Management Information Systems (General) Section 2060.0

Management Information Systems refers to the policies and operating procedures, including systems of internal control, that the board of directors of a bank holding company initiates to monitor and ensure control of its operations and activities, while maintaining and improving the financial strength and objectives of the overall organization. These policies should focus on the overall organizational structure with respect to identifying, monitoring, and managing risks. Subsequent sections of the manual focus on the essential elements of various management information systems. Included are inspection objectives and procedures to be used by Federal Reserve Bank examiners when conducting inspections of bank holding companies.

See 2060.05 Internal Audit Function and Its Outsourcing
2060.1 Audit
2060.2 Budget
2060.3 Records and Statements
2060.4 Reporting
2060.5 Insurance
5052.0 Targeted MIS Inspection

Effective internal control[1] is a foundation for the safe and sound operation of a banking organization (bank holding companies, banking institutions, or savings associations). The board of directors and senior managers are responsible for ensuring that the system of internal control operates effectively. Their responsibility *cannot* be delegated to others within the organization or to outside parties. An important element of an effective internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control. The directors and management can use this information to take prompt, remedial action.

The Federal Reserve System and other federal banking agencies' long-standing examination and inspection policies have called for examiners to review a banking organization's internal audit function and to recommend any needed improvements. More recently, the federal banking agencies adopted Interagency Guidelines Establishing Standards for Safety and Soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).[2] Under these guidelines, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many banking institutions have been engaging independent public accounting firms and other outside professionals (hereafter referred to as outsourcing venders) to perform work that has traditionally been done by internal auditors. These arrangements are often called ''internal audit outsourcing,'' ''internal audit assistance,'' ''audit co-sourcing,'' and ''extended audit services'' (hereafter, collectively referred to as outsourcing).

Such outsourcing may be beneficial to a banking organization if it is properly structured, carefully conducted, and prudently managed. However, the federal banking agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the organization's safety and soundness. Furthermore, these agencies want to ensure that these arrangements with outsourcing venders do not leave directors and senior managers with the impression that they have been relieved of their responsibility for maintaining an effective system of internal controls and for overseeing the internal audit function.

On December 22, 1997, an interagency policy statement was adopted by the Federal Reserve Board and the other federal bank regulatory agencies that provides interagency guidance on sound practices for managing the internal audit function and the use of outsourcing venders for audit activities. This policy statement applies to bank holding companies and their subsidiaries, FDIC-insured banks and savings associations, and U.S. operations of foreign banking organizations (all subsequently referred to as institutions). See SR-97-35 and sections 2124.0.2.4, 2060.1, 3230.0.10.2.5, 5010.7, and 5030.0 (page 7).

The joint policy statement focuses on issues that directors should consider in establishing and maintaining an internal audit function. Such issues involve—

1. organizational structure;
2. internal audit management, staff, and quality;
3. scope; and
4. communication.

When the internal audit function is outsourced, the directors need to ensure that these principles continue to be addressed. Furthermore, when the internal audit function has shifted from an employee/employer relationship to a vender contractual agreement, additional issues must be considered. The institution and the vender also must make provisions that allow examiners to have access to the vender's audit reports and related workpapers.

The policy statement provides examiners with guidance for assessing the quality and effectiveness of an internal audit function. It guides the examiner in appraising how well the organiza-

1. In summary, internal control is a process, brought about by a banking organization's board of directors, management, and other personnel, designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components is essential to achieving the internal control objectives.

2. For national banks, appendix A to part 30; for state member banks, appendix D to part 208; for state nonmember banks, appendix A to part 364; for savings associations, appendix A to part 570.

tion has responded to the issues raised in the policy statement for managing its internal audit function. When the internal audit function is outsourced to a vender, the examiner will appraise how the arrangement affects the quality of the internal audit function. In addition, the policy statement provides guidance on how these outsourcing arrangements may affect an examiner's assessment of internal control. It also discusses the effect these arrangements may have on the independence of an external auditor who is also providing internal audit services to a banking organization. Finally, this statement provides guidance to examiners concerning their reviews of internal audit functions and related matters.

2060.05.1 INTERNAL AUDIT FUNCTION

2060.05.1.1 Director and Senior Management Responsibilities for Internal Audit

The board of directors and senior management are responsible for having an effective system of internal control—including an effective internal audit function—and for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility *cannot* be delegated to anyone else. The board and senior management may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. In discharging their responsibilities, directors and senior management should have reasonable assurance that the system of internal control prevents or detects inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies.

Some institutions have chosen to rely on so-called "management self-assessments" or "control self-assessments," wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and senior managers who rely too much on these reviews may not learn of control weaknesses until they have become costly problems—particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and assessed by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities. Directors and senior managers should ensure that the following matters are reflected in their internal audit function.

2060.05.1.1.1 Internal Audit Placement and Structure within the Organization

Careful thought should be given to placement of the audit function in the institution's management structure. The function should be positioned so that directors have confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. Accordingly, the manager of internal audit should report directly to the board of directors or its audit committee, which should oversee the internal audit function.[3] The board or its audit committee should develop objective performance criteria to evaluate the work of the internal audit function.[4]

2060.05.1.1.2 Internal Audit Management, Staffing, and Audit Quality

The directors should assign responsibility for the internal audit function to a member of management (hereafter referred to as the manager of internal audit or internal audit manager) who understands the function and has no responsibilities for operating the business. The manager of internal audit should be responsible for control risk assessments, audit plans, audit programs, and audit reports.

1. A control risk assessment (or risk assessment methodology) documents the internal auditor's understanding of the institution's sig-

3. Institutions subject to section 36 of the FDI Act must maintain independent audit committees (that is, comprised of directors that are not members of management). For institutions not subject to an audit committee requirement, the board of directors can fulfill the audit committee responsibilities discussed in this policy statement.

4. For example, the performance criteria could include the timeliness of each completed audit, a comparison of overall performance to plan, and other measures.

nificant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line and potential risk due to control deficiencies. They should be updated as needed to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
2. The audit plan is based on the control risk assessment and includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
3. An audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
4. An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers should be maintained that adequately document the work performed and support the audit report.

The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff.[5] The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. Institutions should consider conducting their internal audit activities in accordance with professional standards, such as the Institute for Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address the independence, professional proficiency, scope of work, performance of audit work, and management of internal audit.

2060.05.1.1.3 Internal Audit Frequency and Scope

The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve the internal audit manager's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vender. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[6]

2060.05.1.1.4 Communication of Internal Findings to the Directors, Audit Committee, and Management

To properly discharge their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues so that they will have knowledge of the internal auditor's findings and operating management's solutions to identified internal control weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether internal control weaknesses or other exceptions are being resolved expeditiously by management. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without having management present.

2060.05.1.2 U.S. Operations of Foreign Banking Organizations

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. The internal audit of the U.S.

5. The form and content of policies and procedures should be consistent with the size and complexity of the department and the institution: Many policies and procedures may be communicated informally in small internal audit departments, while many larger departments require more formal and comprehensive written guidance.

6. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include (1) new management; (2) areas or activities experiencing rapid growth; (3) new lines of business, products, or technologies; (4) corporate restructurings, mergers, and acquisitions; and (5) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

operations normally is performed by its U.S.-domiciled audit function, head-office internal audit staff, or some combination thereof. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant, adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

2060.05.1.3 Internal Control Systems and the Audit Function for Small Financial Institutions

An effective system of internal control, including an independent internal audit function, is a foundation for safe and sound operations, regardless of an institution's size. Section 39 of the FDI Act requires each institution to have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is management's responsibility to carefully consider the level of auditing that will effectively monitor the internal control system after taking into account the audit function's costs and benefits. For many institutions that have reached a certain size or complexity of operations, the benefits derived from a full-time manager of internal audit or auditing staff more than outweigh its costs. However, for certain smaller institutions with fewer employees and less complex operations, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a system of independent reviews of key internal controls. The employee conducting the review of a particular function should be independent of the function and be able to report findings directly to the board or audit committee.

2060.05.2 INTERNAL AUDIT OUTSOURCING ARRANGEMENTS

The guidance provided within the previous subsections also applies to internal audit outsourcing arrangements which are further discussed below.

2060.05.2.1 Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between the institution and an outsourcing vender to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. The services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vender reports to him or her. Institutions often use outsourcing venders for audits of areas requiring more technical expertise, such as audits of electronic data processing and capital-markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

Some outsourcing arrangements may require an outsourcing vender to perform virtually all internal audit work. Under such an arrangement, the institution may maintain a manager of internal audit and a very small internal audit staff. The outsourcing vender assists staff in determining risks to be reviewed, recommends and performs audit procedures as approved by the internal audit manager, and reports its findings jointly with the internal audit manager to either the full board or its audit committee.

2060.05.2.2 Additional Inspection and Examination Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing venders provide internal audit services, the board of directors and senior managers of an institution are responsible for ensuring that the system of internal control (including the internal audit function) operates effectively. When negotiating the outsourcing arrangement with an outsourcing vender, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control can occur.

To clearly set forth its duties from those of the outsourcing vender, the institution should have a written contract, often referred to as an engagement letter. At a minimum, the contract should accomplish the following:

1. set the scope and frequency of work to be performed by the vender

2. set the manner and frequency of reporting to senior management and directors about the status of contract work
3. establish the protocol for changing the terms of the service contract, especially for expansion of audit work if significant issues are found
4. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vender
5. specify the locations of internal audit reports and the related workpapers
6. state that examiners will be granted immediate and full access to the internal audit reports and related workpapers prepared by the outsourcing vender
7. prescribe the method for determining who bears the cost of consequential damages arising from errors, omissions, and negligence
8. state that outsourcing venders that are subject to the independence guidance below will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee

2060.05.2.2.1 Management of Outsourced Internal Audit Function

Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vender.

2060.05.2.2.2 Communication of Outsourced Internal Audit Findings to Directors and Senior Management

Communication between the internal audit function and directors and senior management should not diminish because the bank engages an outsourcing vender. All work by the outsourcing vender should be well documented, and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vender's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vender. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial audits, is generally *not* a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

2060.05.2.2.3 Competence of Outsourced Internal Audit Vender

Before entering an outsourcing arrangement, the institution should perform enough due diligence to satisfy itself that the outsourcing vender has sufficient staff who are qualified to perform the contracted work. Because the outsourcing arrangement is a personal services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vender and receive prior notice of staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vender maintains sufficient expertise to effectively perform its contractual obligations.

2060.05.2.2.4 Contingency Planning to Avoid Discontinuity in Internal Audit Coverage

When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it increases its operating risk. Because the arrangement might be suddenly terminated, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Planning for a successor to the prospective outsourcing vender should be part of the negotiations for the prospective vender's service contract.

2060.05.2.3 Independence of the External Auditor

This section of the policy statement applies only to an outsourcing vender who is a certified public accountant (CPA) and who performs a financial-statement audit or some other service for the institution that requires independence

under American Institute of Certified Public Accountants (AICPA) rules.[7]

Many institutions engage certified public accounting firms to audit their financial statements and furnish other attestation services requiring independence. A certified public accounting firm that provides other services for its client (such as consulting, benefits administration, or acting as an outsourcing vender) risks compromising the independence necessary to perform attestation services. The professional ethics committee of the AICPA has issued rulings and interpretations specifically addressing whether a certified public accountant that furnishes both audit outsourcing and external audit or other attestation services to a client can still be considered independent.[8]

Section 36 of the FDI Act and associated regulations require the management of every insured depository institution with total assets of at least $500 million—

1. to obtain an annual audit of its financial statements by an independent public accountant,
2. to report to the banking agencies on the effectiveness of the institution's internal controls over financial reporting and on the institution's compliance with designated laws and regulations (management report), and
3. to obtain a report from an external auditor attesting to management's assertion about these internal controls (internal control attestation report).

To satisfy these requirements, the institution's board of directors must select an external auditor that will satisfy the independence requirements established by the AICPA and the relevant requirements and interpretations of the Securities and Exchange Commission.

Questions have been raised about whether external auditors who perform an audit of the institution's financial statements or provide any other service that requires independence can also perform internal audit services and still be considered independent. The federal banking agencies are concerned that outsourcing arrangements may involve activities that compromise, in fact or appearance, the independence of an external auditor.

The AICPA has issued guidance to CPAs (Interpretation 101-13 and related rulings) on independence that addresses these issues. Under Interpretation 101-13, the CPA's performance of services required by the outsourcing arrangement "would not be considered to impair independence with respect to [an institution] for which the [CPA] also performs a service requiring independence, provided that [the CPA or the CPA's firm] does not act or appear to act in a capacity equivalent to a member of [the institution's] management or as an employee." The interpretation lists activities that would be considered to compromise a CPA's independence. Included are activities that involve the CPA's "authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client."[9]

Also, the AICPA's Ruling No.103 sets forth three criteria that must be met when evaluating the independence of a CPA who concurrently provides internal audit outsourcing services and the internal control attestation report under section 36 of the FDI Act. One of those criterion requires that management "does not rely on [the CPA's] work as the primary basis for its asser-

7. Although outsourcing arrangements involving CPAs who are not performing external audit or attestation services for a client are not subject to this independence guidance, they are subject to the other sections of this policy statement.

8. In May 1997, the AICPA and the Securities and Exchange Commission announced the formation of the Independence Standards Board (ISB), a private-sector body intended to establish independence standards for auditors of public companies. Any future standards established by the ISB should be considered in initiating or evaluating outsourcing arrangements with CPAs.

9. Other examples of outsourcing activities that would compromise a CPA's independence that are listed in Interpretation 101-13 include—

- performing ongoing monitoring activities or control activities (that is, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function;
- reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function;
- preparing source documents on transactions;
- having custody of assets;
- approving or being responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures; and
- being connected with the client in any capacity equivalent to a member of client management or as an employee (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

tion and accordingly has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (b) evaluated the findings and results of the [CPA's] work and other separate evaluations of controls, if any." Accordingly, a CPA's independence would be impaired if the CPA provides the *primary* support for management's assertion on the effectiveness of internal control over financial reporting.

