulting schedule sets forth a framework for observing funding mismatches, thus serving as tool for assessing the parent company's overall liquidity position.

A net positive gap is expected in the 0 to 30 days category to show the parent's ability to ride out a temporary market disarray. Similarly, a cumulative positive position is expected in the 0 to 90 days categories, despite any deficiency within the first 0 to 30 days category. A failure to satisfy those conditions requires the examiner to address the deficiency within the "Examiner's Comments" page. Results of the analysis are to be discussed in the parent company section on the "Analysis of Financial Factors" page in the inspection report.

The report schedule is prepared:

1. To determine whether the bank holding company is avoiding funding strategies that could undermine public confidence in the liquidity or stability of their banks; and
2. To evaluate the holding company's ability to meet its maturing obligations, convert its assets with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations;
3. To determine whether the level of the parent's liquid assets is sufficient to cover its short-term obligations;
4. To analyze the contractual maturity structure of its assets and liabilities and to estimate the underlying liquidity of the parent company's liabilities and assets, giving particular attention to interest bearing deposits in and advances to subsidiaries (Note: Parent company advances to subsidiaries should be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can be readily con-

verted to cash);

5. To identify funding surpluses or deficits for specific maturity intervals;

6. To provide an analytical framework for observing funding mismatches in assessing the parent company's overall liquidity position;

7. To provide an analytical tool and a basis for discussion of parent company liquidity with management; and

8. To provide a basis for developing or evaluating existing parent company contingency plans, including any reliable unused back-up lines of credit. (Note: In the event that maturing liquid assets are not sufficient to satisfy short-term obligations, primarily in the 0 to 90 days categories, and the parent company has no contingency plan to cover mismatches (shortfalls) in the under 1 year categories, the parent company must be requested to develop such contingency plans that must include standby facilities that will be reliable during times of financial stress. For those BHCs with less than satisfactory parent or consolidated supervisory ratings (3 or worse), or any BHC subject to serious liquidity or funding pressures, those BHC's must include in their contingency plan specific plans to reduce or eliminate entirely their outstanding short-term obligations.)

The information for the schedule should be obtained from the parent company's balance sheet for the contractual maturing amounts of assets and liabilities, and slot the amounts into the five maturity categories depicted.

While analyzing the contractual maturities of the assets and liabilities, the examiner must consider the underlying liquidity of the parent's intercompany advances and deposits and the extent to which they fund high quality assets that can be readily converted into cash.

The examiner should refer to the Manual's funding sections 2080.0 to 2080.6 and sections 4010.0 to 4010.2 that address parent company cash flow and liquidity.

The report page data should be entered as of the inspection report financial statement date. The examiner may, at his or her option, incorporate the schedule into the inspection report to substantiate or clarify particular judgements. Assets should be recorded net of any allowance (contra asset) accounts.

The examiner should assess the contractual maturity structure of the parent company's balance sheet by preparing the schedule according



to the parent's maturing assets and liabilities. The scheduled can be adjusted to better appraise the parent company's liquidity position by analyzing interest bearing deposits with bank subsidiaries and advances to subsidiaries. The "Other Assets" may be sub-categorized within the additional space provided. The completed schedule may be used as a basis of discussing parent company liquidity with management. The examiner should comment on the findings on the "Analysis of Financial Factors" page in the inspection report (whether or not the schedule is included in the report).

The total of each asset account should equal the respective assets as listed on the "Parent Company Comparative Balance Sheet" for the inspection report financial statement date, net of any separately listed allowance or contra asset account balances or any adjustments for market valuations. The total of each liability account should equal the respective liabilities as listed on the "Parent Company Comparative Balance Sheet" as of the inspection report financial statement date.

This report page is included in all reports when assets are classified and written up. For inspections of bank holding companies with less than \$150 million in total assets, it is to be included in the Core section of the report. The information reported represents analyses and conclusions for the classification of the parent's assets and identifies all of the nonbank subsidiary's classified assets. Refer to the instructions for the "Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems," Core page 7, for a discussion of classification standards.

The purpose of the report page is to—

- determine the risk involved in the parent's activities,
- determine the adequacy of reserves,
- disclose problem assets requiring management's attention, and
- aid in the analysis of the condition of the nonbank subsidiary(ies).

The information is obtained by an evaluation of the parent's assets and the assets of nonbank subsidiaries. For nonbank company assets, the information is obtained through examining the loan and lease portfolios, and reviewing credit files, loan reviews, past-due lists, credit analyses, and watch lists prepared by the holding company.

Any asset classified doubtful or loss requires a write-up unless the amount is insignificant to the company's operations. *Where asset reviews are undertaken, the examiner should note at which entities the asset reviews were performed, and their level of coverage.* Any classified asset that is challenged by management also requires a write-up.

Loan write-ups may extend across the entire page. At a minimum, show the total amount of

extension of credit booked by the parent, name of debtor, name of guarantors, collateral, amount of classification in appropriate category, date originated, maturity, purpose, and where deemed necessary, a short write-up giving the reason for the classification. Also identify any participation with a subsidiary, including the subsidiary's name and amount held by the subsidiary.

