

The *Bank Holding Company Supervision Manual* has been prepared by Federal Reserve supervision personnel to provide guidance to examiners as they conduct on-site inspections of bank holding companies (BHCs) and their non-bank subsidiaries. The manual is a compilation of formalized procedures and Board supervisory policies that supervision and inspection personnel should follow. The manual includes new concepts and keeps pace with the ever-changing industry. An integral part of the Federal Reserve's overall program to supervise banking organizations operating under a holding company structure, the manual enhances the staff's ability to implement the Board's inspection and monitoring efforts.

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

The Federal Reserve System conducts risk assessments and a full-scope inspection program for BHCs. At a minimum, full-scope inspections should include sufficient procedures to reach an informed judgment on the assigned ratings for the factors included in the bank holding company RFI/C(D) rating system. The procedures of a full-scope inspection focus in part on assessing the types and extent of risks to which a BHC and its subsidiaries are exposed. Some of these types of risks include credit, market, liquidity, operational, legal, and reputational risks. Inspections also focus on evaluating the organization's policies and procedures for identifying, managing, and controlling such risk exposures and on determining whether the management and directors are actively involved in the oversight of the organization's risk-management program. To determine whether the organization's policies and procedures for risk management are fully effective and being followed, inspections or reviews also generally include transaction and compliance testing

The inspection process commences with a preliminary risk assessment. The risk assessment highlights the strengths and weaknesses of the holding company and is the basis for determining the procedures to be conducted during an inspection. Risk assessments identify the organization's principal business activities and the types and quantities of risks associated with the activities (including those conducted off-balance-sheet). The quality of management and the control of risks are factored into the initial

risk profile of the holding company. Sources of information for the risk assessment include prior bank and BHC inspection reports and workpapers, surveillance program reports, and regulatory reports. In addition, other relevant supervisory materials derived from within the Federal Reserve System or other federal and state banking supervisors, as well as from other responsible regulatory agencies (for example, the Securities and Exchange Commission and state insurance authorities) are used. Other sources for the risk assessment may include the banking organization's publicly available reports, such as annual and other periodic reports and informational releases; strategic plans and budgets; internal management reports; information packages for the board of directors; correspondence; the board of directors executive and audit committee minutes; internal audit workpapers and reports; and stock-analysis reports. The activities, transactions, and identified areas having the most significant risks, inadequate risk-management processes, or rudimentary internal controls will represent the banking organization's highest risks. The risk-assessment process culminates in a formalized and structured supervisory strategy, which examination staff will follow when conducting an inspection.

The banking organization's highest risks are expected to undergo the most rigorous scrutiny, analysis, and transaction testing by examiners and supervisors. Transaction testing is a reliable and essential inspection technique for assessing the banking organization's condition and verifying its adherence to internal policies, procedures, and controls. Transaction testing alone, however, is not sufficient for ensuring safe and sound operations in a highly dynamic banking environment. The changing nature of financial instruments and markets allows institutions to rapidly reposition their portfolio risk exposures. To ensure that banking organizations have systems in place to identify, measure, monitor, and control their changing risk exposures, inspections further focus on evaluating the banking organization's risk-management processes. These risk-management evaluations determine the extent to which the banking organization's management processes can be relied on.

The full-scope inspection may be conducted at a point in time or through a series of targeted or limited-scope reviews conducted on an ongoing or continuous basis for the largest and most

complex banking organizations. Irrespective of the duration of the inspection, planned supervisory activities should be coordinated well in advance with other responsible bank, thrift, and functional regulators in order to avoid duplication of effort and to minimize burden on the banking organization. Supervisory findings of inspections should be communicated to the banking organization's management or boards of directors, as well as to the banking organization's other bank supervisors and functional regulators, when relevant.

An inspection also measures the financial strength of a BHC or financial holding company (FHC) and focuses on financial indices of both the consolidated entity and its component parts. In addition to the analysis of risk, the other principal indices appraised are quality of assets, earnings, capital adequacy, cash flow and liquidity, and the competency of management. An inspection or supervisory program should also assess the banking organization's program for transactions between insured subsidiaries and affiliates. The basic objective of this assessment is to determine the impact or consequences of transactions between the parent holding company or its nonbanking subsidiaries and the insured subsidiaries. Of particular importance is whether intercompany transactions result in a diversion of income (or income opportunity)

away from a federally insured subsidiary to a holding company affiliate.

The competency of BHC management in overseeing the banking organization's business activities, risk management, and financial condition is also evaluated. The FHC and BHC inspection process provides a vehicle for a comprehensive assessment of the effectiveness of management, resulting in a more open and informed dialogue between management and representatives of the Federal Reserve.

In summary, the inspection process is intended to increase the flow of information to the Federal Reserve System concerning the soundness of FHCs and BHCs. This information will permit the Federal Reserve to encourage sound banking practices and to take appropriate supervisory action when warranted.

This manual is updated periodically to reflect current supervisory policy and procedures and changing practices within the industry. The manual is also available on the Board's public web site at www.federalreserve.gov/boarddocs/supmanual/. We solicit the input and contribution of all supervisory staff and others in refining and modifying its contents. Please address all correspondence to the Director of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, DC 20551.

General Table of Contents

Bank Holding Company Supervision Manual

1010.0

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

1000	Foreword, Contents, Preface, Use of the Manual
2000	Supervisory Policy and Issues
3000	Nonbanking Activities
4000	Financial Analysis
5000	BHC Inspection Program
6000	Alphabetical Subject Index

A detailed table of contents, which lists the subheads within each major section, precedes parts 2000 through 5000.