2060.05.2.3.1 Agencies' Views on Independence

The agencies believe that other actions compromise independence in addition to those in Interpretation 101-13. Such actions include the following:[10]

1. contributing in a decision-making capacity or otherwise actively participating (for example, advocating positions or actions rather than merely advising) in committees, task forces, and meetings that determine the institution's strategic direction
2. contributing in a decision-making capacity to the design, implementation, and evaluation of new products, services, internal controls, or software that are significant to the institution's business activities

2060.05.3 INSPECTION AND EXAMINATION OBJECTIVES

1. To determine whether the banking organization has an adequate system of internal controls that forms a foundation for safe and sound operations.
2. To determine if the internal audit function and the internal audit outsourcing arrangements of the parent company and its subsidiaries are adequately managed by the board of directors and senior management.
3. To determine whether the internal audit function provides management with vital information about weaknesses in the system of internal controls and that management takes prompt remedial action when weaknesses exist.
4. To determine the adequacy of the internal audit function (including its use of outsourced internal audit venders) as to organizational structure, prudent management, staff having sufficient expertise, audit quality, and the ability of auditors to directly and freely communicate internal audit findings to the board of directors, its audit committee, and senior management.

2060.05.4 INSPECTION AND EXAMINATION PROCEDURES

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

2060.05.4.1 Internal Audit Function Examination and Inspection Procedures

1. Assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vender. Consider whether—
   a. the board of directors (or audit committee) promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
   b. the internal audit function's risk assessment, plans, and programs are appropriate for the institution's activities;
   c. the internal audit function is adequately managed to ensure that audit plans are accomplished, programs are carried out, and results of audits are promptly communicated to the managers and directors;
   d. the institution has promptly responded to identified internal control weaknesses;
   e. management and the board of directors use reasonable standards when assessing the performance of internal audit;
   f. the internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
   g. the activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and
   h. the audit function provides high-quality advice and counsel to management and

10. The agencies believe that this guidance is consistent with the AICPA interpretation.

the board of directors on current developments in risk management, internal control, and regulatory compliance.

2. Assess the competence of the institution's internal audit staff and management by considering the education and professional background of the principal internal auditors.

2060.05.4.2 Additional Aspects of the Examiner's Review of Outsourcing Arrangements

1. Determine whether—
   a. the outsourcing arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
   b. key employees of the institution and the outsourcing vender clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vender are to be addressed;
   c. the scope of work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
   e. the directors have ensured that the outsourced internal audit function is effectively managed by the institution;
   f. the arrangement with the outsourcing vender compromises its role as external auditor; and
   g. the institution has performed sufficient due diligence to satisfy itself of the vender's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vender maintains sufficient expertise to perform effectively throughout the arrangement.
2. Adjust the scope of the inspection if the outsourcing arrangement has diminished the quality of the institution's internal audit. If the quality of the internal audit is diminished, inform senior management and the board of directors and consider it in the institution's management and composite ratings.

2060.05.4.3 Assessment of Auditor Independence

1. Ask the institution and the external auditor to demonstrate that the outsourcing of the internal audit arrangement has not compromised the auditor's independence, if the initial review of the arrangement raises doubt about the external auditor's independence.
2. Discuss the matter with appropriate Federal Reserve System management and staff, if the independence issue is not adequately addressed.
3. If Federal Reserve System management and staff concur that the independence of the external auditor appears to be compromised, discuss the findings and determine what appropriate actions the Federal Reserve should take with the institution's senior management, board of directors (or audit committee), and the external auditor. Note: These actions may include referring the external auditor to the state board of accountancy and the AICPA for possible ethics violations, and barring the external auditor from engagements with regulated institutions. Moreover, the Federal Reserve may conclude that the organization's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including section 36 of the FDI Act and related guidance and regulations.

Audit is an independent appraisal activity which serves as a managerial control within an organization. The primary responsibility for the maintenance of sound systems of internal controls and an adequate internal audit program rests with the directorate of the bank holding company. Included among the objectives of a comprehensive audit program are the detection of irregularities; the determination of compliance with applicable laws and regulations; and the appraisal of the soundness and adequacy of accounting, operating, and administrative controls designed to ensure prompt and accurate recording of transactions and a proper safeguarding of assets. At a minimum, an audit program should ensure that adequate systems of checks and balances are in effect to deter fraud and detect control deficiencies.

The size and complexity of a bank holding company operation are major determinants in the scope and extent of the audit program that is developed. In the smaller, less sophisticated organizations, such as holding company shells for small banks, it may not be feasible to employ an auditor or implement an audit program. In some cases, such as those in which banking assets represent virtually all of the parent company's assets and a comprehensive, effective audit program is being implemented in the various subsidiaries, neither an internal nor an external audit program may be necessary at the parent company level.

The development and implementation of an internal audit program should be delegated to a qualified staff large enough to meet the functional requirements of the job under the guidance and leadership of the auditor. When evaluating the effectiveness of an internal audit program, the examiner may want to consider the size of audit staffs of banking organizations of a similar size and complexity. To ensure freedom of access to corporate records and complete independence and objectivity in administering the audit program, the auditor should report directly to the directorate or a committee thereof. Administratively, the internal auditor is usually responsible to an officer at a major policy-making level.

To supplement the internal audit activities, external accountants-auditors may be engaged to certify and/or audit the financial statements or specified activities of the bank holding company and its subsidiaries. Each top-tier bank holding company with total consolidated assets of $500 million or more must engage independent public accountants to perform audits and report on its annual financial statements in accordance with generally accepted accounting principles. The scope of the audit engagement must be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. Bank holding companies do not have to submit audited financial statements as part of the requirements for the FR-6 annual report. The Federal Reserve may request audited consolidated financial statements from any bank holding company with total consolidated assets of less than $500 million if deemed warranted for supervisory purposes.

The internal and external auditors should work together in establishing the scope and frequency of audits to be performed. In addition to performing some of the basic functions of the internal auditor, the external auditor should review the internal auditing program to assess its scope and adequacy. When a bank holding company is perhaps too small to employ an internal audit staff, but the complexities and activities of the organization suggest the need for an audit, the holding company should consider hiring an external auditor. Independence and objectivity are mandatory in any audit program, and these are difficult to maintain if the audit function is a part-time responsibility. When external auditors are employed to perform the internal audit function, they should be permitted to establish the scope of their audits and schedule surprise audits. They also should be given responsibility for suggesting systems and organizational duty assignments for maximum control consistent with the size of the organization.

2060.1.1 EXTERNAL AUDITORS AND THE RELEASE OF REQUIRED INFORMATION

The enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) on August 9, 1989, requires that FDIC-insured depository institutions that are being audited provide their independent auditors with information concerning their financial condition and any supervisory actions being taken against them. Specifically, section 7(a) of the

Federal Deposit Insurance Act (12 U.S.C. 1817(a)(8)(A)) requires an insured depository institution, which has engaged the services of an independent auditor to perform an audit within the past two years, to provide the auditor with—

1. ". . . A copy of the most recent report of condition made by such depository institution (pursuant to the . . . FDIC Act . . . or any other provision of law) and a copy of the most recent report of examination received by such depository institution";
2. ". . . A copy of any supervisory memorandum of understanding with such depository institution and any written agreement between a Federal or State banking agency and the depository institution which is in effect during the period covered by the audit"; and
3. ". . . A report of any action initiated or taken by a Federal banking agency during . . . the period . . . covered by the audit . . . under subsection (a), (b), (c), (e), (g), (I), or (s) of section 8 . . . of the Federal Deposit Insurance Act . . . or of any similar action taken by a State banking agency under State law, or any other civil money penalty assessed under any other provision of law with respect to . . ." the depository institution or any affiliated party.

External auditors who are serving as agents of a bank holding company may, with the approval of the organization, review examination/inspection reports and supervisory correspondence received and communicate with examiners. Examiners should remind external auditors of their responsibility to maintain the confidentiality of the reports and other supervisory communications reviewed as part of their engagement. Reference should also be made to the Board's rules on the release of confidential supervisory information (see 12 C.F.R. 261, subpart C).

2060.1.2 EXTERNAL AUDITOR INQUIRIES

In some situations, examiners may not be able to fully respond to external auditors' inquiries on certain matters relating to examinations still in progress. The examiners' findings may be incomplete or may be under review by higher supervisory authorities within the Federal Reserve System. In addition, as a general practice, examiners will normally only discuss with external auditors issues and inspection findings that have been presented to the bank holding company's management. These situations relate primarily to the timing of the auditors' inquiries in relation to the stage of inspection work and, thus, should not automatically preclude an auditor from expressing an opinion on the organization's financial statements.

2060.1.3 INSPECTION OBJECTIVES

1. To review the operations of bank holding companies that do not have an audit program to ascertain if such a program should be developed.
2. To determine the adequacy of the scope and frequency of the audit program.
3. To determine that audit reports and findings receive appropriate attention, including follow-up responses to exceptions or weaknesses disclosed during an audit.
4. To determine the respective roles of internal and external auditors and to evaluate the procedures employed in carrying out their assigned responsibilities.
5. To determine the independence of those who administer the audit function.
6. To determine compliance with section 7(a) of the FDIC Act with regard to FDIC-insured depository institution examinations and other designated supervisory reports and correspondence which are required to be released to external auditors.

2060.1.4 INSPECTION PROCEDURES

The primary thrust of the inspection should be directed toward the audit activities that relate to the parent company and all subsidiaries. An assessment of the audit function as it pertains to the bank(s) is primarily the responsibility of the regulatory agency that examines that particular bank. The examiner should review the latest bank examination reports to note comments and deficiencies cited concerning internal controls and the audit function. In addition to providing an input into the overall assessment of the audit function, review of the bank examination reports may provide a basis for determining areas of investigation during the inspection. Further, if matters cited in the latest bank examination report are deemed to be significant and indications are that corrective action has not been taken, the examiner should mention the facts to senior management of the bank holding com-

pany and note the details in the inspection report.

To judge the adequacy of the audit program, including scope and frequency, the following procedures, with equal emphasis being placed on the parent, bank, and nonbank subsidiaries, are recommended as minimum guidelines for the inspection:

1. Review the parent company and nonbank operations and the audit comments in the bank examination reports to ascertain the adequacy of the existing audit program or the need for developing such a program, if the organization currently lacks one.
2. Review the scope of the audit function to ensure that procedures are in place to cover adequately those areas that may be susceptible to exposure. When reviewing the audit scope, determine whether the auditor was able to perform all the procedures necessary to complete the audit. If not—
   a. establish whether the scope limitations were imposed by the directorship or management and
   b. determine whether the auditor established and documented the reasons why the scope limitations were imposed.
      (1) Was the auditor able to quantify the effects of the scope limitation on the financial statements and the audit results, and if not pervasive, was a qualified opinion or disclaimer of opinion issued?
      (2) Did the auditor evaluate all possible effects on his ability to express an opinion on the financial statements?
      (3) Were there any external circumstances that imposed limitations on the audit's scope?
      (4) Were alternative procedures used to accomplish the same audit objectives? If so, did the use of the alternative procedures justify issuance of an unqualified opinion?
3. Review the audit schedule to determine that the audits are satisfactorily spaced and that all functions are audited with adequate frequency.
4. Review audit workpapers and reports on a test-check basis for adequacy of content, satisfactory maintenance, and conformance to audit guidelines outlined by the board of directors.
5. Determine the qualifications and background of the auditor and others participating in the audit function.
6. To establish that the auditor has a direct communication line to the board of directors and freedom of access to all records for audit purposes, review audit reports and minutes of meetings held by directors or a committee thereof.
7. Determine the entity responsible for maintaining the audit function. If a bank provides audit services to affiliates, indicate the manner in which the bank is reimbursed for the cost of such services.
8. Determine whether audit reports are submitted on a timely basis to—
   a. the directors and senior management and
   b. management in the area being audited.
9. Review responses to exceptions and recommendations noted in audit reports.
10. Check on the relationship between the internal and external auditors to determine whether their activities are coordinated in a manner that effects comprehensive coverage of the organization and at the same time avoids duplication of effort.
11. Review the letter addressed to management by the external auditor and determine that steps have been taken to correct any deficiencies noted. If no deficiencies were noted in the letter, inquire as to whether such comments were communicated to management by any other means.
12. Ascertain that the audit program is annually reviewed and approved by the directors.
13. Scan the external auditor's engagement letter and reports noting any qualifications contained therein. If new external auditors have been engaged, ascertain the reasons for such change.
14. Determine if the parent company or nonbank subsidiaries have reported any defalcations. If so, determine if adequate controls have been initiated to lessen any further risk and exposure.
15. Determine if the external auditors received copies of the FDIC-insured institution's examination and other designated supervisory reports and correspondence required by section 7(a) of the FDIC Act.
16. Review the engagement letter between the board of directors and the external auditor to determine the scope of the audit and the degree of reliance on internal audit staff. Letters requesting opinions from external auditors should also be reviewed to determine that the opinion obtained was not influenced by management.
17. Determine the degree of independence of the external audit firm by reviewing any

financial ties between the bank, audit firm, and any of its partners or employees. Also review any other relationships or potential conflicts of interest that may exist.

The independence of the internal auditor should be evaluated by ascertaining whether the following conditions exist: (1) reports are distributed directly to the board or a committee thereof or, less desirably, to an officer not connected with the area being reviewed; (2) there are no relationships within the organization which are incompatible with the internal audit function; and (3) severe restrictions are not placed on the program or scheduling by management. In order to maintain the degree of objectivity essential to the audit function, the examiner should establish that the internal auditor does not install procedures, originate and approve entries, or otherwise engage in any activity which would be subject to audit review and appraisal.

The examiner should consider meeting with the auditor and, subsequently, with senior bank holding company management to communicate conclusions concerning the adequacy of the scope and frequency of the audit program. During the discussions, the examiner should concentrate on detailing criticisms or deficiencies noted. The auditor and senior bank holding company management should be made fully cognizant of the examiner's analyses and the comments concerning the audit function that will appear on the relevant pages in the inspection report.

An assessment of management's strategic plans and its success in meeting previously established budgetary goals is one of the factors considered in evaluating a BHC's management, operations, financial condition, and prospects.[1] Through review of the budget figures, insight can be gained concerning an organization's future plans and other matters such as capital adequacy, liquidity, sources and applications of funds, level and quality of earnings, and performance of management.