Nonbank loans classified substandard may be listed alphabetically with no write-up required, unless the holding company management disagrees with the classification. For other nonbank assets classified substandard, some minimum comment is necessary. For example, the examiner may make one general comment concerning the deficiencies of several credits or other assets listed.

Any nonbank subsidiary loan classified doubtful or loss, where the amount classified exceeds the lesser of \$100,000 or 5 percent of the subsidiary's total assets, should include a brief write-up stating the reason(s) for classification. However, at the discretion of the examiner, any doubtful or loss classification may be the subject of a write-up.

In the case of nonbank subsidiaries such as consumer finance companies where there are relatively small amounts and a large volume of accounts involved, the use of "bulk classification" by degree of delinquency may be more desirable than listing each loan individually. The examiner may provide write-ups on any classified nonbank subsidiary asset deemed appropriate.

The classification totals should agree with "Examiner's Comments," and/or "Analysis of Financial Factors" pages. Any major asset problems may be discussed on the "Examiner's Comments" or "Analysis of Financial Factors" pages and should be cross checked.

This FR 1225 report page or section (continuous flow reporting basis) presents consolidated financial statement data (a condensed balance sheet and income data) for the lead bank and any other subsidiary bank or banks (that is, subsidiary banks that have consolidated assets of \$500 million or more) or for those bank subsidiaries that exhibit conditions warranting special supervisory attention (that is, rated composite 3, 4, or 5 under the Uniform Interagency Bank Rating System). The summary of the examiner's comments and other important data extracted from the latest report of examination are incorporated into the analysis of the bank component of the RFI/C(D) rating (see section 4070.0) on the "Analysis of Financial Factors" page or section. The summary is incorporated when a bank subsidiary comprises 10 or more percent of consolidated assets and/or when a bank subsidiary evidences material financial deficiencies or other characteristics that should be brought to the attention of the bank holding company's board of directors, including noted bank violations.<sup>1</sup> As banking assets make up the majority of the assets of the holding company, the condition of the larger banks and special supervisory attention banks may have a significant impact on the condition of the consolidated organization.

The financial statements should be requested in the officer's questionnaire. Balance-sheet and income data can be obtained from the reports of condition, income, and dividends of the subsidiary banks.

Provide a condensed balance sheet as of the

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1. In determining the subsidiary banks that require write-ups, examiners should be mindful of the effect that cross-guarantee provisions of can have on nontroubled bank subsidiaries.

inspection date and a statement of income. The income data should be presented in a comparative columnar format and should include total operating revenue, total operating expenses, net operating income, applicable income taxes, net securities gains or losses, and net income. The balance-sheet and income data, while condensed, should provide detail to permit analysis of earnings and capital. Where any past or potential problems exist, the examiner may include more detailed statements to support comments presented.

All pages should bear the same "Bank Subsidiaries" page number, except that the number should be suffixed with a -1, -2, -3, etc., to reflect the subsequent "Bank Subsidiaries" pages.

The following items should be checked to make certain that—

1. advances from the parent company agree with the "Investment in and Advances to Subsidiaries" page;
2. the holding company's proportionate share of the capital accounts reconciles with the investment shown on the "Investment in and Advances to Subsidiaries" page;
3. external (unaffiliated) debt shown agrees with that on the "Unaffiliated Borrowings" page;
4. net income reconciles with the sum of equity in undistributed earnings and dividends on the "Income from Subsidiaries" pages, in proportion to the holding company's percentage of ownership; and
5. any relevant comments made on the "Bank Subsidiaries" pages agree with Core page 1, "Examiner's Comments and Matters Requiring Special Board Attention."

For each direct nonbank subsidiary (and its significant subsidiaries not consolidated in its statements), a summary is to be provided of its history, activities, classifications, and risk exposure. Nonbank subsidiary pages consist of “Nonbank Subsidiary,” “Nonbank Subsidiary Financial Statements,” and “Nonbank Assets Subject to Classification.” Each subsidiary should be presented as a “unit.” Successive subsidiaries should be sequentially presented (for example, 18a, 18b, etc.). The information provided on the report page should aid in the determination of permissibility of activities and locations, and the evaluation of the subsidiary’s asset quality.

1. Provide the proper name of the organization, location, date of approval, date of acquisition or establishment, date activity commenced, statutory authority, and approved branch office locations should be obtained from Reserve Bank records, presented, and verified with the holding company’s records. Note the date of approval for each activity and office, if applicable.

2. For going concerns acquired by the bank holding company, state the date acquired. For de novo subsidiaries, state the date established .

3. For de novo subsidiaries, state the date activity commenced. Indicate if the BHC has received approval for any de novo activity that has not yet been commenced. Identify any approved activity for which authority has expired.

4. Number 6 refers to the exemptive provision (statutory authority) of the Bank Holding Company Act relied upon to continue to engage in the activity. If section 4(c)(8) of the act is indicated, also provide the corresponding reference to section 225.25(b) of Regulation Y to indicate the specific activities.