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
1000		FOREWORD, CONTENTS, PREFACE, MANUAL USE
	1000.0	Foreword
	1010.0	Table of Contents
	1020.0	Preface
	1030.0	Use of the Manual
	1040.0	Bank Holding Company Examination and Inspection Authority
2000		SUPERVISORY POLICY AND ISSUES
	2000.0	Introduction to Topics for Supervisory Review
	2010.0	Supervision of Subsidiaries
	2010.1	Funding Policies
	2010.2	Loan Administration
	2010.3	Investments
	2010.4	Consolidated Planning Process
	2010.5	Environmental Liability
	2010.6	Financial Institution Subsidiary Retail Sales of Nondeposit Investment Products
	2010.7	<i>Reserved</i>
	2010.8	Sharing of Facilities and Staff by Banking Organizations

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	2010.9	Required Absences from Sensitive Positions
	2010.10	Internal Loan Review
	2010.11	Private-Banking Functions and Activities
	2010.12	Fees Involving Investments of Fiduciary Assets in Mutual Funds and Potential Conflicts Interest
	2010.13	Establishing Accounts for Foreign Governments Embassies, and Political Figures
	2020.0	Intercompany Transactions—Introduction
	2020.1	Transactions Between Affiliates—Sections 23A and 23B of the Federal Reserve Act
	2020.2	Loan Participations
	2020.3	Sale and Transfer of Assets
	2020.4	Compensating Balances
	2020.5	Dividends
	2020.6	Management and Service Fees
	2020.7	Transfer of Low-Quality Loans or Other Assets
	2020.8	Trade Name or Royalty Fees
	2020.9	Split-Dollar Life Insurance
	2030.0	Grandfather Rights—Retention and Expansion of Activities
	2040.0	Commitments to the Federal Reserve
	2050.0	Extensions of Credit to BHC Officials
	2060.0	Management Information Systems
	2060.05	Policy Statement on the Internal Audit Function and Its Outsourcing
	2060.1	Audit
	2060.2	Budget
	2060.3	Records and Statements
	2060.4	Structure and Reporting
	2060.5	Insurance

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	2065.1	Accounting, Reporting, and Disclosure Issues— Nonaccrual Loans and Restructured Debt
	2065.2	Determining an Adequate Level for the Allowance for Loan and Lease Losses
	2065.3	Maintenance of an Adequate Allowance for Loan and Lease Losses
	2065.4	ALLL Methodologies and Documentation
	2070.0	Taxes—Consolidated Tax Filing
	2080.0	Funding—Introduction
	2080.05	Bank Holding Company Funding and Liquidity
	2080.1	Commercial Paper and Other Short-Term Uninsured Debt Obligations and Securities
	2080.2	Long-Term Debt
	2080.3	Equity
	2080.4	Retention of Earnings
	2080.5	Pension Funding and Employee Stock Option Plans
	2080.6	Bank Holding Company Funding from Sweep Accounts
	2090.0	Control and Ownership—General
	2090.05	Qualified Family Partnerships
	2090.1	Change in Control
	2090.2	BHC Formations
	2090.3	Treasury Stock Redemptions
	2090.4	Nonvoting Equity Investments by BHCs
	2090.5	Acquisitions of Bank Shares Through Fiduciary Accounts
	2090.6	Divestiture Control Determinants
	2090.7	Nonbank Banks
	2090.8	Liability for Commonly Controlled Depository Institutions
	2100.0	Foreign Banking Organizations

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	2100.1	Supervision of Foreign Banking Organizations
	2110.0	Formal Corrective Actions
	2120.0	Foreign Corrupt Practices Act and Federal Election Campaign Act
	2122.0	Internal Credit-Risk Ratings at Large Banking Organizations
	2124.0	Risk-Focused Safety-and-Soundness Inspections
	2124.01	Risk-Focused Supervisory Framework for Large Complex Banking Organizations
	2124.02– 2124.03	<i>Reserved</i>
	2124.04	Ongoing Risk-Focused Supervision Program for Large Complex Banking Organizations
	2124.1	Assessment of Information Technology in Risk-Focused Supervision
	2124.2– 2124.3	<i>Reserved</i>
	2124.4	Information Security Standards
	2125.0	Trading Activities of Banking Organizations— Risk Management and Internal Controls
	2126.0	Nontrading Activities of Banking Organizations— Risk Management and Internal Controls
	2126.1	Investment Securities and End-User Derivatives Activities
	2126.2	<i>Reserved</i>
	2126.3	Counterparty Credit Risk Management Systems
	2127.0	Interest-Rate Risk—Risk Management and Internal Controls
	2128.0	Structured Notes—Risk Management and Internal Controls
	2128.01	<i>Reserved</i>
	2128.02	Asset Securitization
	2128.03	Credit-Supported and Asset-Backed Commercial Paper
	2128.04	Implicit Recourse Provided to Asset Securitizations

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
	2128.05	Securitization Covenants Linked to Supervisory Actions or Thresholds
	2128.06	Valuation of Retained Interests and Risk Management of Securitization Activities
	2128.07	<i>Reserved</i>
	2128.08	Subprime Lending
	2129.0	Credit Derivatives—Risk Management and Internal Controls
	2129.05	Risk and Capital Management—Secondary-Market Credit Activities
	2130.0	Futures, Forward, and Option Contracts
	2140.0	Securities Lending
	2150.0	Repurchase Transactions
	2160.0	Recognition and Control of Exposure to Risk
	2170.0	Purchase and Sale of Loans Guaranteed by the U.S. Government
	2175.0	Sale of Uninsured Annuities
	2178.0	Support of Bank-Affiliated Investment Funds
	2180.0	Securities Activities in Overseas Markets
	2187.0	Violations of Federal Reserve Margin Regulations Resulting from “Free-Riding” Schemes
	2220.3	Note Issuance and Revolving Underwriting Credit Facilities
	2231.0	Real Estate Appraisals and Evaluations
	2240.0	Guidelines for the Review and Classification of Troubled Real Estate Loans
	2241.0	Retail-Credit Classification
	2250.0	Domestic and Other Reports to Be Submitted to the Federal Reserve
	2260.0	Venture Capital
3000		NONBANKING ACTIVITIES
	3000.0	Introduction to BHC Nonbanking and FHC Activities