The budget is a coordinated financial plan used to estimate and control all or a few of the activities of the various divisions or subsidiaries in a bank holding company. Based on an assessment of future economic developments and conditions, management formulates a plan of action and indicates anticipated changes in the balance-sheet accounts and profitability (predicated on implementation of the plan). The budget is a significant management tool in that it projects expected results and also serves as an important check on management decisions and performance by providing a basis for comparison and corrective action on a timely basis. The comparison of actual performance to budget allows management to give careful attention to various possible courses of action and to choose the course which should result in the greatest benefit. Budgeting is also useful in measuring the performance of individuals and the departments they manage. Further, the comparison of budget totals to actual changes in activities such as loans, investments, and deposits assists in decision making and can promote coordination and cooperation among affiliates. The variance indicated by the comparison process may be construed as a measure of management's performance and planning record and its relationship to the organization's goals and objectives. It should be noted that some significant variances may be caused by factors beyond management's control or factors that could not reasonably be anticipated.

1. The *stragetic planning process* focuses on intermediate and long-term strategic goals and is the vehicle used to determine the overall direction and focus of the organization. The *budgeting process* refers to the tactical decisions required to meet goals and objectives. The budget is a subset of the strategic plan. While smaller bank holding company organizations may not always have formal written budgets, all organizations should have a strategic planning process, which determines overall corporate direction, general resource allocation, and balance-sheet relationships with respect to capital needs, growth, asset mix, and risk.

While various individuals may be responsible for input to the budget process, the chief executive officer typically has the ultimate responsibility for preparation and implementation of the formal budget. The time period covered by a budget typically encompasses one year, although it often covers longer periods in the larger, more sophisticated bank holding companies. The longer the budget period, the greater are the prospects for increased variances from original budget figures. In some cases in which four- or five-year projections are made, bank holding companies may formulate several forecasts based on different sets of assumptions. In such instances, the examiner should work with the ''most likely'' situation that may evolve based on economic trends, history, and experience of the organization, but should also give serious consideration to the ''worst-case'' projections.

Many bank holding companies, particularly the smaller organizations, may not have formal written budgets or plans. In small shell companies, while it is not essential to have a formal budget, budgeting procedures should be encouraged where appropriate. Budgeting at the parent level could be appropriately limited to debt-servicing and dividend considerations.

2060.2.1 INSPECTION OBJECTIVES

1. To determine the extent of an organization's financial planning and budget program.
2. To indicate to management of organizations that are without formal planning procedures the advantages of adopting a budget.
3. To understand the institution's decision-making process as it relates to the budget.
4. To determine the causes of significant variances between the budget and actual performance.
5. To assess the reasonableness of projected figures, including controls over the data throughout the budgeting process.
6. To assess the impact of the budget on the present condition and future prospects of the bank holding company.
7. To determine whether the plan outlined in the budget is supported by the financial and managerial resources of the holding company.

2060.2.2 INSPECTION PROCEDURES

1. Familiarity with a bank holding company's financial condition and results of operations should begin before the start of the inspection with a review of the annual report to shareholders, financial reports submitted to the Federal Reserve System, and other financial documentation contained in the files. The more significant accounts, statistical data, and pertinent ratios should be compared on a period-to-period basis to highlight significant changes and discern trends.

2. The examiner also should become familiar with current and projected economic conditions, both nationally and locally, including general industry conditions.

3. Based on a review of the aforementioned data, the examiner should be in a position to substantiate the reasonableness of budgeted figures without a systematic examination of all of the transactions affecting the figures presented. Further, such an analysis provides a better understanding of the operation and highlights matters of interest and potential problem areas to be investigated during the inspection.

4. Throughout the review process, the examiner must maintain a sense of perspective to avoid spending excessive time on relatively immaterial amounts.

5. The examiner should meet with the officer responsible for the preparation of the budget to determine the scope of the organization's financial plans. The extent of senior management's and the board of directors' involvement in the strategic planning and budgeting process should also be ascertained in this preliminary meeting.

6. Workpapers which document or illustrate the rationale for the budget data should be reviewed and discussed with budget personnel, including the existence and extent of internal controls over the data.

7. The examiner should evaluate plans, projections, and forecasts in light of market-area characteristics and the present condition and history of the organization.

8. The examiner should determine whether the accounting principles of major importance have been applied consistently and, if not, the impact of the alternative accounting treatment on the budget totals.

9. The sources of input for the budget should be reviewed and the frequency and procedures for effecting revision should be ascertained.

10. When there are significant budget variances, the examiner should seek documented explanations. Review any such documentation to determine if management policy or factors beyond management control were responsible for the variances.

11. A final summary discussion should be held with management to discuss goals which the examiner believes may be unattainable and to communicate conclusions concerning the budget. Due consideration should be given to management's views, whether or not in concurrence with the examiner's conclusions. If management indicates future changes which could have a significant impact on the organization, the matter should be noted in the inspection report. Further, management's assessment of the effect of contemplated action on the operations and financial condition of the bank holding company should be noted.

12. For those bank holding companies that do not have formal written plans, the examiner should obtain from senior management information on their plans for matters such as growth and expansion, capital injections, debt retirement, and changes in sources of funding. Except for small, shell companies, the examiner should recommend adoption of a budget program and emphasize the need for strategic planning by indicating how management methods may be improved as a result of a logically conceived and properly operated budget. Budgets and planning are especially important in cases in which a bank holding company is losing its share of the market or in which inefficiencies are depressing profitability.

Adequate and accurate records and financial statements are an integral part of a sound bank holding company operation. Records should be maintained to allow preparation of financial statements in accordance with generally accepted accounting principles and to ensure proper accountability for all assets, liabilities, income, and expenses. Generally, an independently certified statement inspires greater confidence than a statement prepared internally. Moreover, an unqualified, independently certified statement may act as a check on management recordkeeping policies and procedures, and provide more assurance that transactions are being properly recorded and that books accurately reflect overall financial condition.

Management may exercise reasonable discretion in selecting and adopting the type of books and records it uses and in formulating accounting systems and bookkeeping procedures. From the examiner's viewpoint, the test of a bank holding company's records is one of adequacy, consistency, and accuracy. The financial statements of every bank holding company must accurately reflect financial condition and operating results. This principle is applicable whether a bank holding company is small and has a relatively simple bookkeeping system or whether it is a larger institution with a fully automated system. A recordkeeping system that is capable of generating a wide variety of pertinent internal data and other information facilitates problem solving and decision making and, thus, contributes to the efficiency of a bank holding company's operations. Further, such a system serves as a convenient tool to provide directors, stockholders, and other interested parties with information on conditions in a bank holding company.

2060.3.1 INSPECTION OBJECTIVES

1. To determine whether financial statements are prepared in accordance with generally accepted accounting principles and are sufficiently detailed to accurately portray the company's financial condition.
2. To determine that sufficient records are maintained to provide detail on material balance-sheet items, income-statement items, and various contingent liabilities and off-balance-sheet risks that permit the preparation of appropriate financial information.
3. To recommend corrective action when policies and procedures employed have resulted in inadequate or inaccurate records and financial statements.

2060.3.2 INSPECTION PROCEDURES

1. The examiner should review the sections relating to audit and records in the prior inspection report and the latest examination reports of the subsidiary banks to note any comments or deficiencies cited concerning records, including any MIS deficiencies. In addition to providing an input into the overall assessment of the quality of records, the review may provide a basis for determining areas of emphasis and follow-up during the inspection.
2. The examiner should discuss recommendations and criticisms contained in such reports with an appropriate officer to ascertain what changes, if any, have taken place.
3. The examiner should review the external auditing firm's management letter, giving particular attention to comments concerning recordkeeping. Determine if any corrective actions were recommended by the external auditors and the extent to which the cited items have been corrected.
4. In those situations when it appears that records are deficient or financial statements are inaccurate, a thorough investigation of applicable transactions may be required. The purpose of the investigation is to obtain information needed in outlining improved controls over MIS, accounting methods, and records so that the financial data presented are in accordance with generally accepted accounting principles. Thus, information is provided which will better serve bank holding company management. The investigation should not necessarily involve a review of every transaction, but should involve a check of a sufficient number of transactions to ensure the examiner that the records, as checked, reflect an accurate financial condition. The extent of the review will depend largely on the procedures and controls over MIS and the condition and adequacy of the books and underlying records. During the investigative process, the examiner should be careful to distinguish between documented facts and statements of intent or interpretations set forth by company representatives.

Management of Information Systems (Structure and Reporting) Section 2060.4

The directorate and management of bank holding companies have a responsibility to contribute to the health and growth of the organization they serve. To carry out this responsibility effectively, they must be kept fully informed of conditions throughout the organization and trends within the banking industry. Reporting is the process of developing and communicating information internally to directors and management and externally to shareholders and regulatory authorities. Management and the board of directors must recognize that as a company develops and grows, its environment, strategic goals, and information needs change. The guidelines and requirements for reports flowing to management and the board of directors should be established and allow for change, recognizing the fact that informational needs can vary, including those at different levels of the organization.

Informational needs will also be dictated by the particular type of management structure in place—centralized, decentralized, legal entity, or business line. The ultimate decision-making responsibility rests with the corporation's board of directors, and the responsibility for implementing their decisions rests with designated board committees, executive management, or other designated management committees or individuals. As such, examiners should make an assessment of the qualifications of the persons on the board of directors, executive management staff, and the board and executive management committees to ensure that they have the necessary knowledge, experience, and expertise to understand the information presented and to act on it constructively. The assessment should include a review of reporting lines to identify information flows and the various decision-making levels involved or needed.

All reports flowing to executive management, board committees, and the board of directors should be analyzed for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. A review of board and committee minutes should reveal if participants had any questions or whether there were any uncertainties as to the meaning of the data presented.

Each bank holding company prepares various reports for submission to its management and directors; an effective internal reporting system facilitates their ability to analyze a situation and to make informed decisions. Although such reports may vary in content from company to company, emphasis is generally placed on the financial data generated. The important consideration is whether each company is providing sufficient data to keep the interested parties informed of the financial condition and performance of all the divisions or entities. The frequency of the reporting and the detail of information provided can be categorized as being on a need-to-know basis. The form of reports ranges from consultations and meetings to submission of printed material for study and review. The scope and size of the operations will have an effect on the frequency and detail of the information submitted. In the larger, more sophisticated companies, frequent meetings and consultations are held to discuss the performance of various entities, the impact of performance on the organization's goals and objectives, and policies and strategies to be followed. Written reports outlining important matters and summarizing various financial data are typically reviewed and discussed regularly.

The number and variety of reports depends on the size and sophistication of the bank holding company operation. For smaller bank holding companies, the extent of their reports may be limited to annual statements, as more frequent periodic reports may not be necessary under normal conditions. The larger holding companies normally prepare monthly comparative balance sheets and income statements covering similar periods for two consecutive years. Thus, any significant deviation from the prior year's data can be readily detected. Generally, reports detailing the extent of delinquent and nonaccrual loans are prepared monthly. Facts and figures pertaining to the adequacy of the loan-loss provision are presented periodically. Additional reports containing information on budgets, cash flow, liquidity, and capital adequacy are prepared to assist management in assessing the organization's overall financial condition and performance. Summaries of internal audit reports and reports of examinations of subsidiary banks are brought to management's attention. Data relative to other bank holding companies or banks in the same peer groups are assembled, when available, so that comparisons with similarly sized organizations are possible. All of the aforementioned information may be prepared for directors, although not necessarily in as much detail as that submitted to management. On occasion, key management personnel of the holding company attend directors' meetings to expand on the topics being discussed.

Reports to shareholders usually consist of quarterly and annual reports which detail the company's financial condition and results of operations. Additional information may include the chief executive officer's overall assessment of the company, future plans, and other financial and analytical data. The financial information is used for public disclosure and enables investors, depositors, and creditors to make informed judgments concerning the financial condition of the bank holding company. Bank holding companies whose securities have been registered pursuant to the Securities and Exchange Act of 1934 are required to prepare various reports containing specific financial information.

2060.4.1 INSPECTION OBJECTIVES

1. To review the organizational structure to determine the various levels of decision-making and reporting lines, including board and executive management committees.
2. To determine whether the bank holding company has written policies and procedures, and internal controls covering the types of reports required to be submitted to management and the directors.
3. To determine that the required reports are adequate to accurately reflect the financial condition and performance within the organization's divisions and units and whether the reporting systems and reports are adequate to monitor the risks therein.
4. To evaluate whether the reports and reporting systems are adequate to measure and reflect the company's financial position and performance in all areas, to measure the company's progress in meeting its financial and business goals, and to monitor inherent risks.
5. To determine that the contents of the reports are complete and submitted on a timely basis.
6. To recommend corrective action when reporting practices, policies, or procedures are deficient.
7. To evaluate management's procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by reporting systems, and to evaluate the system's ability to adapt to change caused by regulatory and accounting issues or other market conditions.

2060.4.2 INSPECTION PROCEDURES

1. Review the organizational structure to determine reporting lines and the various levels of decision making, risk assessment, and controls.
2. Ascertain whether any corporate policies address risk managment or internal reporting requirements and determine:
   a. the types of reports required to be submitted and
   b. the adequacy of such reporting requirements in light of a company's particular circumstances.

   Comment: In a holding company with a decentralized system of control over subsidiaries, the existence of written policies and procedures is important since each subsidiary operates as a relatively autonomous unit.
3. Obtain a listing of internal reports that are submitted to corporate executive management and the board of directors (including packages for the board of directors and executive committees).
4. Randomly sample, based on a material risk focus, the individual as well as the various types of management reports and determine whether they are adequately prepared in accordance with established policies and procedures and submitted to the appropriate individuals on a timely basis. Determine whether the management reports are sufficient to measure the company's progress in achieving its financial and business goals and forecasts.
5. Identify and document management procedures for reacting to elevated risk, weaknesses, or deficiencies disclosed by MIS. Also evaluate the ability of the information system to handle regulatory and accounting issues and to adapt to change.
6. At the conclusion of the review process, the examiner should discuss with management, as appropriate, topics such as—
   a. the lack of established policies and procedures and internal controls,
   b. inadequate reporting requirements, and
   c. noncompliance with reporting requirements and/or the untimely submission of reports.