5. Provide the city and state location for each branch; however, if the subsidiary has a great number of branches (for example, a consumer finance subsidiary), the examiner may present only the number of offices located in each state or foreign location.

6. For the history and description section,

summarize the activities in which the company is engaged and discuss how it has expanded its operations (de novo or by acquisition). Discuss any violations that may have been uncovered.

7. Prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below.<sup>1</sup> This assessment is to identify subsidiaries with a risk profile that warrants an on-site presence. 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;
- 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. Examiners are expected to document their assessment of the overall risk posed by each nonbank subsidiary on this report page or equivalent inspection workpaper. See SR-93-19.

The examiner should make certain that the classifications and valuation reserves summarized for the nonbank subsidiaries agree with totals on either the “Summary of Consolidated Classified and Special Mention Assets, and Other Transfer Risk Problems” page or the “Parent Company and Nonbank Assets Subject to Classification” page.

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.

This page presents a condensed statement of condition for credit extending and special supervisory attention nonbank subsidiaries (and others at the examiner's discretion) as of the inspection date, and income data for the latest fiscal year and the year-to-date. The purpose of the report page is to aid in the analysis of the condition of each nonbank subsidiary and in the analysis of its effect on the consolidated company. The page is completed for all credit extending subsidiaries and may be completed for any other subsidiary deemed appropriate.

Financial statements should be requested in the officer's questionnaire. In the case of larger subsidiaries other financial information may be obtained from the F.R. Y-6, the SEC Form 10-K, published reports to stockholders and reports filed with professional associations. Details relevant to the financial statements can be found by reviewing various accounting records.

The balance sheet should be structured to provide sufficient detail for meaningful analysis, including specifics on valuation reserves and

stockholders' equity. Income data should also be provided for the latest fiscal year plus the year to date (i.e., total revenue, net operating income, net income, rates of return). Provide a condensed income statement for the year to date if considered necessary.

The examiner should ascertain that:

1. Advances from the parent agree with the "Investment in and Advances to Subsidiaries" page;

2. The holding company's proportionate share of the capital accounts reconcile to the investment shown on the "Investment in and Advances to Subsidiaries" page;

3. External debt reported agrees with the information reported on the "Liquidity and Debt" Confidential page "C"; and that

4. Net income reconciles with equity in undistributed earnings and dividends paid on the "Income from Subsidiaries" pages, in proportion to the holding company's percentage of ownership.

This page presents the fidelity and other indemnity insurance coverage of the holding company and its subsidiaries. Refer to section 2060.5 for related information. The report page is used to provide a summary as to whether:

1. The parent and nonbank subsidiaries have been insured against the potential for significant losses by maintaining proper and sufficient insurance;

2. 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;

3. A determination can be made as to which entity(ies) is responsible for paying the premiums and if the manner in which such payments are allocated is equitable among the affiliates that receive the coverage benefits; and

4. Procedures are in place to assure that claims are filed promptly.

The information on insurance coverage is

usually available from an “insurance officer” and from a review of insurance policies during the inspection. The examiner should conduct a review of insurance coverage with the “insurance officer.” In summarizing results, the examiner should indicate if any nonbank subsidiary is covered under a separate policy or if it is not covered. Also, it should be stated whether the policy is maintained by the bank and whether the BHC and nonbanks are covered by the bank’s policy. The method used to allocate the cost of insurance to the subsidiaries should also be provided.

The comments detailed on the report page should be consistent with summarized comments on the “Policies and Supervision” page and the “Other Supervisory Issues” page, item 7, if included in the report. Any noteworthy deficiencies in the insurance program may be included on the “Examiner’s Comments” page at the examiner’s discretion.



This report page consists of topics dealing with litigation and commitments, the supervisory reports, intercompany transactions and other topics of supervisory concern.

The report page includes questions that are worded to evoke a “yes” response, or if there are no problems in a particular area, a “no” response. If there are any deviations therefrom, responses are required. Positive responses as to either the adequacy of the insurance or audit programs should only be accompanied by a reference to the appropriate inspection report page that addresses the topic. For additional guidance on answering the questions on this inspection report page refer to the “Other Supervisory Issues” FR 1241 report page instructions.

#### 5010.35.1 INTERCOMPANY TRANSACTIONS (QUESTIONS 1)

This question inquires as to the existence of significant intercompany transactions or diversions of bank income subject to adverse comments. This question guides the examiner when documenting the review of compliance with Board policy, statutes and regulations regarding various kinds of intercompany transactions.

For information on diversion of bank income, review management and service fees charged the bank and any compensating balances maintained by the bank on behalf of affiliates indicated on the “Comparative Statement of Income and Expenses (Parent)” and the “Commercial Paper (Parent)” pages, respectively. Comments on section 23A considerations may be found by a review of bank examination reports. The examiner may refer to Manual 2020.6 (management and service fees) for instructions on examining for diversions of bank income. For information on examining for 23A and 23B violations, see Manual section 2020.1 (transactions between affiliates) and the other Manual intercompany transactions sections 2020.2–2020.7.