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
3001.0		Section 2(c) of the BHC Act—Savings Bank Subsidiaries of BHCs Engaging in Nonbanking Activities
3005.0		Section 2(c)(2)(F) of the BHC Act—Credit Card Bank Exemption from the Definition of a Bank
3010.0		Section 4(c)(i) and (ii) of the BHC Act—Exemptions from Prohibitions on Acquiring Nonbank Interests
3020.0		Section 4(c)(1) of the BHC Act—Investment in Companies Whose Activities Are Incidental to Banking
3030.0		Section 4(c)(2) and (3) of the BHC Act—Acquisition of DPC Shares, Assets, or, Real Estate
3040.0		Section 4(c)(4) of the BHC Act—Interests in Nonbanking Organizations
3050.0		Section 4(c)(5) of the BHC Act—Investments Under Section 5136 of the Revised Statutes
3060.0		Section 4(c)(6) and (7) of the BHC Act—Ownership of Shares in Any Nonbank Company of 5 Percent or Less
3070.0		Section 4(c)(8) of the BHC Act—Mortgage Banking
3071.0		Section 4(c)(8) of the BHC Act—Mortgage Banking—Derivative Commitments to Originate and Sell Mortgage Loans
3072.0		Section 4(c)(8) of the BHC Act—Activities Related to Extending Credit
3072.8		Real Estate Settlement Services
3073.0		Section 4(c)(8) of the BHC Act—Education-Financing Activities
3080.0		Section 4(c)(8) of the BHC Act—Servicing Loans
3084.0		Section 4(c)(8) of the BHC Act—Asset-Management, Asset-Servicing, and Collection Activities
3090.0		Section 4(c)(8) of the BHC Act—Receivables
3090.1		Factoring
3090.2		Accounts Receivable Financing
3100.0		Section 4(c)(8) of the BHC Act—Consumer Finance

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
3104.0		Section 4(c)(8) of the BHC Act—Acquiring Debt in Default
3105.0		Section 4(c)(8) of the BHC Act—Credit Card Authorization and Lost/Stolen Credit Card Reporting Services
3107.0		Section 4(c)(8) of the BHC Act—Stand-Alone Inventory Inspection Services
3110.0		Section 4(c)(8) of the BHC Act—Industrial Banking
3111.0		Section 4(c)(8) of the BHC Act—Acquisition of Savings Associations
3120.0		Section 4(c)(8) of the BHC Act—Trust Services
3130.0		Section 4(c)(8) of the BHC Act—General Financial and Investment Advisory Activities
3130.1		Investment or Financial Advisers
3130.2		<i>Reserved</i>
3130.3		Advice on Mergers and Similar Corporate Structurings, Capital Structurings, and Financing Transactions

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	3130.4	Informational, Statistical Forecasting, and Advisory Services for Transactions in Foreign Exchange and Swaps, Commodities, and Derivative Instruments
	3130.5	Providing Educational Courses and Instructional Materials for Consumers on Individual Financial Management Matters
	3130.6	Tax-Planning and Tax-Preparation Services
	3140.0	Section 4(c)(8) of the BHC Act—Leasing Personal or Real Property
	3150.0	Section 4(c)(8) of the BHC Act—Community Welfare Projects
	3160.0	Section 4(c)(8) of the BHC Act—EDP Servicing Company
	3160.1	EDP Servicing—Network for the Processing and Transmission of Medical Payment Data
	3160.2	Electronic Benefit Transfer, Stored-Value-Card, and Electronic Data Interchange Services
	3160.3	Data Processing Activities: Obtaining Traveler’s Checks and Postage Stamps Using an ATM Card and Terminal
	3160.4	Providing Data Processing for ATM Distribution of Tickets, Gift Certificates, Telephone Cards, and Other Documents
	3160.5	Engage in Transmitting Money
	3165.1	Support Services—Printing and Selling MICR-Encoded Items
	3170.0	Section 4(c)(8) of the BHC Act—Insurance Agency Activities of Bank Holding Companies
	3180.0	Section 4(c)(8) of the BHC Act—Insurance Underwriters
	3190.0	Section 4(c)(8) of the BHC Act—Courier Services
	3200.0	Section 4(c)(8) of the BHC Act—Management Consulting and Counseling
	3202.0	Section 4(c)(8) of the BHC Act—Employee Benefits Consulting Services
	3204.0	Section 4(c)(8) of the BHC Act—Career Counseling