2060.4.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Registration, reports, and examinations or inspections		225.5		
Reporting requirements emanating from the Securities Exchange Act of 1934	15 USC 78a et seq.			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2060.5.1 INTRODUCTION

In establishing an insurance program, a bank holding company should be aware of where it is exposed to loss, the extent to which insurance is available to cover potential losses and the cost of such insurance. These various factors should be weighed to determine how much risk the bank holding company will assume directly. In assessing the extent of risk an organization is willing to assume, it is important to analyze the impact of an uninsured loss not only on the entity where the loss occurs, but also on the affiliates and the parent. Once appropriate coverage has been acquired, procedures should be established for the periodic review of the program to assure the continuing adequacy of the coverage. Particularly for larger BHCs, these procedures should include at least an annual review of the program by the board of directors of the parent organization.

Insurance is a highly specialized field and no attempt is made here to discuss all the various types and forms of insurance coverage that are available to financial institutions. Examiners are not expected to be insurance experts; however, examiners should recognize that a financial organization's primary defenses against loss include adequate internal controls and procedures and that insurance is intended to complement, not replace, an effective system of internal controls. Thus, an overall appraisal of the control environment becomes a significant consideration in assessing the adequacy of the insurance program. To the extent controls are lacking, the need for additional coverage increases.

2060.5.2 BANKER'S BLANKET BOND

The most important and comprehensive insurance coverage available is the bankers' blanket bond which is usually extended to encompass all the entities in a bank holding company structure. Generally, the scope of the blanket bond contract is intended to cover risks of loss due to criminal acts, such as embezzlement, burglary, robbery, theft, larceny, forgery, etc., but in addition it provides indemnity for loss of property through damage, destruction, misplacement and mysterious, unexplainable disappearance. The most important item of protection under the bond, however, is the blanket fidelity coverage for officers and employees.

2060.5.3 TYPES OF BLANKET BONDS

While there are several similar forms of blanket bonds in use, those commonly found are the Financial Institutions Bond Standard Form No. 24, the Bankers Blanket Bond Standard Form No. 2, and Lloyd's Banks' and Trust Companies' Policy HAN Form (C). Under these blanket forms, every employee is usually covered for the total amount of the bond. Typically, new employees and new offices are automatically covered and no notice is required for an increase in the number of employees or in the number of offices established, unless such increases result from a merger or consolidation with another institution. The word "blanket," however, refers to the over-all amount that applies to the several specified risks covered under the bond and is not intended to mean "all risks" coverage. A most important feature of the bankers' blanket bond is the "discovery rider." The rider, which converts the blanket bond from a "loss sustained basis" to a "discovery basis," provides indemnity against any loss sustained by the insured entity at any time but discovered after the effective date of the bond and prior to the termination or cancellation of the bond, even though lower amounts of insurance and more restrictive coverage may have been carried when the loss was actually sustained.

2060.5.4 DETERMINING THE COVERAGE NEEDED

One of the most difficult insurance problems management faces is the determination of the amount of blanket bond coverage that should be maintained. An estimate of the maximum amount of money and securities that may be lost through burglary or robbery can be calculated with reasonable accuracy, but the potential loss resulting from dishonest acts of officers and employees is not easily measured. The Insurance and Protective Committee of the American Bankers Association has conducted several studies of the problems of determining adequate coverage and has concluded that total deposits represent the most appropriate item in bank financial statements upon which to base an estimate of a reasonable or suitable amount of blanket bond coverage.

In a bank holding company structure, the amount of blanket bond coverage is generally determined by the deposits of the largest bank and the amount of suggested coverage in the ABA's schedule. Such an amount is considered to be a minimum and other factors such as a rapidly expanding operation, excessive cash on hand, or inferior audit and control practices may suggest the need for larger coverage. Since coverages are generally extended to include the nonbank subsidiaries and such subsidiaries usually operate on a smaller scale than their affiliated banks, the question concerning the adequacy of the amount of the blanket bond coverage for a nonbank subsidiary is more easily addressed and is typically a function of the parent's and the bank's coverage.

2060.5.5 NOTIFICATION OF LOSS

When submitting a claim, most blanket bonds have provisions which require a report to be submitted within a specified period after a reportable item comes to the attention of management. Occasionally, items are not reported to the bonding company because of uncertainty as to whether the incident constitutes a reportable item. Failure to report in a timely manner could invalidate the claim and jeopardize existing coverages. Thus, it should be emphasized to management that any questionable items should be reported.

2060.5.6 DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance ("DOL Insurance") insures the Directors and Officers against *personal* liability resulting from claims of alleged negligence, wrongful acts, errors and omissions, etc. This insurance is not included in the blanket bond or other standard fidelity coverage.

2060.5.7 INSPECTION OBJECTIVES

1. To determine the scope and extent of insurance coverages for the various entities in the organization.
2. To determine the adequacy of insurance coverage after giving due consideration to the overall control environment and factors such as the organization's claim experience and costs associated with various coverages.
3. To ascertain that a comprehensive review of the insurance program is conducted periodically by management and at least annually by the board of directors and entered into the minutes.
4. To determine the entity(ies) responsible for paying the premiums and the manner in which such payments are allocated among the affiliates that receive the coverage benefits.
5. To determine if procedures are in place to assure that claims are filed promptly.

2060.5.8 INSPECTION PROCEDURES

1. The prior year's inspection report should be reviewed for comments relative to controls and insurance. The examiner should note the types and extent of coverages, comments concerning the control environment and any deficiencies related to the administration of the insurance program and the coverages in force.
2. A similar review encompassing the latest examination reports of all major affiliated banks should be conducted. The review process is intended to provide a basis for determining areas of emphasis and follow-up during the inspection. The examiner need not re-examine the insurance program or the controls in force in the individual banks.
3. The examiner should meet with the officer responsible for maintaining the insurance policies and related documentation and ascertain the location of such policies and documentation. Review any independent review of coverages and any deficiencies that may have been cited by the internal or external auditors.
4. Review the manner and frequency of presentations to the board of directors of the insurance coverage.

Working with borrowers who are experiencing financial difficulties may involve formally restructuring their loans and taking other measures to conform the repayment terms to the borrowers' ability to repay. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve the prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for reporting that may alleviate certain concerns that lenders may have about working constructively with borrowers who are having financial difficulties.

Interagency policy statements and guidance, issued on March 1, 1991; March 10, 1993; and June 10, 1993, clarified supervisory policies regarding nonaccrual assets, restructured loans, and collateral valuation (additional clarification guidance may be found in SR-95-38 and in the glossary of the reporting instructions for the bank call report and the FR-Y-9C, the consolidated bank holding company report). When certain criteria[1] are met, (1) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs; (2) nonaccrual assets can be restored to accrual status when subject to formal restructurings, according to Financial Accounting Standards Board (FASB) Statement Nos. 15 and 114, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (SFAS 15) and "Accounting by Creditors for Impairment of a Loan" (SFAS 114); and (3) restructurings that specify a market rate of interest would not have to be included in restructured loan amounts reported in the years after the year of the restructuring. These supervisory policies apply to federally supervised financial institutions. The board of directors and management of bank holding companies should therefore incorporate these policies into the supervision of their federally supervised financial institution subsidiaries.

2065.1.1 CASH-BASIS INCOME RECOGNITION ON NONACCRUAL ASSETS

Current regulatory reporting requirements do not preclude the cash-basis recognition of income on nonaccrual assets (including loans that have been partially charged off), if the remaining book balance of the loan is deemed fully collectible. Interest income recognized on a cash basis should be limited to that which would have been accrued on the recorded balance at the contractual rate. Any cash interest received over this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

2065.1.2 NONACCRUAL ASSETS SUBJECT TO SFAS 15 AND SFAS 114 RESTRUCTURINGS

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. When the asset is returned to accrual status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. Such information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant

1. A discussion of the criteria is found within the corresponding subsections that follow.

returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms.[2] Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay, in order to use the reporting treatment specified in SFAS 15. Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

2065.1.3 RESTRUCTURINGS RESULTING IN A MARKET INTEREST RATE

An SFAS 114 restructuring that specifies an effective interest rate that is equal to or greater than the rate the lending banking organization is willing to accept at the time of the restructuring, for a new loan with comparable risk (assuming the loan is not impaired by the restructuring agreement), does not have to be reported as a troubled-debt restructuring after the year of restructuring.

2065.1.4 NONACCRUAL TREATMENT OF MULTIPLE LOANS TO ONE BORROWER

As a general principle, whether to place an asset in nonaccrual status should be determined by an assessment of the individual asset's collectibility. One loan to a borrower being placed in nonaccrual status does not automatically have to result in all other extensions of credit to that borrower being placed in nonaccrual status. When a single borrower has multiple extensions of credit outstanding and one meets the criteria for nonaccrual status, the lender should evaluate the others to determine whether one or more of them should also be placed in nonaccrual status.

2065.1.4.1 Troubled-Debt Restructuring—Returning a Multiple-Note Structure to Accrual Status

On June 10, 1993, interagency guidance was issued to clarify a March 10, 1993, interagency policy statement on credit availability. The guidance addresses a troubled-debt restructuring (TDR) that involves multiple notes (sometimes referred to as A/B note structures). An example of a multiple-note structure is when the first, or A, note would represent the portion of the original-loan principal amount that would be expected to be fully collected along with contractual interest. The second part of the restructured loan, or B note, represents the portion of the original loan that has been charged off.

Such TDRs generally may take any of three forms: (1) In certain TDRs, the B note may be a contingent receivable that is payable only if certain conditions are met (for example, if there is sufficient cash flow from the property). (2) For other TDRs, the B note may be contingency-forgiven (note B is forgiven if note A is paid in full). (3) In other instances, an institution would have granted a concession (for example, a rate reduction) to the troubled borrower but the B note would remain a contractual obligation of the borrower. Because the B note is not reflected as an asset on the institution's books and is unlikely to be collected, the B note is viewed as a contingent receivable for reporting purposes.

Financial institutions may return the A note to accrual status provided the following conditions are met:

1. *The restructuring qualifies as a TDR as defined by SFAS 15 and there is economic substance to the restructuring.* (Under SFAS 15, a restructuring of debt is considered a TDR if "the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.")

2. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule.

2. *The portion of the original loan represented by the B note has been charged off.* The charge-off must be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.

3. *The institution is reasonably assured of repayment of the A note and of performance in accordance with the modified terms.*

4. *In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the A note is returned to accrual status.* Sustained payment performance generally would be for a minimum of six months and involve payments in the form of cash or cash equivalents.

The A note would be initially disclosed as a TDR. However, if the A note yields a market rate of interest and performs in accordance with the restructured terms, the note would not have to be disclosed as a TDR in the year after the restructuring. To be considered a market rate of interest, the interest rate on the A note at the time of the restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk. (See SR-93-30.)

2065.1.4.2 Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

Certain borrowers have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although prior arrearages may not have been eliminated by payments from the borrowers, some borrowers have demonstrated sustained performance over a time in accordance with contractual terms. The interagency guidance of June 10, 1993, announced that such loans may henceforth be returned to accrual status, even though the loans have not been brought fully current. They may be returned to accrual status if (1) there is reasonable assurance of repayment of all principal and interest amounts contractually due (including arrearages) within a reasonable period and (2) the borrower has made payments of cash or cash equivalents over a sustained period (generally a minimum of six months) *in accordance with the contractual terms.* When the federal financial institution regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet this criteria should continue to be disclosed as past due as appropriate (for example, 90 days past due and still accruing) until they have been brought fully current. (See SR-93-30.)

2065.1.5 ACQUISITION OF NONACCRUAL ASSETS

Banking organizations (or the receiver of a failed institution) may sell loans or debt securities maintained in nonaccrual status. Such loans or debt securities that have been acquired from an unaffiliated third party should be reported by the purchaser in accordance with AICPA Practice Bulletin No. 6. When the criteria specified in this bulletin are met, these assets may be placed in nonaccrual status.[3]

2065.1.6 TREATMENT OF NONACCRUAL LOANS WITH PARTIAL CHARGE-OFFS

Whether partial charge-offs associated with a nonaccrual loan that has not been formally restructured must first be fully recovered before the loan can be restored to accrual status is an issue that has not been explicitly addressed by GAAP and bank regulatory reporting requirements. In accordance with the instructions for the bank call report and the bank holding company reports (FR-Y series), restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) it is expected that the full contractual balance of the loan (including any amounts charged off) plus interest will be fully collectible under the terms of the loan.[4]

3. AICPA Practice Bulletin No. 6, "Amortization of Discounts on Certain Acquired Loans." American Institute of Certified Public Accountants, August 1989.

4. The instructions for the call reports and "Y reports" discuss the criteria for restoration to accrual status in the glossary entries for "nonaccrual status." This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured *and* in the process of collection. In addition, this guidance permits restoration to accrual status, when certain criteria are met, of formally restructured debt and acquired nonaccrual assets.

Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the banking organization expects to receive the full amount of principal and interest called for by the terms of the loan.

When a loan has been brought fully current with respect to contractual principal and interest and the borrower's financial condition and economic conditions that could affect the borrower's ability to repay have improved to the point that repayment of the full amount of contractual principal (including any amounts charged off) and interest is expected, the loan may be restored to accrual status even if the charge-off has not been recovered. However, this treatment would not be appropriate if the charge-off reflects continuing doubt about the collectibility of principal or interest. Because loans or other assets are required to be placed in nonaccrual status when full repayment of principal or interest is not expected, such loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with SFAS 15 so that it meets the criteria for restoration to accrual status presented in section 2065.1.2 addressing restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, it does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed earlier in this section are applicable.

2065.1.7 IN-SUBSTANCE FORECLOSURES

FASB Statement No. 114, "Accounting for Creditors for Impairment of Loans," addresses the accounting for impaired loans and clarifies existing accounting guidance for in-substance foreclosures. Under the impairment standard and related amendments to SFAS 15, a collateral-dependent real estate loan[5] would be reported as "other real estate owned" (OREO) only if the lender had taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable.[6] Such loans would remain in the loan category and would not be reported as OREO. For depository institution examinations, any portion of the loan balance on a collateral-dependent loan that exceeds the fair value of the collateral and that can be identified as uncollectible would generally be classified as a loss and be promptly charged off against the ALLL.