Violations of section 23A and 23B of the Federal Reserve Act and section 106(b) of the 1970 Amendments to the Bank Holding Company Act may be summarized on the “Examiner’s Comments” page and listed on the “Violations” page with the reader referred to this page for detail. If the examiner includes comments concerning other intercompany transactions on Core page 1, “Examiner’s Comments,” the information should be cross-checked.

#### 5010.35.2 COMPENSATING BALANCES (QUESTION 2)

If a subsidiary bank is not adequately compensated for maintaining compensating balances at another institution for debt advances to the holding company, provide:

1. The average collected and book balance or the range of the balance;
2. Any arrangement whereby the loan or line of credit agreement between the creditor bank and parent contains a requirement to maintain a correspondent account; and
3. Comments as to whether the subsidiary bank is reimbursed for maintaining the compensating balance.

Refer to Manual section 2020.4 (compensating balances).

#### 5010.35.3 INTERCORPORATE INCOME TAX PRACTICES (QUESTION 3)

Information on intercorporate tax practices may be obtained from the accounting or comptroller’s department. Manual section 2070.0 (taxes) may be referred to for information on examining intercorporate tax transactions which includes the Board’s intercorporate tax policy statement of September 20, 1978.

In addition to the above references, examiners should be aware that whenever there is a consolidated income tax return filed, it is important that a formal tax agreement exists between the parent and each subsidiary (approved by each board of directors). Examiners should encourage management to prepare such an agreement if not already in place.

Board policy states that taxes paid by a subsidiary bank to its parent should not be in excess of what the bank would pay if it filed on a separate entity basis. However, certain adjustments, in particular the allocation of tax benefits in a consolidated return, may result in higher payments than would have been made had the bank been unaffiliated (i.e., the surtax exemption must be allocated between organizations filing a consolidated return whereas an entity filing alone could use the entire exemption). The Board normally would regard such adjustments (that result in amounts in excess of filing alone) as acceptable. The Board does not wish to pre-



scribe the tax accounting methods to be used by BHCs. However, the Board does require that those methods employed give bank subsidiaries equitable treatment.

The examiner should comment whenever any of the following has occurred:

1. A subsidiary has been required to make tax payments to its parent that significantly preceded the date the consolidated tax payments are paid to IRS. (In general, “significantly” means not in excess of five business days.)
2. A subsidiary bank is due a tax refund due to a fiscal net loss on a taxable basis (or due to other tax credits) and the parent has not refunded to the bank taxes paid by the bank to the parent in previous tax periods.
3. The subsidiary bank has passed up deferred income tax liabilities to the parent along with an equivalent amount of cash or earning asset. Such transactions must be reversed by a reinstatement of the deferred tax on the books of the bank, along with the transfer by the parent of an equivalent amount of cash or appropriate earning asset.

#### 5010.35.4 TIE-IN ARRANGEMENTS (QUESTION 4)

As for tie-in arrangements, see Manual section 3500.0 (tie-in considerations). This Manual section provides information on examining for impermissible tie-in arrangements. Information on tie-in arrangements is available from BHC and nonbank subsidiary management and may also be found by reviewing standard lending agreements and manuals.

#### 5010.35.5 INSIDER TRANSACTIONS (QUESTION 5)

Consider:

1. The policy in regard to extensions of credit by a bank holding company or its nonbank subsidiaries to the BHC officials (executive officers, directors or “more than 10 percent” shareholders) or the BHC officials’ interests in the organization;
2. Prohibitions on bank extensions of credit contained in the Financial Institutions Regulatory and Interest Rate Control Act of 1978; and
3. Whether the bank holding company has a conflict of interest statement or business ethics policy that has been distributed to employees.

If there are insider transactions subject to comment, list the parent and nonbank subsidiary extensions of credit to BHC officials. Also, comment on the compensation to the officials. See Manual sections 2050.0, 2110.0, and 5010.36.

#### 5010.35.6 LITIGATION (QUESTION 6)

A “yes” response to this question would require a summary of any litigation involving the parent bank holding company and the bank and nonbank subsidiaries, which could have a significant effect on the holding company. The purpose of this question is to aid the examiner in the analysis of the financial condition of the holding company by determining if any pending litigation poses a threat to the financial condition of the BHC.

Any information on law suits should be requested in the officer’s questionnaire. Information on litigation which may have a significant impact on the company is often included in the published annual report to stockholders or in the SEC Form 10-K.

Comments on litigation should be presented in narrative form summarizing the details of the lawsuit, including, if possible, the opinion of the holding company’s counsel as to the possible outcome of the suit. Generally, include only suits representing more than 10 percent of the holding company’s stockholders’ equity capital. Discussion of immaterial litigation should be avoided.

Any litigation which may have a significant effect on the bank holding company may be summarized on the Examiner’s Comments, Core page 1, at the discretion of the examiner. Also, any litigation which, in the opinion of management or counsel, is expected to result in a significant liability should be noted on the “Contingent Liabilities (Parent)” page.