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	3210.0	Section 4(c)(8) of the BHC Act—Money Orders, Savings Bonds, and Traveler’s Checks
	3210.1	Payment Instruments
	3220.0	Section 4(c)(8) of the BHC Act—Arranging Commercial Real Estate Equity Financing
	3230.0	Section 4(c)(8) of the BHC Act—Agency Transaction Services for Customer Investments (Securities Brokerage)
	3230.05	Securities Brokerage (Board Decisions)
	3230.1	Securities Brokerage in Combination with Investment Advisory Services
	3230.2	Securities Brokerage with Discretionary Investment Management and Investment Advisory Services
	3230.3	Offering Full Brokerage Services for Bank-Ineligible Securities
	3230.4	Private-Placement and Riskless-Principal Activities
	3230.5	Acting as a Municipal Securities Brokers’ Broker
	3230.6	Acting as a Conduit in Securities Borrowing and Lending
	3240.0	Section 4(c)(8) of the BHC Act—Underwriting and Dealing in U.S. Obligations, Municipal Securities, and Money Market Instruments
	3250.0	Section 4(c)(8) of the BHC Act—Agency Transactional Services (Futures Commission Merchants and Futures Brokerage)
	3251.0	4(c)(8) Agency Transactional Services—FCM Board Orders
	3255.0	Section 4(c)(8) of the BHC Act—Agency Transactional Services for Customer Investments
	3260.0	Section 4(c)(8) of the BHC Act—Investment Transactions as Principal
	3270.0	Section 4(c)(8) of the BHC Act—Real Estate and Personal Property Appraising
	3320.0	Section 4(c)(8) of the BHC Act—Check-Guaranty and Check-Verification Services

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
	3330.0	Section 4(c)(8) of the BHC Act—Operating a Collection Agency
	3340.0	Section 4(c)(8) of the BHC Act—Operating a Credit Bureau
	3500.0	Tie-In Considerations of the BHC Act
	3510.0	Sections 4(c)(9) and 2(h) of the BHC Act—Nonbanking Activities of Foreign Banking Organizations
	3520.0	Section 4(c)(10) of the BHC Act—Grandfather Exemption from Section 4 for BHCs Which Are Banks
	3530.0	Section 4(c)(11) of the BHC Act—Authorization for BHCs to Reorganize Share Ownership Held on the Basis of Any Section 4 Exemption
	3540.0	Section 4(c)(12) of the BHC Act—Ten-Year Exemption from Section 4 of the BHC Act
	3550.0	Section 4(c)(13) of the BHC Act—International Activities of Bank Holding Companies
	3560.0	Section 4(c)(14) of the BHC Act—Export Trading Companies
	3600.0	Permissible Activities by Board Order
	3600.1	Operating a “Pool Reserve Plan”
	3600.2– 3600.4	<i>Reserved for future use</i>
	3600.5	Engaging in Banking Activities via Foreign Branches
	3600.6	Operating a Securities Exchange
	3600.7	Acting as a Certification Authority for Digital Signatures
	3600.8	Private Limited Investment Partnerships
	3600.9– 3600.12	<i>Reserved for future use</i>
	3600.13	FCM Activities
	3600.14– 3600.16	<i>Reserved for future use</i>
	3600.17	Insurance Activities

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
	3600.18– 3600.20	<i>Reserved for future use</i>
	3600.21	Underwriting and Dealing
	3600.22	<i>Reserved for future use</i>
	3600.23	Issuance and Sale of Mortgage-Backed Securities Guaranteed by GNMA
	3600.24	Sales-Tax Refund Agent and Cashing U.S. Dollar Payroll Checks
	3600.25	Providing Government Services
	3600.26	Real Estate Settlement through a Permissible Title Insurance Agency
	3600.27	Providing Administrative and Certain Other Services to Mutual Funds
	3600.28	Developing Broader Marketing Plans and Advertising and Sales Literature for Mutual Funds
	3600.29	Providing Employment Histories to Third Parties
	3600.30	Real Estate Title Abstracting
	3610.1	Section 4(c)(8) of the BHC Act—Board Staff Legal Interpretation—Financing Customers’ Commodity Purchase and Forward Sales
	3610.2	Section 4(c)(8) of the BHC Act—Board Legal Staff Interpretation—Certain Volumetric-Production- Payment Transactions Involving Physical Commodities
	3700.0	Impermissible Activities
	3700.1	Land Investment and Development
	3700.2	Insurance Activities
	3700.3	Real Estate Brokerage and Syndication
	3700.4	General Management Consulting
	3700.5	Property Management
	3700.6	Travel Agencies
	3700.7	Providing Credit Ratings on Bonds, Preferred Stock, and Commercial Paper

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
	3700.8	Acting as a Specialist in Foreign-Currency Options on a Securities Exchange
	3700.9	Design and Assembly of Hardware for Processing or Transmission of Banking and Economic Data
	3700.10	Armored Car Services
	3700.11	Computer Output Microfilm Service
	3700.12	Clearing Securities Options and Other Financial Instruments for the Accounts of Professional Floor Traders
	3900.0	Section 4(k) of the BHC Act—Financial Holding Companies
	3901.0	U.S. Bank Holding Companies Operating as Financial Holding Companies
	3903.0	Foreign Banks Operating as Financial Holding Companies
	3905.0	Permissible Activities for FHCs
	3906.0	Disease Management and Mail-Order Pharmacy Activities
	3907.0	Merchant Banking
	3909.0	Supervisory Guidance on Equity Investment and Merchant Banking Activities
	3910.0	Acting as a Finder
	3912.0	To Acquire, Manage, and Operate Defined Benefit Pension Plans in the United Kingdom (Section 4(k) of the BHC Act)
	3920.0	Limited Physical-Commodity-Trading Activities
	3950.0	Insurance Sales Activities and Consumer Protection in Sales of Insurance
4000		FINANCIAL ANALYSIS
	4000.0	Financial Factors—Introduction
	4010.0	Parent Only: Debt-Servicing Capacity—Cash Flow
	4010.1	Leverage
	4010.2	Liquidity