A collateralized loan that becomes impaired is not considered "collateral dependent" if repayment is available from reliable sources other than the collateral. Any impairment on such a loan may, at the depository institution's option, be determined based on the present value of the expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, on the loan's observable market price.

Consistent with FFIEC interagency guidance, the Federal Reserve will not automatically require an additional allowance for credit losses for impaired loans over and above what is required on these loans under SFAS 114. However, an additional allowance on impaired loans may be necessary based on consideration of factors specific to the depository institution, such as historical loss experience compared with estimates of such losses and concerns about the reliability of cash-flow estimates, the quality of an institution's loan review function, and controls over its process for estimating its SFAS 114 allowance. When an institution's reported ALLL does not meet the objectives for an adequate ALLL set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses (see section 2010.7), the depository institution must restore the level of the ALLL to an adequate level as of the evaluation date. Refer to SR-95-38.

Losses must be recognized on real estate loans that meet the in-substance foreclosure criteria with the collateral being valued according to its fair value. Such loans do not have to be reported as OREO unless possession of the

5. A collateral-dependent real estate loan is a loan for which repayment is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment.

6. The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale.

underlying collateral has been obtained. (See SR-93-30.)

2065.1.8 LIQUIDATION VALUES OF REAL ESTATE LOANS

In accordance with the March 10, 1993, interagency policy statement, "Credit Availability," loans secured by real estate should be based on the borrower's ability to pay over time, rather than on a presumption of immediate liquidation. Interagency guidance issued on June 10, 1993, emphasizes that it is *not* regulatory policy to value collateral that underlies real estate loans on a liquidation basis. (See SR-93-30.)

The adequacy of a banking organization's allowance for loan and lease losses (ALLL) (including amounts based on an analysis of the commercial real estate portfolio) must be based on a careful, well-documented, and consistently applied analysis of the loan and lease portfolio.[1] The determination of the adequacy of the ALLL should be based on management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient, without further analysis, to produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should consider factors such as changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past-due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans, and commitments. In addition, this analysis should consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems. Furthermore, management should consider external factors such as local and national economic conditions and developments, competition, and legal and regulatory requirements, as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the organization and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. The examiner's analysis will also consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems.

The value of the collateral will be considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an organization maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio, examiners should give considerable weight to management's estimates in assessing the adequacy of the overall ALLL.

Examiners and bank holding company management should give consideration to the impact of the Financial Accounting Standards Board's (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114) (as amended by FASB Statement No. 118, "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures") on the ALLL estimating process. FAS 114 sets forth guidance for estimating the impairment of a loan for general financial reporting purposes.

1. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb overall credit losses originating from the loan and lease portfolio. The balance of the ALLL is management's estimation of potential credit losses, synonymous with its determination as to the adequacy of the *overall* ALLL.

Under FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement.

When a creditor has determined that a loan is impaired, FAS 114 requires that an allowance be established based on the present value of the expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since the allowances under FAS 114 apply only to a subset of loans,[2] FAS 114 does not address the adequacy of a creditor's *overall* ALLL or how the creditor should assess the adequacy of its ALLL. Examiners should not focus unduly on the adequacy of this or any other portion of the ALLL established for a subset of loans. Bank holding companies are required to follow FAS 114 (as amended by FAS 118) when reporting in the FR Y-9C report for the holding company on a consolidated basis.

2065.2.1 INSPECTION OBJECTIVES

1. To evaluate the methodology and process that management employs in compiling an *overall* estimate of the allowance for loan and lease losses.
2. To understand and evaluate the nature of the external (economic and social climate, and the extent of competition) and internal lending environment (credit strategies, levels of acceptable credit risk, lending policies and procedures) and how they might influence management's estimate of the allowance for loan and lease losses.
3. To determine the accuracy and reasonableness of management's estimate of the *overall* allowance for loan and lease losses.
4. To evaluate the quality of the BHC's systems and management performance in identifying, monitoring, and resolving asset-quality problems.

2065.2.2 INSPECTION PROCEDURES

1. Determine whether the banking organization has carefully documented and applied an accurate and consistent method of analysis for estimating the *overall* allowance for loan and lease losses. When making such a determination, ascertain whether—
   a. management has considered all significant factors and conditions that might affect the collectibility of the loan, including the borrower's repayment practices, the value of accessible underlying collateral, and other factors (i.e., those factors listed in this section);
   b. management has documented all factors that were considered and the methodology and process that were used to evaluate the adequacy of the allowance; and
   c. the complexity and scope of the analysis are appropriate for the size and nature of the organization.
2. Evaluate the methodology and process that management has followed in arriving at an overall estimate of the allowance for loan and lease losses.
3. Determine the reasonableness of management's consolidated estimate of the allowance for loan and lease losses, including the range of possible credit losses. Determine whether management has properly evaluated the overall composition of the loan portfolio at all organizational levels by—
   a. identifying potential problem loans, including loans classified by all bank regulatory agencies;
   b. determining trends with respect to loan volume (growth (in particular, rapid growth), levels of delinquencies, nonaccruals, and nonperforming loans);
   c. considering the previous loss and recovery experience including the timeliness of charge-offs;
   d. evaluating the performance of concentrations of credit (related interests, geographic regions, industries, lesser developed countries (LDC), highly leveraged loans, and size of credit exposures (few large loans versus numerous small loans));
   e. determining the amount of loans and problem loans (delinquent, nonaccrual, and nonperforming) by lending officer or committee; and
   f. evaluating the levels and performance of loans involving related parties.

2. FAS 114's guidance on impairment does not apply to "large groups of smaller balance homogeneous loans that are collectively evaluated for impairment," loans that are measured at fair value or at the lower of cost or fair value, or leases and debt securities as defined in FAS 115, "Accounting for Certain Investments in Debt and Equity Securities." FAS 114 does apply to loans that are restructured in a troubled-debt restructuring involving a modification of terms.

4. For each level of the organization, determine the percentage of past-due loans to the loan portfolio and compare it with prior periods. The examiner may find it beneficial to compute the ratio for groups of loans by type, size, or risk levels.

5. Compare the loans classified during regulatory examinations/BHC inspections with the previous examinations/inspections and also those classified by management prior to the regulatory examinations/inspections. Investigate the current status of previously classified loans.

6. Compute the percentage of the allowance for loan and lease losses to average outstanding loans and compare those results with those of the previous inspection. Investigate the reasons for variations between those periods.

7. Assess the quality of the organization's systems and internal controls in identifying, monitoring, and addressing asset-quality problems.

Taxes (Consolidated Tax Filing)

Section 2070.0

A holding company and its depository institution subsidiaries may generally file a consolidated group income tax return. For bank regulatory purposes, however, each depository institution is viewed as, and reports as, a separate legal and accounting entity. Each holding company subsidiary that participates in filing a consolidated tax return should record its tax expenses or tax benefits as though it had filed a tax return as a separate entity. The amount and timing of any intercompany payments or refunds to the subsidiary that result from its being a part of the consolidated return group should be no more favorable than if the subsidiary was a separate taxpayer. A consolidated return permits the parent's and other subsidiaries' taxable losses to be offset against other subsidiaries' taxable income, with the parent most often providing the principal loss. This can be illustrated with the following example:

	Parent Only	*Bank*	*Non-bank A*	*Non-bank B*	*Consolidated*
Contribution to consolidated net taxable income (loss):	$(100)	$2,000	$500	$(50)	$2,350
Assumed tax rate	40%	40%	40%	40%	40%
Tax payment/ (benefit)	$(40)	$ 800	$200	$(20)	$ 940

In this example, the parent, as the representative of the consolidated group to the Internal Revenue Service, would collect $800 from the bank subsidiary and $200 from Nonbank Subsidiary A, and pay $20 to Nonbank Subsidiary B. In return, the parent would remit to the tax authorities $940, resulting in a net cash retention of $40 by the parent.

Bank holding companies employ numerous methods to determine the amount of estimated payments to be received from their subsidiaries. Although the tax-accounting methods to be used by bank holding companies are not prescribed by the Federal Reserve System, the method employed must afford subsidiaries equitable treatment compared with filing separate returns. In general terms, tax transactions between any subsidiary and its parent should be conducted as though the subsidiary was dealing directly with state or federal taxing authorities.

In 1978 the Board of Governors addressed the issue of intercorporate income tax settlements by issuing a formal Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That Are Members of the Federal Reserve System. The statement was revised and replaced by the December 1998 Policy Statement on Income Tax Allocation in a Holding Company Structure, which does not materially change any of the guidance previously issued.

The tax structure of bank holding companies becomes more complicated when deferred taxes are considered in the intercorporate tax settlements.[1] Deferred taxes occur when taxable income, for financial reporting purposes, differs from taxable income as reported to the taxing authorities. This difference is due to timing differences between financial-statement income and tax income for loan-loss provisions and other items, such as foreign tax credits. In addition, differences result from the use of the cash basis of accounting for tax purposes, as opposed to the accrual basis of accounting used in financial reporting. The different bases are chosen by management.

An example of deferred income taxes follows, using an estimated tax rate of 40 percent.

	Financial Reporting	*Tax Return*
Pre-tax income	$200	$150
Currently payable	60	60
Deferred portion	20	—
TOTAL	80	60
Net income	$120	$90

The deferred portion represents the tax effect of delaying the recognition of income or taking more of a deduction for tax-return purposes (40% x $50). This is a temporary difference since over the ''life'' of the bank holding company, income and deductions should theoretically equalize for both book and tax purposes.

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1. The issue becomes more complex because of GAAP-based tax expenses versus actual taxes paid under relevant tax laws (the difference between the two expenses is either a deferred tax liability or asset on the balance sheet). If the sharing agreement is based on the tax expense on the statement of income, more funds may be transferred to the paying agent than are required to settle the actual taxes owed.

ment No. 109 (FASB 109), "Accounting for Income Taxes," provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax liabilities and assets. FASB 109 describes how a bank holding company should record (1) taxes payable or refundable for the current year and (2) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the banking organization's financial statements or tax returns.

Generally, all bank holding companies must file annual income tax returns. The bank holding company can pay the entire amount of tax (that is, the amount still due after estimated tax payments) on or before the due date for filing, or it can elect to pay by the extension deadline if one is granted. Bank holding companies may receive extensions from taxing authorities to file their returns later. For the federal tax return, a six-month extension may be granted.

Bank holding companies generally pay estimated taxes throughout the year. The most common payment dates will be as follows (assuming calendar period):

April 15	—first estimate (25%)
June 15	—second estimate (25%)
September 15	—third estimate (25%)
December 15	—fourth estimate (25%)
March 15	—Due date for income tax return for U.S. corporations or foreign corporations with offices in the United States. Last day for filing for the automatic six-month extension.
September 15	—Due date of return if six-month extensions were granted.

The bank holding company will calculate the amount of the estimated payments to the Internal Revenue Service by using one of two methods: (1) prior year's tax liability (most commonly used) or (2) 90 percent of the estimated tax based on the current year's estimated taxable income.

Bank holding companies have engaged in intercorporate income tax settlements that have the effect of transferring assets and income from a bank subsidiary to the parent company in excess of those settlements that would be consistent with the Board's 1978 policy statement. The Board will apply appropriate supervisory remedies to situations that are considered inequitable or improper. These remedies may include, under certain circumstances, the Board's cease-and-desist powers.

On occasion, bank holding companies have used deferred tax assets as a vehicle to transfer cash or other earning assets of subsidiaries, principally from the bank, into the parent company. The Board's opinion is that each deferred tax asset or liability must remain on the books of the subsidiary. If deferred tax assets have been transferred to the parent, regardless of when the transfer may have occurred, immediate arrangements must be made to return the asset to the appropriate subsidiary. Instances of transferring deferred tax assets to the parent are worthy of inclusion in the Examiner's Comments and Matters Requiring Special Board Attention, page one of the inspection report.

2070.0.1 INTERAGENCY POLICY STATEMENT ON INCOME TAX ALLOCATION IN A HOLDING COMPANY STRUCTURE

The federal bank and savings association's regulatory agencies (the agencies) issued the following policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its subsidiaries will often file a consolidated group income tax return. However, for bank regulatory purposes, each depository institution of the consolidated group is viewed as, and reports as, a separate legal and accounting entity. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed as a separate tax-paying entity.[2] The amount and timing of payments or refunds should be no less favorable to a subsidiary than if it was a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action. See SR-98-38.

2070.0.1.1 Tax-Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written,

2. Throughout the policy statement, the terms "separate entity" and "separate taxpayer" are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate-entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

comprehensive tax-allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax-allocation agreements usually address certain issues common to consolidated groups.

Therefore, such an agreement should—

1. require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate-entity basis;
2. discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
3. discuss reimbursements to an institution when it has a loss for tax purposes; and
4. prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

2070.0.1.2 Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the federally supervised bank Reports of Condition and Income, and other guidance issued by the agencies require depository institutions to account for their current and deferred tax liability or benefit.

When the depository-institution members of a consolidated group prepare separate bank regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate-entity basis, regardless of the consolidated group's tax-paying or -refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate-entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

2070.0.1.3 Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate-entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[3] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

2070.0.1.4 Tax Refunds from the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the

3. These restrictions include the prompt-corrective-action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR 325, subpart B; for national banks, 12 CFR section 6.6; for savings associations, 12 CFR 565; and for state member banks, 12 CFR 208.45.

refund amount it is due on a separate-entity basis. Provided the institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carry-back benefits available on a separate-entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carry-forward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[4] Accordingly, an organization's tax-allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

2070.0.1.5 Income-Tax-Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate-entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by "forgiving" some or all of the subsidiary's deferred tax liability. Transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because each member of the consolidated group is jointly and severally liable for the group's potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

4. See 26 CFR 1.1502-77(a).

2070.0.2 QUALIFYING SUBCHAPTER S CORPORATIONS

The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code (the code). On October 29, 1996, the FFIEC issued a bulletin notifying all federally insured banks and thrifts of the impact of these changes. Thrift organizations may qualify for Subchapter S corporation status under the code's revisions and could generally receive pass-through tax treatment for federal income tax purposes if certain criteria are met.