#### 5010.35.7 INSURANCE PROGRAM (QUESTION 7)

See Manual sections 2060.5 and 5010.33.

#### 5010.35.8 AUDIT PROGRAM (QUESTION 8)

A negative response to this question will result from application of the inspection instructions found in Manual sections 2060.1 and 5010.34. Comments responding to this question should

be confined to briefly summarizing any audit program deficiencies and should reference any detailed information provided on other report pages.

#### 5010.35.9 CREDIT QUALITY REVIEW PROGRAM (QUESTION 9)

This question refers to the examiner's review of the BHC's internal loan review program. A negative response would result from the examiner's use of the inspection instructions and procedures found in Manual section 2060.6.

#### 5010.35.10 SUPERVISORY REPORTS (QUESTION 10)

A "yes" response with regard to this topic would result in providing information on the timeliness and accuracy of the bank holding company's submittal of required reports, such as the FR Y-6, Y-8 and the Y-9's to the Reserve Banks. If the bank holding company is consistently late in filing its reports or if there are repeated discrepancies that need correction, it could be indicative of operational deficiencies or a lack of managerial direction within the bank holding company.

Information on the timeliness and accuracy of reports must be obtained from the Reserve Bank unit handling the reports and by verifying selected items to corporate records. If reports are rou-

tinely filed late or inaccurately, the reason and the measures the bank holding company may be taking to eliminate the problem should be stated on this inspection report page.

#### 5010.35.11 OUTSTANDING COMMITMENTS TO THE BOARD OF GOVERNORS (QUESTION 12)

This question reminds the examiner to appraise the bank holding company's compliance in fulfilling commitments made to the Board or the Reserve Bank. Thus, if there are any commitments outstanding which the holding company has made to the Board or the Reserve Bank, appropriate comments should be provided on the page.

Each Federal Reserve Bank is required to report to the Board's Division of Banking Supervision and Regulation on a semi-annual basis the status of unfulfilled commitments. The examiner should review this Reserve Bank report before beginning the inspection.

Commitments should be summarized presenting the nature of the commitment, the date the commitment was made, and, if applicable, the time frame in which it must be fulfilled. If the time frame has expired, or if an extension is deemed necessary to fulfill the commitment, details must be presented. The examiner may choose to make a reference to the unfulfilled commitment on the "Examiner's Comments" Core page 1, if considered appropriate.

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA), as amended by FDICIA, accompanied by the Board's complimentary Regulation O, governs *bank* extensions of credit to insiders. With the passage of FDICIA and the complementary revision of Regulation O, there is the possibility that there will be an increase in the volume of parent company and nonbank subsidiary extensions of credit to BHC officials and their related interests. The report page presents information on parent company and nonbank extensions of credit to insiders, as well as parent company and nonbank subsidiary investments in and loans on stock or obligations of BHC officials' related interests. Examiners must reference Manual section 2050.0 to complete this page.

This report page is intended to identify extensions of credit to BHC officials so that those credits may be reviewed for propriety and compliance with the policies of the BHC and Manual section 2050.0. Although *Regulation O applies only to bank extensions of credit*, for BHC inspection purposes, definitions contained in Regulation O shall be used by System examiners in order to provide a uniform, comparable approach to reviewing extensions of credit to BHC officials.

The information requested on the report page should be requested in the officer's questionnaire. Other sources may include the annual report to shareholders, the FR Y-6 and filings with the Securities and Exchange Commission.

BHC examiners should review Manual section 2050.0 and Regulation O, and should be familiar with the definitions contained in the regulation. Examiners are asked to identify such credits for in-depth review and analysis. Although Regulation O applies specifically to extensions of credit by banks, and not the parent or nonbank subsidiaries, examiners may criticize a BHC's or nonbank subsidiary's direct extensions of credit to BHC officials or their related interests as an unsound practice or may criticize a specific loan for credit reasons. *Such extensions of credit are not to be cited as violations of Regulation O.*

During a BHC inspection, BHC officials should be made aware that information necessary for the completion of this page is being collected to evaluate practices, policies, or particular credits, but that FIRA and Regulation O apply exclusively to bank extensions of credit.

Section 215.4 of Regulation O entitled "General Prohibitions" sets forth various restrictions on bank extensions of credit to BHC officials. In

general, if the BHC examiner reviewing BHC and nonbank subsidiary direct extensions of credit to BHC officials and their related interests concludes, after consultation with counsel for the Reserve Bank, that the extension of credit would not have been in compliance with section 215.4 had it been a bank extension of credit, the examiner may conclude that it is appropriate to criticize the practice or the loan. If it is concluded that the BHC or nonbank subsidiary extended the loan in order to circumvent the restrictions on bank extensions of credit, comments to that effect should be incorporated onto the "Other Supervisory Issues" page or a "Continued" page. Such comments may be also summarized on page 1, "Examiner's Comments", at the discretion of the examiner based on the degree of materiality, severity and impact.