<i>Tab</i>	<i>Sections</i>	<i>Title</i>
4020.0		Banks
4020.1		Banks: Capital
4020.2		Banks: Asset Quality
4020.3		Banks: Earnings
4020.4		Banks: Liquidity
4020.5		Banks: Summary Analysis
4020.6– 4020.8		<i>Reserved</i>
4020.9		Supervision Standards for De Novo State Member Banks of Bank Holding Companies
4030.0		Nonbanks
4030.1		Nonbanks: Credit Extending—Classifications
4030.2		Nonbanks: Credit Extending—Earnings
4030.3		Nonbanks: Credit Extending—Leverage
4030.4		Nonbanks: Credit Extending—Reserves
4040.0		Nonbanks: Noncredit Extending
4050.0		Nonbanks: Noncredit Extending—Service Charters
4060.0		Consolidated—Earnings
4060.1		Consolidated: Asset Quality
4060.2		<i>Reserved</i>
4060.3		Consolidated Capital—Examiners’ Guidelines for Assessing the Capital Adequacy of BHCs
4060.4		Consolidated Capital—Leverage Measure
4060.5– 4060.6		<i>Reserved</i>
4060.7		Assessing Capital Adequacy and Risk at Large Banking Organizations and Others with Complex Risk Profiles
4070.0		BHC Rating System
4070.1		Rating the Adequacy of Risk-Management Processes and Internal Controls of Bank Holding Companies

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	4070.2	<i>Reserved</i>
	4070.3	Revising Supervisory Ratings
	4070.4	<i>Reserved</i>
	4070.5	Nondisclosure of Supervisory Ratings
	4080.0	Federal Reserve System BHC Surveillance Program
	4080.1	Surveillance Program for Small Bank Holding Companies
	4090.0	Country Risk
5000		BHC INSPECTION PROGRAM
	5000.0	BHC Inspection Program—General
	5010.0	Procedures for Inspection Report Preparation— Inspection Report References
	5010.1	General Instructions to FR 1225

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	5010.2	Cover
	5010.3	Page i—Table of Contents
	5010.4	Core Page 1—Examiner’s Comments and Matters Requiring Special Board Attention
	5010.5	Core Page 2—Scope of Inspection and Abbreviations
	5010.6	Core Page 3—Analysis of Financial Factors
	5010.7	Core Page 4—Audit Program
	5010.8	Appendix Page 5—Parent Company Comparative Balance Sheet
	5010.9	Appendix Page 6—Comparative Statement of Income and Expenses (Parent)
	5010.10	Appendix Page 7—Consolidated Classified and Special Mention Assets and OTRP
	5010.11	Appendix Page 8—Consolidated Comparative Balance Sheet
	5010.12	Appendix Page 9—Comparative Consolidated Statement of Income and Expenses
	5010.13	Capital Structure
	5010.14	Page—Policies and Supervision
	5010.15	Page—Violations
	5010.16	Page—Other Matters
	5010.17	Page—Classified Assets and Capital Ratios of Subsidiary Banks
	5010.18	Page—Organization Chart
	5010.19	Page—History and Structure
	5010.20	Page—Investment in and Advances to Subsidiaries
	5010.21	Page—Commercial Paper (Parent)
	5010.22	Page—Lines of Credit (Parent)
	5010.23	Page—Questions on Commercial Paper and Lines of Credit (Parent)
	5010.24	Page—Contingent Liabilities and Other Accounts

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	5010.25	Page—Statement of Changes in Stockholders' Equity (Parent)
	5010.26	Page—Income from Subsidiaries
	5010.27	Page—Cash Flow Statement (Parent)
	5010.28	Page—Parent Company Liquidity Position
	5010.29	Page—Classified Parent Company and Nonbank Assets
	5010.30	Page—Bank Subsidiaries
	5010.31	Page—Nonbank Subsidiary
	5010.32	Page—Nonbank Subsidiary Financial Statements
	5010.33	Page—Fidelity and Other Indemnity Insurance
	5010.34	<i>Reserved</i>
	5010.35	Page—Other Supervisory Issues
	5010.36	Page—Extensions of Credit to BHC Officials . . .
	5010.37	Page—Interest Rate Sensitivity—Assets and Liabilities
	5010.38	Treasury Activities/Capital Markets
	5010.39	<i>Reserved</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	Bank Subsidiary (FR 1241)
	5020.2	Other Supervisory Issues (FR 1241)
	5030.0	BHC Inspection Report Forms
	5040.0	Procedures for “Limited-Scope” Inspection Report Preparation—General Instructions
	5050.0	Procedures for “Targeted” Inspection Report Preparation—General Instructions

<i>Tabs</i>	<i>Sections</i>	<i>Title</i>
	5052.0	Targeted MIS Inspection
	5060.0	Portions of Bank Holding Company Inspections Conducted in Federal Reserve Bank Office
6000		ALPHABETICAL SUBJECT INDEX
	6000.0	Alphabetical Subject Index

1020.0.1 INTRODUCTION

This manual is designed to aid personnel of the Federal Reserve System in supervising bank holding companies. As such, it will review in considerable detail current policies and procedures for supervising the financial affairs of these banking organizations and will also discuss statutes, regulations, interpretations and orders that pertain to bank holding company supervision. Before proceeding, however, it is desirable to step back and view bank holding companies and their supervision in a broader perspective. This preface is designed to provide that perspective.

While the holding company form of organization exists in many industries, it is particularly prevalent in the regulated industries—telephone, electric and gas utility, railroad, savings and loan, and banking. Regulated industries have learned that a holding company structure allows certain entities to avoid some of the constraints of regulation. For example, regulation often limits the geographic area that a regulated firm can serve. By forming a holding company, many regulated organizations can serve a broader area, thereby potentially benefiting from economies of scale and risk reduction through geographic diversification.

A second purpose for the use of a holding company structure by regulated firms is to expand into other product markets, often ones that are not subject to regulation.