The bulletin states that no formal application is required to be filed with the federal bank and thrift regulatory agencies merely as a result of an election by a bank, thrift, or parent holding company to become a Subchapter S corporation. However, if an institution takes certain steps to meet the criteria to qualify for this tax status, particularly the code's limitations on the number and types of shareholders, applications or notices to the agencies may be required.

The FFIEC bulletin also states that any distributions made by the Subchapter S banking organization to its shareholders, including distributions intended to cover shareholders' personal tax liabilities for their shares of the income of the institution, will continue to be regarded as dividends and subject to any limitations under relevant banking law. See SR-96-26.

2070.0.3 INSPECTION OBJECTIVES

1. To determine whether the supervisory and accounting guidance set forth in FASB 109, other tax-accounting standards, and the 1998 interagency policy statement on income tax allocation has been appropriately, equitably, and consistently applied.

2. To verify that the parent's intercorporate tax policy contains a provision requiring the subsidiaries to receive an appropriate refund from the parent when they incur a loss, and that such a refund would have been receivable from the tax authorities if the subsidiary was filing a separate return.
3. To ascertain that tax payments and tax refunds between financial institution subsidiaries and the parent company have been limited to no more than what the institution might have paid to or received from the tax authorities, if it had filed its tax returns on a timely, separate-entity basis.[5]
4. To determine that no deferred tax liability, corresponding asset, or the deferred portion of its applicable income taxes has been transferred from a bank subsidiary to the parent company.
5. To verify that there has been proper accountability for tax-forgiveness transactions between the parent company and its financial institution subsidiaries.
6. To substantiate that corporate practices are consistent with corporate policies.

2070.0.4 INSPECTION PROCEDURES

1. Obtain and discuss with the bank holding company's management its intercorporate income tax policies and tax-sharing agreements. Obtain and retain a copy of the intercorporate tax policies and agreements in the workpaper files. Review the written intercorporate tax-settlement policy and ascertain that it includes the following:
   a. a description of the method(s) used in determining the amount of estimated taxes paid by each subsidiary to the parent
   b. an indication of when payments are to be made
   c. a statement that deferred taxes are maintained on the affiliate's general ledger
   d. procedures for handling tax claims and refunds

Bank holding companies should also have written tax-sharing agreements with their subsidiaries that specify intercorporate tax-settlement policies. The Board encourages bank holding companies to develop such agreements. For tax-sharing agreements, the following inspection procedures should be followed:
   a. Determine whether each subsidiary is required to compute its income taxes (current and deferred) on a separate-entity basis.
   b. Ascertain if the amount and timing of payments for current tax expense, including estimated tax payments, are discussed.
   c. Determine if reimbursements are discussed when an institution has a loss for tax purposes.
   d. Determine if there is a prohibition on the payment or other transfer of deferred taxes by an institution to another member of the consolidated group.
2. Review briefly the parent's intercompany transaction report; general ledger income tax accounts; cash receipts and disbursements; and, if necessary, tax-return workpapers and other pertinent corporate documents.
   a. Ascertain that the taxes collected by the parent company from each depository institution subsidiary do not exceed the amount that would have been paid if a separate return had been filed.
   b. When depository institution subsidiaries are making their tax payments directly to the taxing authorities, determine whether other subsidiaries are paying their proportionate share.
3. Review the separate regulatory reports for depository institution members of the holding company that are included in the filing of a consolidated tax return.
   a. Verify that each subsidiary institution is recording current and deferred taxes as if it was filing its own tax returns on a separate-entity basis.
   b. Ascertain that any adjustments for statutory tax considerations, arising from filing a consolidated return, are also made to the separate-entity calculations consistently and equitably among the holding company affiliates.
4. Determine if any excess amounts (tax benefits), resulting from the filing of a consolidated return, are consistently and equitably allocated among the members of the consolidated group.
5. Review the tax payments that are made from the bank and the nonbank subsidiaries to the parent company.

5. The term "separate-entity basis" recognizes that certain adjustments, in particular tax elections in a consolidated return, may, in certain periods, result in higher payments by the bank than would have been made if the bank was unaffiliated.

a. Determine that payments, including estimated payments, that are being requested do not significantly precede the time that a consolidated or estimated current tax liability would be due and payable by the parent to the tax authorities.
b. Verify with management that the tax payments to the parent company were not in excess of the amounts recorded by its depository institution subsidiaries as current tax expense on a separate-entity basis.
c. Determine that subsidiary institutions are not paying their deferred tax liabilities on the deferred portions of their applicable income taxes to the parent company.
d. Ascertain that the parent company is not deriving tax monies from depository institution subsidiaries that are used for other operating needs.

6. When a subsidiary incurs a loss, review the tax system to determine that bank and nonbank subsidiaries are receiving an appropriate refund from the parent company, that is, an amount that is no less than what would have been received if the tax return had been filed on a separate-entity basis.
   a. Verify that the refund(s) are received no later than the date the institutions would have filed their own returns and that the refund is not characterized as the parent company's property.
   b. If the parent company does not require a subsidiary to pay its full amount of current tax liability, ascertain that the amount of the tax liability is recorded as having been paid and that the corresponding credit is recorded as a capital contribution from the parent company to the subsidiary.
7. Determine that the deferred tax accounts of each bank subsidiary are maintained on its books and that they are not transferred to the parent organization.
8. Determine if the Internal Revenue Service or other tax authorities have assessed any additional tax payments on the consolidated group, and whether the holding company has provided an additional reserve to cover the assessment.
9. Complete the Other Supervisory Issues page of the Report of Bank Holding Company Inspection (FR 1225 and FR 1241).
10. Verify the accuracy of the FR Y-8, Report of Intercompany Transactions, pertaining to the information on tax settlements.

2070.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
FFIEC Policy Statement on Income Tax Allocation in a Holding Company Structure			4-870	1999 FRB 111

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The purpose of this Section is to discuss the types of funding ordinarily found in holding companies and to analyze their respective characteristics. It is not intended that this section include an analysis of the inter-relationships of these factors because that will be addressed in the various subsections of Section 4000 of the Manual.

The three major types of funding are short-term debt, long-term debt and equity. The ideal ''hypothetical'' holding company balance sheet would reflect sufficient equity to fund total bank and nonbank capital needs.

The complexity of the debt and/or equity financing will depend greatly upon the size and financial status of the holding company as well as the access to certain capital markets. The small holding company will be limited in the type and/or sophistication of financing instruments available for its use, and probably would look to local sources for its debt and equity needs. This would include sale of equity and debt instruments to owners of the holding company. The medium-sized holding company has access to public markets through investment bankers and occasionally may issue its own corporate notes in the commercial paper market. The large holding company has a wide range of choices depending upon its financial condition and the economic climate at the time of any offering. It also has the ability to place debt privately as an alternate to dealing with public markets. In summary, the type of financing needed by a holding company will vary with the size and nature of its banking and nonbanking operations. The following subsections address those issues.

Funding (Bank Holding Company Funding and Liquidity) Section 2080.05

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.05.1 FUNDING AND LIQUIDITY

A principal objective of a parent bank holding company's funding strategy should be to support capital investments in subsidiaries and long-term assets with capital and long-term sources of funds. Long-term or permanent financing not only reduces funding and liquidity risks, but also provides an organization with investors and lenders that have a long-run commitment to its viability. Long-term financing may take the form of term loans, long-term debt securities, convertible debentures, subordinated debt, and equity.

In general, liquidity can be measured by the ability of an organization to meet its maturing obligations, convert assets into cash with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations. A major determinant of a bank holding company's liquidity position is the level of liquid assets available to support maturing liabilities. The use of short-term debt, including commercial paper, to fund long-term assets can result in unsafe and unsound banking conditions, especially if a bank holding company does not have alternative sources of liquidity or other reliable means to refinance or redeem its obligations. In addition, commercial paper proceeds should not be used to fund corporate dividends or pay current expenses. Funding mismatches can exacerbate an otherwise manageable period of financial stress or, in the extreme, undermine public confidence in an organization's viability. For this reason, bank holding companies, in managing their funding positions, should control liquidity risk by maintaining an adequate cushion of liquid assets to cover short-term liabilities. Holding companies should at all times have sufficient liquidity and funding flexibility to handle any runoff, whether anticipated or unforeseen, of commercial paper or other short-term obligations—without having an adverse impact on their subsidiary banks.

This objective can best be achieved by limiting the use of short-term debt to funding assets that can be readily converted to cash without undue loss. It should be emphasized, however, that the simple matching of the maturity of short-term debt with the stated or nominal maturity of assets does not, by itself, adequately ensure an organization's ability to retire its short-term obligations if the condition of the underlying assets precludes their timely sale or liquidation. In this regard, it is particularly important that parent company advances to subsidiaries be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can readily be converted to cash. Consequently, effective procedures to monitor and ensure on an ongoing basis the quality and liquidity of the assets being funded by short-term debt are critical elements of a holding company's overall funding program.

Bank holding companies should establish and maintain reliable funding and contingency plans to meet ongoing liquidity needs and to address any unexpected funding mismatches that could develop over time. Such plans could include reduced reliance on short-term purchased funds, greater use of longer-term financing, appropriate internal limitations on parent company funding of long-term assets, and reliable alternate sources of liquidity. It is particularly important that bank holding companies have reliable plans or backup facilities to refinance or redeem their short-term debt obligations in the event assets being funded by these obligations cannot be liquidated in a timely manner when the debt must be repaid. In this connection, holding companies relying on backup lines of credit for contingency plan purposes should seek to arrange standby facilities that will be reliable during times of financial stress, rather than facilities that contain clauses which may relieve the lender of the obligation to fund the borrower in the event of a deterioration in the borrower's financial condition.

In developing and carrying out funding programs, bank holding companies should avoid overreliance or excessive dependence on any single short-term or potentially volatile source of funds, such as commercial paper, or any single maturity range. Prudent internal liquidity

policies and practices should include specifying limits for, and monitoring the degree of reliance on, particular maturity ranges and types of short-term funding. Special attention should be given to the use of overnight money since a loss of confidence in the issuing organization could lead to an immediate funding problem. Bank holding companies issuing overnight liabilities should maintain on an ongoing basis a cushion of superior quality assets that can be immediately liquidated or converted to cash with minimal loss. The absence of such a cushion or a clear ability to redeem overnight liabilities when they become due should generally be viewed as an unsafe and unsound banking practice.

2080.05.2 ADDITIONAL SUPERVISORY CONSIDERATIONS

Bank holding companies and their nonbank affiliates should maintain sufficient liquidity and capital strength to provide assurance that outstanding debt obligations issued to finance the activities of these entities can be serviced and repaid without adversely affecting the condition of the affiliated bank(s). In this regard, bank holding companies should maintain strong capital positions to enable them to withstand potential losses that might be incurred in the sale of assets to retire holding company debt obligations. It is particularly important that a bank holding company not allow its liquidity and funding policies or practices to undermine its ability to act as a source of strength to its affiliated bank(s).

The principles and guidelines outlined above constitute prudent financial practices for bank holding companies and most businesses in general. Holding company boards of directors should periodically assure themselves that funding plans, policies and practices are prudent in light of their organizations' overall financial condition. Such plans and policies should be consistent with the principles outlined above, including the need for appropriate internal limits on the level and type of short-term debt outstanding and the need for realistic and reliable contingency plans to meet any unanticipated runoff of short-term liabilities without adversely affecting affiliated banks.

2080.05.3 EXAMINER'S APPLICATION OF PRINCIPLES IN EVALUATING LIQUIDITY AND IN FORMULATING CORRECTIVE ACTION PROGRAMS

Reserve Bank examiners should be guided by these principles in evaluating liquidity and in formulating corrective action programs for bank holding companies that are experiencing earnings weaknesses or asset-quality problems, or that are otherwise subject to unusual liquidity pressures. In particular, bank holding companies with less than satisfactory parent or consolidated supervisory ratings (that is, 3 or worse), or any other holding companies subject to potentially serious liquidity or funding pressures, should be asked to prepare a realistic and specific action plan for reducing or redeeming entirely their outstanding short-term obligations without directly or indirectly undermining the condition of their affiliated bank(s).[1] Such contingency plans should be reviewed and evaluated by Reserve Bank supervisory personnel during or subsequent to on-site inspections. Any deficiencies in the plan, if not addressed by management, should be brought to the attention of the organization's board of directors. If the liquidity or funding position of such a company appears likely to worsen significantly, or if the company's financial condition worsens to a sufficient degree, the company should be expected to implement on a timely basis its plan to curtail or eliminate its reliance on commercial paper or other volatile, short-term sources of funds. Any decisions or steps taken by Reserve Banks in this regard should be discussed and coordinated with Board staff.

Reference should also be made to other manual sections that address funding, cash flow, or liquidity (for example, 2010.1, 2080.0, 2080.1, 2080.2, 2080.4, 2080.5, 2080.6, 4010.0, 4010.1, 4010.2, 5010.27, and 5010.28).

1. It is important to note that there are securities registration requirements under the Securities Act of 1933 related to the issuance of commercial paper. A bank holding company should have procedures in place to ensure compliance with all applicable securities and SEC requirements. Refer to manual section 2080.1.

Commercial paper is a generic term that is generally used to describe short-term unsecured promissory notes issued by well-recognized and generally financially sound corporations. The largest commercial paper issuers are finance companies and bank holding companies which use the proceeds as a source of funds in lieu of fixed rate borrowing.

Generally accepted limitations on issuances and uses of commercial paper derive from Section 3(a)(3) of the Securities Act of 1933 (1933 Act). Section 3(a)(3) exempts from the registration requirements of the 1933 Act "any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. . . ." The Securities and Exchange Commission (SEC) has rulemaking authority over the issuance of commercial paper.

The five criteria, as set forth in an SEC interpretation (SA Release #33–4412, September 20, 1961), that are deemed necessary to qualify securities for the commercial paper exemption are that the commercial paper must:

- Be of prime quality and negotiable;
- Be of a type not ordinarily purchased by the general public;
- Be issued to facilitate current operational business requirements;
- Be eligible for discounting by a Federal Reserve Bank;
- Have a maturity not exceeding nine months.