Specifically, section 215.4 of Regulation O (in part) requires bank extensions of credit to BHC officials not to be on preferential terms, not to have more than the normal risk of repayment, and over certain dollar amounts to be approved by the bank's directors. In addition, it requires bank extensions of credit to executive officers, principal shareholders, and their related interests not to exceed the bank's legal lending limit to any such individual and his/her related interests.

In reviewing BHC and nonbank extensions of credit to "related interests," note that a related interest is defined in section 215.2(k) of Regulation O as "a company that is controlled by a person . . ." The definition of "company" for purposes of Regulation O specifically excludes any "insured bank." However, for purposes of completing these report pages, and evaluating the propriety of BHC and nonbank extensions of credit to (and investments in) "related interests" of BHC officials, "related interests" shall include "banks." Therefore, a BHC or nonbank direct extension of credit to (or investment in) a BHC official's "related interest" that is itself a bank (other than a subsidiary bank of the subject BHC), should be reported.

For purposes of this page, "direct" extensions of credit represent obligations of the BHC official or related interest, alone or as co-maker while an "indirect" extension of credit includes a BHC official's or a related interest's endorsement or guarantee of an extension of credit to a third party, and obligation's to the BHC official's immediate family (spouse, all minor chil-

dren, and all children, including adults, residing in the individual's home). BHC and nonbank extensions of credit to a BHC official who serves in two or more capacities, i.e., director and executive officer, should only be presented once.

In completing the "Schedule," the examiner may select the cut-off amount used to determine which items are listed individually based on materiality. However, any extension of credit (or group of credits) to an individual BHC official and his/her related interests that would have exceeded the subsidiary bank's lending limit had it been made by the bank, should be listed individually. (In multibank holding companies, use the banks' aggregate lending limit.)

In listing "Terms" within the "Schedule," include at a minimum interest rate and date of maturity. "Comments" are intended to include a brief description of any collateral, endorsements, the purpose of the loan, the nature of the borrower's relationship to the lender if not self-evident, and status of repayment if delinquent or classified.

Identify the source and cost of funds used by the BHC to extend the loan. Any adverse affect to the BHCs net income should be commented on.

Extensions of credit should be consistent with policies summarized on the "Policies and Supervision" page. Otherwise, additional comments might be warranted.

The purpose of this report page is to present a brief analysis of the interest sensitivity of assets and liabilities on the inspection date and to further support the analysis in the form of ratios similar to a current ratio and a net working capital to total assets ratio. Positive or negative gaps within maturity buckets are gathered in the form of cumulative gap totals. The analysis can be prepared for each level of the organization.

Such an analysis is designed to determine whether maturing interest sensitive assets match maturing interest sensitive liabilities on a 1 to 1 basis within specified maturity ranges and on a cumulative basis over time.

The information for the report page can be gathered from financial management maturity analyses and interest sensitivity reports prepared by the bank holding company's management. A limited amount of maturity information on interest sensitive assets and liabilities may be obtained from Bank Call Reports, Bank Holding Company Y reports, Bank Performance Reports, and BHC Performance Reports, and can be used if the inspection "as of" date is the same as the date of these reports.

From information collected, list interest sensitive asset totals and liability totals within the maturity buckets provided for the consolidated entity. The maturity ranges may be adjusted to or expanded to coincide with interest rate sensitivity reports generated by the bank holding company management.

Next, subtract the liability totals from the asset totals to get the "Gap" totals. For each maturity range beyond 91 days, add the next repricing interval "Gap" total to the previous "Cumulative Gap" totals to obtain the repricing interval's cumulative gap.

To determine the ratio of interest sensitive assets to interest-sensitive liabilities, use the cumulative gap for the denominator. Extend the percent out to at least two decimal places.

Provide narrative analysis for any maturity period or cumulative negative or positive gap positions, stating what measures will be taken by management to address any adverse gap positions.

# Procedures for Inspection Report Preparation (Page—Treasury Activities/Capital Markets) Section 5010.38

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This report page presents generalized questions for the examiner to answer on treasury activities and capital markets. This page must be included in inspection reports prepared for bank holding companies that have significant exposure in the capital markets. Specific guidance can be found in section 2125.0, in the Federal Reserve System's *Trading Activities Manual*, and in SR-93-69, December 20, 1993. Procedures for

inspecting and preparing the written analysis should be based on this supervisory guidance. In banking organizations with national or state nonmember lead banks and where capital markets activities are conducted exclusively at the subsidiary bank, examiners should coordinate the collection of the information included on this page with the lead bank supervisory agency.

# Procedures for Inspection Report Preparation (Confidential Page A—Principal Officers and Directors) Section 5010.40

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The purpose of this report page is to identify directors and principal officers and determine the level of participation and responsibility in the affairs of the holding company, and to identify outside relationships in order to determine conflicts of interest. The page contains the names of the principal officers of the company and their position with other subsidiaries. This page also presents the names of directors, the number of years they have served in that capacity, their year of birth (to possibly assess management's plans for succession), regularity of their attendance at directors' meetings, and principal outside employment. Note if any director is also a director of a Federal Reserve Bank or branch.