A third purpose for the use of a holding company structure is to increase the organization's financial flexibility, thereby avoiding some of the financing constraints imposed by regulation. These constraints can include limitations on leverage, the types of assets that the firm can acquire and the types of liabilities that it can issue. Another possible financial advantage of the holding company is to obtain tax benefits.

Bank holding companies were created for essentially the same reasons that holding companies were created in other industries; to expand geographically, to move into other product markets, and to obtain greater financial flexibility and tax benefits. The primary use of the bank holding company device prior to the late 1960's was to expand banking operations geographically. The holding company form was needed because many States either prohibited or sharply curtailed branching within the State. Moreover, banks generally did not have the authority to branch beyond the geographic limits of the State in which the bank was chartered. By employing

the holding company form of organization, several banking organizations had succeeded by the 1950's in expanding over an entire region of the country, operating banks in several States.

During the 1960's many banks, especially the largest ones, desired to expand into new lines of activity. In most cases, these new activities were financial in nature and were closely related to traditional banking operations. While some banks were successful in obtaining supervisory approval to enter certain of these new activities, the courts subsequently voided many of these approvals. Unable to enter these activities as a bank, many of these organizations converted into the holding company form and entered these activities through the holding company.

In recent years banking organizations also have used the holding company device to increase their financial flexibility. For example, in order to avoid the reserve requirements and interest rate ceilings applicable to deposits of their bank subsidiaries, many banking organizations have utilized the parent company as a vehicle to fund the organization. Moreover, the holding company structure has allowed organizations to attain higher leverage levels than otherwise might have been permitted.

Historically, the Bank Holding Company Act sought to provide for the separation of banking from commerce. In order to avoid any detrimental effects on the public interest, the activities of bank holding companies have been limited by law and regulation and transactions with banking subsidiaries are virtually prohibited. This basic rationale is the cornerstone for regulating the financial affairs of bank holding companies.

1020.0.2 POSSIBLE CONSEQUENCES OF HOLDING COMPANY FORMATION

There are two primary ways that a holding company can have an adverse effect on the financial condition of a regulated subsidiary. The first is for the holding company (or its unregulated-regulated subsidiaries) to take excessive risks and fail. This failure could have a "ripple effect" on the regulated firm, impairing its access to financial markets. The classic case is the Insull empire in the electric utility industry, which involved the pyramiding of numerous highly leveraged holding companies. The col-

lapse of this pyramid during the Depression of the 1930's severely impacted the regulated electric utility operating companies and impaired their ability to service the public.

A second major way that a holding company can have a harmful effect on the financial condition of a regulated subsidiary is through adverse intercompany transactions and excessive dividends. Adverse intercompany transactions typically involve either the purchase and sale of goods and services or financial transactions that are on nonmarket terms. Concern over the use of the holding company device to transfer financial resources from the regulated firm has been particularly prevalent. In this case, there has been a conflict of views between the government, and the firms which want to diversify in order to increase their return on investment.

In the mid 1970's, concern over holding companies forcing regulated firms into adverse transactions surfaced in the banking industry. In this instance, the objective was not to divert resources from the bank to more profitable areas, but rather to use bank resources to save a non-bank affiliate from failure.

1020.0.3 REGULATORY RESPONSE TO THE HOLDING COMPANY

Historically, public policymakers have recognized that holding companies can have both positive and negative effects on regulated subsidiaries. The fact that policymakers have permitted holding companies to exist in all of the major regulated industries indicates that the effects, on balance, have not been decidedly negative. However, there have been enough problems over the years that holding companies in most regulated industries are subject to at least some form of regulation. This regulation varies substantially from one regulated industry to another.

Until the mid-1970's, Congressional concerns with bank holding companies were primarily oriented to competition, concentration of financial resources and the proper range of banking activities. However, there was also some limited recognition of the possible impact of holding companies on the financial condition of banks. The earliest evidence was the Banking Act of 1935, in which Congress gave the Federal Reserve Board authority to issue permits to holding companies to vote the stock of their banks. In acting on permit applications, the Board was required

to consider the holding company's financial condition, the character of its management, and the effect of granting the permit on the bank. Congress also gave the Federal Reserve the right to inspect bank holding companies.

About two decades later, Congress passed the Bank Holding Company Act of 1956. This legislation required the Federal Reserve, in passing on proposed bank acquisitions by holding companies, to consider the competitive, financial and managerial implications of the proposal. More recently, the Bank Holding Company Act Amendments of 1970 required the Federal Reserve to make a similar determination in applications by holding companies to acquire nonbanking companies. The amendments also brought one-bank holding companies into the Federal Reserve's jurisdiction.

Subsequently, Congress and the public became seriously concerned over the possible adverse impact of holding companies on the financial condition of subsidiary banks. These adverse developments led to two results; additional legislation and stepped-up holding company supervision. The major Congressional action was to give the Federal Reserve much needed cease and desist powers over bank holding companies. This authority now supplements certain statutes, such as dividend restrictions and limitations on bank transactions with affiliates, that tend to protect banks in a holding company organization.

In the mid-1970's, the Federal Reserve stepped up its supervision and monitoring of bank holding companies in a variety of ways. First, the Federal Reserve increased the scope and frequency of holding company inspections, and later introduced a bank holding company rating system designed to focus attention on those organizations having the most serious problems. Second, the Federal Reserve began to monitor transactions between bank subsidiaries and the rest of the holding company organization through quarterly intercompany transactions reports. Third, the Federal Reserve implemented a computer-based surveillance program designed to identify emerging financial problems. Finally, the Federal Reserve began to employ its new holding company cease and desist powers in an effort to curtail unsafe and unsound practices.