2080.1.1 MEETING THE SEC CRITERIA

The above criteria are discussed below.

2080.1.1.1 Nine-Month Maturity Standard

Although roll-over of commercial paper proceeds on maturity is common, the SEC has stated that obligations that are payable on demand or have provisions for automatic roll-over do not satisfy the nine-month maturity standard. However, the SEC staff has issued "no action" letters for commercial paper master note agreements which allow eligible investors to make daily purchases and withdrawals (subject to a minimum amount of $25,000) as long as the note and each investor's interest therein, does not exceed nine months. Such master note agreements may permit prepayment by the issuer, or upon demand of the investor, at any time.

2080.1.1.2 Prime Quality

Most commercial paper is rated by at least one of five nationally recognized statistical rating organizations. The SEC has not clearly articulated the line at which it will regard a specific rating of commercial paper as being "not prime" and, indeed, there is no requirement that a rating be obtained at all in order to qualify. SEC staff has issued a series of "no-action" letters to individual bank holding companies based on specific facts and circumstances even where it does not appear that a rating was obtained. However, where commercial paper is downgraded to below what is generally regarded as "investment quality" (ratings of less than medium grade—refer to the *Commercial Bank Examination Manual*, section 203.1), or a rating is withdrawn, BHCs may not be able to issue commercial paper based on the Section 3(a)(3) exemption, in the absence of a marked significant improvement in the issuer's financial condition.

2080.1.1.3 Current Transactions

There have been considerable interpretative problems arising out of the current transactions concept. The SEC staff has issued a partial laundry list of activities which would not be deemed suitable for investment of commercial paper proceeds, namely:

1. The discharge of existing indebtedness, unless such indebtedness is itself exempt under section 3(a)(3) of the 1933 Act;
2. The purchase or construction of a plant or the purchase of durable machinery or equipment;
3. The funding of commercial real estate development or financing;
4. The purchase of real estate mortgages or other securities;
5. The financing of mobile homes or home improvements; or

6. The purchase or establishment of a business enterprise.

The SEC has opined that commercial paper, which is used as bridge financing by a bank holding company to fund a permanent acquisition within the 270-day maturity period of the paper, will meet the current transactions criterion. The amount of a bank holding company's commercial paper cannot exceed the aggregate amount of "current transactions" of the bank holding company and its subsidiaries *on a consolidated basis*. For this purpose, "current transactions" include dividends, interest, taxes and short-term loan repayments. In summary, in most cases, the "current transactions" requirement will not be a significant limitation on issuances of commercial paper by bank holding companies.

In addition to meeting SEC requirements, a bank holding company must meet funding and liquidity criteria prescribed by the Board. For a detailed discussion on acceptable use of commercial paper in connection with a bank holding company overall funding strategies, see Sections 2080.05 and 2080.6.

2080.1.1.4 Sales to Institutional Investors

Commercial paper is generally marketed only to institutional investors (corporations, pension funds, insurance companies, etc.) although sales to individuals are not prohibited. It is clear, however, from the legislative history of the Section 3(a)(3) exemption that commercial paper was not to be marketed for sale to the general public. Currently, SEC staff will not issue a no-action letter if the minimum denomination of the commercial paper to be issued is less than $25,000. One of the underlying premises of the Section 3(a)(3) exemption is that purchasers of commercial paper have sufficient financial sophistication to make informed investment decisions without the benefit of the information provided by a registration statement. It is, therefore, generally recognized today that any individual purchaser of commercial paper should meet the "accredited investor" criteria of commercial paper set forth in SEC Regulation D (17 C.F.R 230.501(a)). To qualify as an "accredited investor", an individual can meet one of two tests—a net worth test or an income test. To qualify under the net worth test, an individual or an individual and his or her spouse must have a net worth at the time of purchase in excess of $1 million. The alternative test requires $200,000 in income for each of the last two years ($300,000 if the spouse's income is included) and a reasonable expectation of reaching the same income level in the current year.

For additional information on marketing of commercial paper, see the next subsection.

2080.1.2 MARKETING OF COMMERCIAL PAPER

The sale of bank holding company (or nonbank subsidiary) commercial paper by an affiliated bank to depositors or other investors raises a number of supervisory issues. Of particular concern is the possibility that individuals may purchase holding company paper with the misunderstanding that it is an insured deposit or obligation of the subsidiary bank. The probability of this occurring is increased when a bank subsidiary is actively engaged in the marketing of the paper of its holding company or nonbank affiliate, or when the holding company or nonbank affiliate has a name similar to the name of the commercial bank subsidiary.

It is a long-standing policy of the Federal Reserve (refer to letters SR 90–19 and SR–620) that debt obligations of a bank holding company or a nonbank affiliate should not be issued, marketed or sold in a way that conveys the misimpression or misunderstanding that such instruments are either: 1) federally-insured deposits, or 2) obligations of, or guaranteed by, an insured depository institution. The purchase of such holding company obligations by retail depositors of an affiliated depository institution can, in the event of default, result in losses to individuals who believed that they had acquired federally-insured or guaranteed instruments. In addition to the problems created for these individuals, such a situation could impair public confidence in the affiliated depository institution and lead to unexpected withdrawals or liquidity pressures.

Events surrounding the sale of uninsured debt obligations of holding companies to retail customers of affiliated depository institutions have focused attention on the potential for problems in this area. In view of these concerns, the Federal Reserve emphasizes that this policy applies to the sale of both long- and short-term debt obligations of a bank holding company and any nonbank affiliate, as well as to the sale of uninsured debt securities issued by a state member bank or its subsidiaries. Debt obligations covered by this supervisory policy include commercial paper and all other short-term and long-

term debt securities, such as thrift notes and subordinated debentures.

Bank holding companies and nondepository affiliates that have issued or plan to issue uninsured obligations or debt securities should not market or sell these instruments in any public area of an insured depository institution where retail deposits are accepted, including any lobby area of the depository institution. Bank holding companies and any affiliates that are engaged in issuing debt obligations should establish appropriate policies and controls over the marketing and sale of the instruments. In particular, internal controls should be established to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of uninsured debt obligations is separated from the retail deposit-taking functions of affiliated depository institutions.

State member banks, including their subsidiaries, may also be engaged in issuing nondeposit debt securities (such as subordinated debt), and it is equally important to ensure that such securities are not marketed or sold in a manner that could give the purchaser the impression that the obligations are federally-insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. Consistent with long-standing Federal Reserve policy, debt obligations of bank holding companies or their nonbank affiliates, including commercial paper and other short- or long-term debt securities, should prominently indicate that: 1) they are not obligations of an insured depository institution; and 2) they are not insured by the Federal Deposit Insurance Corporation. In cases where purchasers do not take physical possession of the obligation, the purchasers should be provided with a printed advice that conveys this information. Employees engaged in the sale of bank holding company debt obligations should be instructed to relate this information verbally to potential purchasers. In addition, with respect to the sale of holding company debt obligations, the instruments or related documentation should not display the name of the affiliated bank in such a way that could create confusion among potential purchasers about the identity of the obligor. State member banks involved in the sale of uninsured nondeposit debt securities of the bank should establish procedures to ensure that potential purchasers understand that the debt security is not federally-insured or guaranteed.

Federal Reserve examiners are responsible for monitoring compliance with this supervisory policy; and, as part of the examination of state member banks and bank holding companies, are expected to continue to review the polices and internal controls relating to the marketing and sale of debt obligations and securities. Examiners should determine whether the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function of the insured depository affiliate.

In determining whether the activities are sufficiently separated, examiners should take into account: 1) whether the sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area[1]; 2) whether advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion; 3) whether similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor; 4) whether retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate; 5) whether information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and 6) whether retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

The Board's policy is that the manner in which commercial paper is sold should not lead bank customers or investors to construe commercial paper as an insured obligation or an instrument which may be higher in yield but equal in risk to insured bank deposits. All purchasers of commercial paper should clearly understand that such paper is an obligation of the parent company or nonbank subsidiary and not an obligation of the bank and that the quality

1. This policy is not intended to preclude the sale of holding company affiliate obligations from a bank's money market desk, provided that the money market function is separate from any public area where retail deposits are accepted, including any lobby area.

of the investment depends on the risks and operating characteristics associated with the overall holding company and its nonbanking activities.

2080.1.3 THRIFT NOTES AND SIMILAR DEBT INSTRUMENTS

In the event a bank holding company or nonbanking affiliate issues thrift notes or other debt obligations which do not fall within the generally accepted definition of commercial paper, examiners should be guided by the Board's 1978 position on the issuance of small denomination debt obligations by bank holding companies and their nonbanking affiliates. At that time, the Board was considering thrift notes issued by a nonbanking subsidiary of a bank holding company and concluded that such obligations should prominently indicate in bold type on their face that the obligations are not obligations of a bank and are not FDIC insured. The Board also stated that the obligations should not be sold on the premises of affiliated banks. Where there is substantial reliance on the sale of thrift notes to fund the operations of a bank holding company or nonbanking subsidiary, other than an industrial bank, a violation of the Glass–Steagall Act may be involved. Such cases should be discussed with Reserve Bank counsel.

2080.1.4 OTHER SHORT-TERM INDEBTEDNESS

A company's access to bank credit is almost universal, and most small to medium-sized companies will reflect this type of debt on their balance sheets. An important point to remember about bank debt is that maturities of the bank notes are usually short-term while the proceeds of the borrowings are often applied to long-term assets, that is, investment in the bank's capital and/or long-term debt accounts. The note may be subject to renewal on an annual basis, and the creditor may have the opportunity to call the note at renewal if the financial condition of the company has deteriorated. Rates of interest on short- term bank notes are usually pegged to the creditor's prime rate plus some fraction thereof. The principal is often repaid over a period of years as the notes are rolled over despite their short-term maturity.

2080.1.5 CURRENT PORTION OF LONG-TERM DEBT

This type of debt has many of the short-term characteristics of bank debt, with possibly one additional important feature. Such debt is usually tied to a written agreement between creditor and debtor, and encompasses certain minimum standards of performance to be adhered to by the company. The examiner must review the agreement to determine that the company is operating within the parameters of the covenants laid out in the agreement. Failure to abide by the covenants can trigger default provisions of the agreement and escalate the repayment of the total loan balance outstanding.

2080.1.6 INSPECTION OBJECTIVES

1. To determine the company's policy and actual practices with respect to the sale of uninsured debt obligations and securities issued by bank holding companies, nonbank affiliates or State member banks. More often than not, an informal policy evolves from practice. It then becomes important to interview senior officers in charge of this function to determine if they are adequately aware of the statutory and regulatory constraints with respect to appropriate usage of commercial paper.
2. To review the company's funding and liquidity strategy with a view to determining whether it has sufficient liquid assets to support maturing liabilities and whether there are any funding mismatches. (See Manual sections 2080.05, 4010.2.3, 4010.2.7, and 5010.24.1)
3. To determine compliance with the Federal Reserve System's supervisory policy with regard to the marketing of commercial paper, thrift notes or similar type debt instruments (refer to Board letter S 2427 dated June 27, 1980, and supervisory letters SR 90–19 and SR 620).
4. To identify potential weaknesses in corporate policy and practices.

2080.1.7 INSPECTION PROCEDURES

1. Review the bank holding company's procedures for authorizing the issuance of commercial paper and other uninsured debt obligations and securities of the holding company and/or its nonbank affiliates.
2. Review the board of directors' resolution authorizing the issuance of commercial paper and other uninsured debt obligations and securities.

3. Determine whether the company has sought a "no action" letter from the SEC. A "no action" letter indicates the SEC has reviewed the company's issuance of commercial paper and plans "no action" to require the registration of the commercial paper as "securities." Some companies rely on the opinion of their own counsel that their paper is not subject to SEC registration requirements. If the company does not have a "no action" letter there should be a legal opinion on file from the holding company's attorney regarding exemption from registration under section 5 of the 1933 Act.

4. Obtain a copy of the holding company's written policy on paper usage to compare with resolution and practice.

5. Review to determine the extent to which the commercial paper and other uninsured debt obligations are supported by back-up lines of credit provided by unaffiliated banks. These lines are established to cover any unexpected run-off of paper at maturity. Commitments for lines of credit should be in writing and have expiration dates. Commitment fees substantiate the enforceability of the commitment whereas compensating balances tend to indicate that the lending commitment is less formal. The examiner should determine whether material adverse change clauses exist in back-up line of credit agreements which may affect their reliability. Comment if it appears that those provisions might be utilized.

Compensating balance arrangements should be disclosed. A company may commit to a compensating balance, but if it relies on its bank subsidiary to provide the funds the bank should be compensated for utilization of its funds.

Reciprocal back-up lines may be established. This may eliminate the need for fees or compensating balances and may provide a certain comfort level for company management.

6. Obtain a listing of commercial paper and other uninsured debt obligation holders from management to the extent known. In the case of larger BHCs, there is a choice between issuing paper on a local level or placing it nationally through the auspices of an investment banking firm. In the latter case, there is likely to be no record of who purchases the paper because the paper is usually sold on a bearer basis. Holding companies looking for a wider market, national recognition, and higher ratings place their paper through an investment banking firm. However, it should be recognized that the market for commercial paper placed in this manner is more sophisticated and knowledgeable and therefore more sensitive to adverse developments than a local market. The smaller company can be content to sell its paper on a local level through its corporate headquarters, knowing its customer profile and limiting the amount to any one paperholder, thereby limiting its exposure to refinancing problems caused by large scale redemptions.

7. Review for potential weaknesses in corporate policy and practices. Any amounts in excess of 10 percent in the hands of one paperholder should be discussed with management and noted in the report. A large paperholder could refuse to purchase new paper at maturity (rollover) and place the company in a liquidity squeeze, requiring sell-off of assets or draw down of back-up lines.

Rollovers are prohibited under the 1933 Act. The instrument must have a definite date of maturity with no automatic provision for reinvestment of proceeds. Companies must abide by the 270-day provision and if the paperholder elects to reinvest the funds, a new instrument should be executed.