The directors and principal officers' fees, compensation and other benefits information is also to be obtained and retained in the workpapers. If desired by the Reserve Bank, such salary, bonus, benefits, and other remuneration information may be included on this page. Criticism of directors' fees should be carefully considered.

The directors' ownership information (i.e. address of each director and the number of shares owned) is also to be obtained and may also be reported or retained in the workpapers. If the holding company has an advisory board or honorary directors, the data on these persons may be included on the report page at the examiner's discretion.

All information on principal officers and directors such as year of birth, responsibility and compensation, etc. should be requested in the officer's questionnaire. Attendance data should be available from the board of directors' minutes. Such information may also be contained in reports to shareholders, FR Y-6, proxy statements and SEC filings.

The directors and principal officers should be listed alphabetically with their city and State of residence indented immediately below their names. If appropriate for mailing purposes, show each director's mailing address.

The principal officers and directors are to be listed in order of rank, and alphabetically where officers have identical titles. For directors and principal officers, membership on principal com-

mittees of the board should be coded and placed immediately after the name on the same line (i.e., E = Executive, A = Audit). If a director has been elected since the last inspection, the date of election should be shown immediately after his name. For example:

John Smith      elected 4-1-x1

The officer and director positions held with subsidiaries should be kept as brief as possible, utilizing abbreviations established on the "Structure and Abbreviations" Core Page 3. List only major positions if routinely assigned to staff of all subsidiaries.

A brief summary of benefits provided to officers and employees (i.e., pension plans, life and health insurance) may be presented at the bottom. Such information can assist in determining whether the principal officers appear to be adequately or overly compensated.

Special financial arrangements for specific officers may also be noted. Such arrangements would include salary contracts, unusual bonuses, fees or expense allowances, stock options, deferred compensation, and exclusive use of real estate, automobiles and airplanes.

When indicating occupation or principal business affiliation of directors, use concise, descriptive designations instead of general notations such as "merchant" or "industrialist." If the director is an officer or principal in a firm, show also the nature of the business in parentheses (e.g., law firm, CPA, pharmaceutical manufacturer, etc.).

The examiner should verify that the directorship is in compliance with Regulation L or R and that the number of directors is consistent with the corporations' bylaws. The examiner should also indicate the regular schedule of directors' meetings at the bottom of the report page to provide the Reserve Bank with information needed to plan attendance at board meetings.

Examiners should be careful to use the same names and titles of officers when referring to the individuals elsewhere in the report.

# Procedures for Inspection Report Preparation (Confidential Page B—Condition of Bank Holding Company) Section 5010.41

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In general, this report page or section (continuous flow reporting basis) presents pertinent information that is deemed confidential by the Reserve Bank and available to regulatory authorities. The report page or section is used to discuss and assess, confidentially, the going-concern operating results and the prospects for resolving any problems or areas of concern. The report page or section should be also used to discuss compliance problems relating to statutory, regulatory, or administrative provisions cited within the core or other open sections of the report. The potential for any improvement or weakening in economic conditions should also be discussed to the extent they have a bearing on earnings potential.

The specific information to be provided on the report page or section is—

1. information on the organization's near-future financial prospects, giving particular consideration to debt servicing and the likelihood of improving any current problems;

2. an assessment of holding company management as to the experience and qualifications of principal personnel when relative to the assessment, and a listing of subsidiary bank ratings, effective examination dates, and type and scope of examinations;

3. the examiner's concise assessment of management's oversight of the BHC's policies and supervision of subsidiaries with respect to the level of control and supervision exercised over subsidiaries (see sections 2010.0 to 2010.13) should be discussed. (An evaluation of the bank holding company's recognition and control of exposure to risk should also be provided (see section 2160.0) as well as an evaluation of management information systems (MIS) based on the guidance found in sections 2060.01 through 2060.4.);

4. a discussion of the reasons for the component ratings and overall RFI/C(D) rating assigned (see section 4070.0);

5. an analysis of chain banking organizational structure (The examiner must determine whether the BHC is a member of a *chain banking organization*. A chain banking organization may be defined generally as a collection of independent banking organizations that are controlled by the same individual, family, or a group of individuals closely associated in their business dealings.);

6. a listing of individuals or groups that control more than 5 percent of the BHC's outstanding stock (Discuss any significant changes in ownership. A review of ownership is to include

a determination as to whether an individual or group of shareholders exercise significant influence over the BHC. It should also include a discussion of fiduciary holdings of the parent company's stock and convertible debt of the BHC's subsidiaries.);

7. a presentation of confidential information relating to the components of the BHC rating system, avoiding repetition by cross-referencing report pages in the open section; and

8. examiners' comments on any other supervisory concerns or aspects of the BHC's condition warranting confidential treatment. Comments on any violation and/or a BHC's unsafe and unsound practice should be included with any recommendations for Federal Reserve administrative action. Any plans of the holding company that are considered to be of a confidential nature should also be discussed.

Financial-analysis comments on the bank holding company organization (that is, RFI/C(D) components, not the ratings) that are not of a confidential nature are to be discussed on the Analysis of Financial Factors core page 3.