The period prior to 1980 marked a gradual decline in the ratio of equity capital to total assets within the United States Commercial banking system, particularly for the nation's largest banking organizations. In an effort to reverse that trend, the Federal Reserve System and the Comptroller adopted guidelines for

national and state member banks and bank holding companies in December 1981. The guidelines established minimum capital levels and capital zones. The guidelines provided state member banks and bank holding companies with targets or objectives to be reached over time. As a result, many of the banks and bank holding companies improved their capital positions. However, other developments, including deregulation of interest rates on bank liabilities, weakening of loan portfolios (asset quality) of some banking institutions occasioned by economic shocks in certain industries or geographical areas, and increased competition in the financial services areas, combined to place additional pressures on the profitability of banking institutions and accentuate the potential demands on the capital positions of those institutions.

The Federal Reserve System continued to stress the importance of the capital guidelines in setting standards of capital adequacy. The Board thus amended its guidelines in June 1983, to set explicit minimum capital levels for multinational organizations.

In November 1983, congressional concern over existing conditions, prompted the enactment of the International Lending Supervision Act of 1983 ("ILSA"). The Act directed that the federal banking agencies cause banking institutions to establish minimum capital levels for banking organizations. In December 1983, the Board, therefore, published the guidelines as Appendix A to the totally revised Regulation Y (12 C.F.R. section 225). Then in April 1985, the Board adopted new capital adequacy guidelines to increase the required minimum primary and total capital levels for the larger regional and multinational bank holding companies and state member banks. This action, when considered in conjunction with the capital maintenance regulations of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, established uniform minimum capital levels for all federally supervised bank holding companies, regardless of size, type of charter, primary supervisor or membership in the Federal Reserve System.

The strengthening of supervision over banks and bank holding companies is an equally imposing supervisory concern. The Federal Reserve System adopted a number of supervisory policies in 1985 that directly affected the supervision of bank holding companies, such as the increased frequency and scope of inspections and the communicating of the results of inspections (refer to Manual section 5000). In addition, the scope of the inspection was expanded to provide for a comprehensive analysis of man-

agement's ability to direct and control the organization utilizing the basic assumption that the bank holding company is responsible for the direction and vitality of the organization. Overseeing the supervision of banking organizations entails evaluating management's policies and procedures, wherever they are established within the corporate structure, as part of the examination/inspection process. Such policy areas include the consolidated planning process, risk management, funding, liquidity, lending, management information systems, loan review, and audit and internal controls.

The Board, concerned with strengthening the supervision over member banks and bank holding companies, adopted a policy statement regarding cash dividends not fully covered by earnings on November 14, 1985. The policy statement addressed the situation when cash dividends are not fully covered by earnings, which represents a return of a portion of an organization's capital (refer to Manual section 2020.0 for a discussion regarding the policy statement).

The Board adopted a policy statement on April 24, 1987, also related to the strengthening of the supervision over subsidiary banks of bank holding companies. The Board reaffirmed its long-standing policy that a bank holding company should act as a source of financial and managerial strength to its subsidiary financial institutions. The policy statement provides that a bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing condition when the holding company is in a position to provide the support. The Board emphasized that a bank holding company's failure to provide assistance to a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a violation of the Boards Regulation Y (refer to section 225.4 (a)(1)) or both.

Congress limited the expansion of nonbank banks with the passage of the Competitive Equality Banking Act of 1987. The legislation redefined the definition of "bank" in the Bank Holding Company Act so that an FDIC-insured institution is a bank. Existing nonbank banks were grandfathered but certain limitations were imposed on their operations.

In an effort to further strengthen the capital position in banks and bank holding companies, the Board of Governors of the Federal Reserve System, on January 19, 1989, issued final guidelines to implement risk-based capital require-

ments for state member banks and bank holding companies. The guidelines are based on the framework adopted July 11, 1988, by the Basle Committee on Banking Regulations and Supervisory Practices, which includes supervisory authorities from 12 major industrial countries. The guidelines are designed to achieve certain important goals:

- Establishment of a uniform capital framework, applicable to all federally supervised banking organizations (the guidelines were also adopted by the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation);
- Encouragement of international banking organizations to strengthen their capital positions; and,
- Reduction of a source of competitive inequality arising from differences in supervisory requirements among nations.

The guidelines establish a systematic analytical framework that: (1) makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (2) factors off-balance sheet exposures into explicit account in assessing capital adequacy, minimizes disincentives to holding liquid, low-risk assets; and achieves greater consistency in the evaluation of the capital adequacy of major banking organizations throughout the world.

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. An institution's risk-based capital is calculated by dividing its qualifying total capital (the numerator of the ratio) by its weighted risk assets (the denominator).

The guidelines provide for phasing in of risk-based capital standards through the end of 1992, at which time the standards become fully effective. At that time, banking organizations will be required to have capital equivalent to 8 percent of assets, weighted by risk.

Banking organizations must have at least 4 percent Tier 1 capital, which consists of core capital elements, including common stockholder's equity, retained earnings, and noncumulative and limited amounts of cumulative perpetual preferred stock, to weighted risk assets. The other half of required capital (Tier 2), can include, among other supplementary capital elements,

the non-Tier 1 portion of cumulative perpetual preferred stock, limited-life preferred stock and subordinated debt, and loan loss reserves up to certain limits.

The risk weights assigned to assets and credit equivalent amounts of off-balance sheet items are based primarily on credit risk. Other types of exposure, such as interest rate, liquidity, and funding risk, as well as asset quality problems, are not factored into the risk-based measure. Such risks will be taken into account in determining a final assessment of an organization's, capital adequacy, however.

Congress addressed the recent thrift crisis with the passage of thrift legislation, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which was signed into law on August 9, 1989. The legislation brought forth a number of important developments affecting bank holding companies. The legislation addressed:

1. acquisition of thrifts, in addition to failing ones;
2. conversion of thrifts to banks;
3. merger of thrifts with banks; and the
4. enhancement of enforcement authority.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was signed into law on December 19, 1992. It was enacted to require the least-cost resolution of insured depository institutions, to improve supervision and examinations, to provide additional resources to the Bank Insurance Fund, and for other purposes. It required the federal banking agencies and their holding companies to prescribe standards for credit underwriting, loan documentation, as well as numerous other standards that are intended to preserve the safety and soundness of banking organizations.

FIDICIA further amended the International Banking Act of 1978. The Federal Reserve's authority over foreign bank operations (including representative offices in the U.S.) was significantly increased.

FIDICIA required the federal banking agencies to adopt standards for undercapitalized financial institutions. The Board, on September 18, 1992, issued Prompt Corrective Action Measures for state member banks.

During 1992, the Federal Reserve issued guidance on such issues as the monitoring and controlling of risk from asset concentrations, the disclosure, accounting, and reporting of past due (nonaccrual) loans, and the need for consistent methods in determining the amount of the allowance for loan and lease losses.

With the FIRREA and FIDICIA legislation, Congress re-emphasized the need for continued strengthening of the supervision over financial institutions. The strengthening of supervision over banks and bank holding companies will

continue to be a primary objective of the Federal Reserve. As it is now, it will be continuously emphasized during the examination/inspection of member banks and bank holding companies during the 1990's and beyond.

The Manual is presented in “sections” which have been grouped together into “parts” that have in common a central theme pertaining to BHC supervision. For example, Part II is composed of sections which discuss topics of special interest for supervisory review. Part III is composed of sections which discuss the various exemptive provisions to the nonbank prohibitions of the BHC Act. Part IV presents sections on the preparation of a financial analysis while Part V discusses the methods used to prepare the inspection report forms.

In preparing to conduct an inspection and complete the inspection report forms, the examiner should review the information requirements presented in Part V which include a “section” for each page within the inspection report. Many of these sections contain cross-references to other sections within Parts II–IV of the Manual that present in greater detail the issues to be considered during the inspection process. The examiner assigned to complete a particular inspection report page should review the sections cross-referenced in Part V.

Given that the overall objective of the Manual is to standardize and formalize inspection objectives and procedures that provide guidance to the examiner and enhance the supervisory process, the content of the sections within Parts II–IV are grouped into broad categories. They are:

1030.0.1 INSPECTION OBJECTIVES; INSPECTION PROCEDURES; LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Not all of the categories are presented in each section. Where a particular topic is exclusively financially related and does not involve legal considerations, the subsection on “Laws, Regulations, . . .” may be omitted.

These procedures were designed for a full-scope, comprehensive inspection. It is recog-

nized that in some instances the procedures may not apply in their entirety to all bank holding companies.

Examiners may exercise a measure of discretion depending upon the characteristics of the organization under inspection.

References to the “Examiner’s Comments” inspection report page throughout this Manual are synonymous with Core Page 1 of the inspection report—“Examiner’s Comments and Matters Requiring Special Board Attention”—as discussed in Part V of the Manual.

Part V of the Manual concerns the inspection program and report forms.

1030.0.2 NUMBERING SYSTEM

The Manual is arranged using a numerical coding system based on the Manual’s parts, sections and subsections. Parts are differentiated using “thousands” notations, sections using “digits” notations, and subsections using “tenths” placed after a decimal point as follows:

Part II—Topics for Supervisory Review	2000.0
Section 6—Management Information System	60.0
Subsection 1—Audit	.1
	2060.1

1030.0.3 ABBREVIATION

The Bank Holding Company Act of 1956, as amended, is abbreviated as “the Act” throughout the Manual.

1030.0.4 AMENDMENTS TO THE MANUAL

Amendments will be published periodically as needed.

Bank Holding Company Examination and Inspection Authority

Section 1040.0

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section has been revised to discuss further the authority for the Federal Reserve to conduct BHC inspections under section 5 of the Bank Holding Company Act of 1956.

1040.0.1 BHC INSPECTIONS

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

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

1040.0.1.1 Authority for Bank Holding Company Inspections

Section 5 of the BHC Act of 1956 authorizes the Board to require reports and to conduct inspections of bank holding companies and their affiliates.¹ Subject to the limitations discussed below, Section 5 authorizes the Board to examine each

bank holding company and nonbank subsidiary thereof. Within those limitations, the Federal Reserve System's supervisory staff (includes BHC inspection and examination staff) may review *all* books and records of a banking organization that is subject to Federal Reserve Supervision.²

1040.0.2 FOCUS AND SCOPE OF BHC INSPECTIONS

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

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

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

1040.0.3 EXAMINATIONS OF FUNCTIONALLY REGULATED SUBSIDIARIES

The Board's ability to examine a functionally regulated subsidiary (FRS) is limited. The Board can examine an FRS only if the Board—

1. has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated DI;

² Supervisory staff includes individuals that are on and/or off site.

¹ See 12 U.S.C. 1844.

2. has reasonably determined, after reviewing relevant reports, that an examination of the subsidiary is necessary to be adequately informed of the systems for monitoring and controlling the operational and financial risks posed to any DI; or
3. has reasonable cause to believe, based on reports and other available information, that a subsidiary is not in compliance with the BHC Act or any other federal law that the Board has specific jurisdiction to enforce against such subsidiary. This includes provisions relating to transactions with an affiliated DI, when the Board cannot make its determination by examining the affiliated DI or the BHC.