The date and type of examination and assigned rating can be obtained directly from the latest examination report of each subsidiary bank. The other information is to be derived from discussions with senior management.

The information pertaining to ratings (CAMELS) and ratios of the banks is to be presented in columnar form with the banks listed as they appear on the organization chart. Also include any comment on the bank(s) deemed to warrant confidential treatment.

The examiner is expected to review and use the examination ratings of the other federal agencies where appropriate; however, if substantive differences of opinion exist as to the bank's composite rating, adjustments to the rating may be made and footnoted accordingly.

The examiner should make certain that the bank names or abbreviations are consistent with the organization chart and other tables in the inspection report. Any ratios or comments used in the rating analysis should be checked to corresponding areas in the open section.



This page provides a “snapshot” picture of the parent company’s short-term gap position as it relates to the amount of commercial paper compared to net short-term GAP within repricing maturity categories and also the cumulative GAP position within the maturity buckets. The page provides summary information of aggregate data from the “Commercial Paper (Parent),” “Parent Company Liquidity Position” and the “Unaffiliated Borrowings” pages or workpapers.

The lower portion of the schedule provides details on unaffiliated borrowings such as the amount and types of external indebtedness of the parent and its subsidiaries. Information regarding various debt covenants such as cross default clauses, collateral information and negative covenants can be included.

The purpose of the page is to aid in evaluating the company’s ability to service its debt and to operate within the constraints of debt restrictive covenants. It also aids in evaluating the appropriateness of the uses of the proceeds of the organization’s borrowings.

Information for the source report pages or workpapers required for an analysis of parent company liquidity, commercial paper and other short-term debt, and long-term unaffiliated borrowings should be requested in the officer’s questionnaire or can be obtained from the BHC’s accounting department. Totals should be brought forth from the “Commercial Paper (Parent)” and the “Parent Company Liquidity Position” pages or workpapers, or reconciled to the general ledger. Footnotes to financial statements in published reports contain much of this information.

For the commercial paper information, derive the totals from the total column on the “Commercial Paper (Parent)” report page, combining the totals for over 91 days maturity. Commercial paper maturity totals should be presented as a line item showing the aggregate outstanding balance netted by any amount held by subsidiaries.

For the “Long-term Debt” portion of the report page, present unaffiliated long-term borrowings in tabular form for (a) the parent, (b) each nonbank subsidiary, and (c) the bank subsidiaries (combined).

For the parent company and each nonbank subsidiary, show the borrower, lender, description of the debt, original amount, origination date, interest rate, maturity date, present outstanding balance, any significant repayment provisions, collateral, use of proceeds, major restrictive covenants and any requirements for compensating balances. In addition, mandatory convertible debt instruments of the parent should be identified and the conversion provisions detailed. In the case of large bank holding companies that have an extensive number of debt issues, detail for each issue may be eliminated at the discretion of the examiner so long as aggregates for similar issues are shown along with ranges for rates and maturities and summary information regarding the other terms of the debt.

For the “Net GAP” and “Net Cumulative GAP” use the respective total amounts (“Net Position” and “Cumulative Excess Deficiency”) on the “Parent Company Liquidity Position” report page. Bank mortgage indebtedness may be aggregated at the discretion of the examiner, showing amounts only without other detail. Capitalized lease obligations may be included in that total. For all other bank borrowings, including debentures issued to unaffiliated sources, provide complete detail.

Debt amounts on this page should agree with those shown for the “Parent Company Comparative Balance Sheet” for Core Page 5, the “Bank Subsidiaries”, the “Nonbank Subsidiary Financial Statements” pages or workpapers, and the “Consolidated Comparative Balance Sheet” Core page 8 (when adjusted to net intercompany borrowings).

This report page summarizes the examiner participants and their total workdays devoted to the inspection and provides clarification on checklist items where appropriate. Other comments should be directed to planning arrangements affecting the scope of the inspection. When non-bank subsidiaries are inspected, describe the extent of the review of the records. The examiner should cite any special problems encountered which would aid future inspections. Recommendations, suggestions, and information needed to conduct the next inspection should also be included for the next Examiner-in-Charge.

Information regarding planning is limited to the on-site planning of the work to be performed. Comments should be of a professional nature and should be strictly devoted to providing information that can be used in planning and performing an inspection (location and access to specific BHC records, inspection control problems, availability of facilities for staff, key officer and director contacts, information pertaining

to the Internal Audit Committee members, internal and external auditors, and etc.)

Information pertaining to the access to, and the storage of, workpapers and any personal information such as lodging, travel arrangements and geographical directions should be confined to the workpapers. Comments not directly related to the on-site conducting of the inspection should be avoided.

The purpose of the confidential report page is to present pertinent information to be used only by regulatory authorities. The page is reserved to summarize internal information derived from Reserve Bank inspection staff that would not be addressed in other confidential report pages. The information reported on this page may also be derived from discussions with senior bank management, workpapers, accounting records, board of directors' minutes, and etc.

Bank names or abbreviations should be consistent with the organization chart and other tables in the inspection report.