8. Request a copy of the commercial paper, thrift note or similar type instrument, and any printed advice to the purchasing customer for review. These documents should be checked for compliance with the standards set forth under the captions "Marketing of Commercial Paper" and "Thrift Notes and Similar Debt Instruments" in this section of the Manual.

9. If a bank sells the commercial paper and/or other uninsured debt obligations of its holding company or nonbanking affiliate, review the procedures to separate their sale from the retail operations of the bank.

This segregation should be reviewed as part of all holding company inspections. Examiner judgment must be relied upon, to a large extent, to determine whether the marketing activities of commercial bank subsidiaries for the bank holding company's commercial paper and other uninsured debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit- taking function. In making this determination, the examiner should consider whether:

a. The sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area;

b. Advertisements that promote uninsured debt obligations of the holding company also

promote insured deposits of the affiliated depository institution in a way that could lead to confusion;

c. Similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor;

d. Retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate;

e. Information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and

f. Retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

In those cases where the bank holding company or nonbanking affiliates issue thrift notes or similar type debt instruments, ascertain that these obligations are not being sold on the premises of affiliated banks.

10. The procedures in Nos. 8 and 9 address the manner in which bank holding companies (or nonbanking subsidiaries) market their commercial paper, thrift notes or similar type debt instruments; consequently, implementation will necessitate review of marketing procedures of all holding companies (or nonbanking subsidiaries), regardless of the type of charter or the identity of the primary supervisor of the subsidiary (affiliate) bank. Exceptions to the policies on the marketing of such paper should be noted on the ‘‘Commercial Paper and Lines of Credit’’ pages and discussed on the ‘‘Examiner's Comments’’ page of the inspection report. The managements of all bank holding companies must be fully informed of the Federal Reserve's policy with respect to the marketing of holding company debt obligations, as in SR Letter 90–19, and exceptions should be addressed in the supervisory follow-up process.

Long-term debt represents an alternative financing method to short-term debt and equity funds. Before choosing this type of funding the bank holding company will need to determine how the advantages and disadvantages of long-term debt apply to its financial position and funding needs. Interest on long-term debt is an expense item and therefore is tax deductible. The company issuing debt effectively pays approximately "half-price" (interest expense net of tax deduction) on debt while the company issuing equity pays the full dividend rate without a tax benefit. Counterbalancing the tax advantage is the fact that long-term debt must be serviced and retired to prevent default and cannot be used as an offset for losses.

The issuance of long-term debt will be relatively advantageous to the holding company whose price/earnings ratio is low and whose stock is selling significantly below book value. In this instance, the cost to the company of equity funding rises proportionately to the drop in the price of the stock since less funds are obtained for an equal number of shares, yet the dividend per share remains the same.

A major factor influencing a bank holding company's decision to issue long-term debt instead of equity is the dilution impact of new equity. Straight debt will not dilute ownership and is typically retired from cash flow, whereas new equity dilutes earnings per share (more so than the impact of the debt's interest expense on earnings).

Preferred stock can be retired through a sinking fund and is sometimes convertible to common shares. Convertible stock adds to the dilution effect when the conversion is exercised and prior to conversion, "fully diluted" earnings per share must be reported that assume full conversion. The bank holding company will consider both stockholder and market reaction to any dilution effects of long-term financing. The BHC may view debt financing as the best alternative if it feels that a diluted earnings per share would drive down the market price of its stock and contribute to stockholder discontent.

Inherent in any financing are intangible costs. While it is evident that on the surface debt financing is cheaper than equity financing, it would be hard to quantify the effects of potential missed interest payment or default associated with debt instruments. The bank holding company also will be concerned with its additional "debt capacity" if the present issuance of debt pushes the debt/equity ratio beyond acceptable limits.

Theoretically, "straight debt" is a direct secured or unsecured obligation requiring repayment at maturity and generally taking a senior position in the claim on assets. Principal is sometimes payable in a lump sum, often through the use of a sinking fund, while interest is paid at stated periods throughout the life of the note.

2080.2.1 CONVERTIBLE SUBORDINATED DEBENTURE

A convertible subordinated debenture is an unsecured debt that is subordinate to other debt and convertible to common stock at a certain date or price. The essential provision of this debt is that it may eventually be retired by equity and inherently has the potential for dilution. With this type of financing, the creditor typically has the right to convert the bond into a stated number of shares of common stock at some future time. Usually the conversion price is 10 to 15 percent above the market price of the stock. This encourages the bondholder to keep the bond until the market price meets or surpasses the conversion price. In many convertible debt agreements, the bank holding company issuing debt will have the option to call the issue when the conversion price equals the market price.

The bank holding company will issue a convertible subordinated debenture when its stock price is depressed. The convertibility provision is added as a "sweetner" to the issue and counteracts the negative aspect of its subordinated position. The subordinated nature of this issue will help a bank holding company with prior debt which includes covenants that dictate against additional senior debt.

2080.2.2 CONVERTIBLE PREFERRED DEBENTURE

This debt instrument is similar to straight convertible debt except it is convertible into preferred stock. This alternative is open to the bank holding company which needs to add a "sweetner" to this issue in order to market it, but does not want dilution of "common" ownership.

2080.2.3 NEGATIVE COVENANTS

The lender will be concerned with the borrower's debt structure when offering financing. If the borrower's debt/equity ratio is approaching an unacceptable level, the lender will try to assure that the bank holding company does not overextend itself. While the lender may demand the right to approve future equity issues, the lender is likely to be more willing to give such approval than to allow more debt because the equity issue adds to the capital base, and this base is a possible source of funds for the payment of debt.

Closely related to the restriction on further debt is the position of the lender in the liquidation of assets. The holder of a straight debt issue will usually demand to be senior to other debt holders. This characteristic is particularly suited to straight debt because straight debt is more vulnerable to default than convertible debt and doesn't have other sweetners such as a conversion right or a right to participate in distributions of earnings. The examiner will want to determine how the covenants affect future debt financing and if the effect is positive or negative.

The lender is likely to seek to insure that neither the structure nor policies of the bank holding company are altered without its approval during the life of the debt. The lender can insure this through other negative covenants attached to the debt. Some common covenants of this type include (1) limitations on capital expenditures and on the sale of assets, (2) restrictions on the BHC's redemption of its own stock, (3) restrictions on investments in general, (4) restrictions on dividend payment without prior approval, and (5) the imposition of loan to capital ratios, deposit to capital ratios and asset to capital ratios.

2080.2.4 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to policies on long-term debt.
2. To review the use of long-term funds.
3. To determine the existence of debt covenants and compliance by the holding company.

2080.2.5 INSPECTION PROCEDURES

1. Review the parent-only balance sheet and income statement for debt and interest expense captions.
2. Review the consolidated balance sheet and income statement for debt and interest expense captions.
3. Review any written policies and procedures available as part of an overall capital plan. If no plan or policies exist, the examiner should encourage management to develop them, and in large BHCs, to put them in writing.
4. Determine that the bank holding company does not finance long-term assets with short-term debt, as this leaves the holding company vulnerable to rising interest rates and the possibility of a credit crunch. On the other hand, it may be beneficial for the holding company to finance short-term assets with long-term debt. This is particularly true during periods of rising interest rates because the bank holding company can get higher yields on loans financed by lower cost long-term debt, than it can with commercial paper that has to be turned over at generally increasing rates. In any event, the bank holding company will need to insure that it has ample capacity to finance additional long-term assets with long-term debt when the opportunity presents itself.
5. Review any sinking fund provisions usually found with straight debt and straight preferred issues if the issue is not going to be refinanced by further debt or by an equity issue. Since payments to the fund will directly drain cash reserves, it is imperative that the bank holding company have adequate annual cash flow to service both the interest and add to the sinking fund. The larger the debt, the more the lender will look for a sinking fund feature as a means of precluding a default when maturity occurs and refinancing is not available. When a sinking fund exists the examiner will need to analyze the parent's cash flow statement to see that payments do not produce an adverse cash drain.

The capacity of the holding company to serve as a source of financial strength to its bank subsidiaries is a major consideration of the Federal Reserve Board in supervising a bank holding company. The cornerstone of this financial strength is capital adequacy.

The financial structure of banking organizations allows for the use of substantial leverage. If capital is large in relation to debt, additional borrowing is relatively inexpensive. However, because of added risk to lenders, the cost of borrowing increases as new obligations are assumed. At some point, therefore, equity financing becomes less costly and may become the only alternative available for needed funds.

Basically, a holding company's financial structure can be viewed in two ways: the ''single entity'' approach, whereby the holding company is considered an integrated entity and financial strength is assessed on the basis of its consolidated totals, and the ''building block'' approach, wherein the holding company is seen as a collection of individual components. In the latter view, the company's financial strength is assessed primarily in terms of the financial structure of each component.

When applying the ''building block'' approach, the liability and capital structure of each subsidiary is compared to the norm of its particular industry. The use of the ''building block'' approach has some advantages:

1. Comparative statistics are usually available to measure the performance and strength of the individual subsidiaries.
2. It permits comparison of capitalization between holding companies engaged in differing activities.
3. It identifies the degree of leveraging within a single subsidiary of a bank holding company.

The parent should maintain a favorable balance of debt and equity so that it will be able to assist its subsidiaries when necessary through contributions of its own capital or through additional funds generated from debt or equity financing.

At times, however, sale of additional stock may not be a viable alternative for capital formation, even when a company can show a favorable debt/equity balance. Reluctance to enter into a new stock offering may stem from a desire to avoid further dilution of existing ownership interest or from an unfavorable market price of outstanding stock in relation to book value. In these instances, long-term quasi-capital funds may sometimes be obtained through other sources, such as convertible securities or subordinated debt.

2080.3.1 PREFERRED STOCK

Preferred stock is becoming a more acceptable alternative due to certain advantages. Through contracted covenants, it is senior to common stock because it usually has no voting voice in management as does common stock. Preferred stock usually carries a fixed dividend rate that is either cumulative or noncumulative. Cumulative preferred provides that unpaid dividends in prior years must be paid to preferred shareholders before common dividends can be paid. A noncumulative feature provides that dividends foregone during lean years are lost permanently. From the viewpoint of the bank holding company, a noncumulative preferred issue is more desirable, while investors would desire a cumulative feature.

Perpetual preferred stock does not have a stated maturity date and it may not be redeemed at the option of the holder. Advantages that preferred stock can offer the bank holding company are (1) avoidance of dilution of earnings per common share and (2) absence of voting rights. On the other hand, dividend payments, particularly cumulative dividends, are expensive since they are not a tax-deductible expense as is interest on debt. Cumulative dividends can be particularly draining on cash when they are declared after several years of suspended dividends and payment is then made in a lump sum.

Preferred stock is usually retired by refinancing with debt or through its own conversion feature. If the bank holding company feels that it can afford an equity issue in the future but not at present, it can issue a convertible preferred debenture to postpone the equity issue until a later date. On the other hand, if debt is the desired method of financing but the present debt/equity ratio is not acceptable, the bank holding company will issue preferred and refinance with debt at a more opportune time. However, the Board has expressed concern that in applications to form a BHC, preferred stock not be used as a debt substitute resulting in circumvention of its debt guidelines. On applications with preferred stock which has debt-like characteris-

tics, such stock may be treated as debt in the financial analysis.

2080.3.2 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to parent company policies on capital adequacy within the subsidiaries and for the consolidated organization.
2. To review the use of proceeds of equity capital financings.
3. To review any debt covenants that pertain to a minimum acceptable capital position.

2080.3.3 INSPECTION PROCEDURES

1. Review any existing BHC policies regarding capital adequacy or capital planning.
2. Request any plans regarding proposed capital issues.

Earnings retention provides the most immediate source of capital formation and growth. Earnings retained after dividend payout can often be sufficient to keep pace with asset growth, thereby preserving the balance or relationship between equity capital and total assets. Often referred to as ''internal funding,'' earnings retention should be carefully reviewed to assure that the BHC's capital base is keeping pace with asset growth.

Bank earnings retention should be reviewed carefully due to the dividend requirements often imposed on banks by their parent companies. Although a bank's board of directors must approve the declaration and payment of any bank dividend, often the bank's board is actually ratifying a decision determined at the parent level. The need for bank retention of earnings is particularly pronounced either during periods of expansion or periods of declining earnings or losses.

Parent company management may be under pressure from shareholders or ''the market'' to increase dividends or to maintain dividends at historic levels despite reversals in consolidated earnings trends. Examiners should be careful to point out to management that dividend pressures often serve to the detriment of the bank subsidiary(ies) which is often asked to supply the proceeds via a dividend to the parent company. As a regulator of banks (and bank holding companies), the Federal Reserve System is concerned with the preservation and maintenance of a sound banking system and in particular, soundly capitalized banks. Earnings retention contributes to capital growth and should be encouraged. For additional information on earnings retention and dividends see sections 2020.5.1, 4010.1, and 4020.1.

2080.4.1 PAYMENT OF DIVIDENDS BY BANK SUBSIDIARIES

Bank dividends can be determined to be excessive if they exceed the limitations imposed by either section 5199(b) or 5204 (also referred to as sections 56 and 60(b)) of the Revised Statutes and accordingly, should be reviewed with regard to those limitations. The Federal Reserve Board amended Regulation H on December 20, 1990, regarding the payment of dividends by state member banks [12 C.F.R. 208.19(a) and 208.19(b)]. These new regulations make the elements that are taken into account in determining a state member bank's dividend paying capacity more consistent with generally accepted accounting principles. Two different calculations are performed to measure the amount of dividends that may be paid, a Net Profits Test and an Undivided Profits Test.

2080.4.1.1 Net Profits Test

The approval of the Federal Reserve is required for dividends declared by a member bank that in any calendar year exceeds the net profits of the current year, combined with retained net profits for the two proceeding years (the ''Net Profits Test''). Under the regulation, net profits of a year will equal net income. A member bank is required to use these rules in calculating net profits beginning in 1991 and thereafter.

2080.4.1.2 Undivided Profits Test

The parent company's bank subsidiaries must receive prior approval of the Federal Reserve before paying dividends in amounts greater than undivided profits then on hand, after deducting any bad debts in excess of the allowance for loan and lease losses. Under the regulations effective January 25, 1991, undivided profits then on hand include undivided profits plus the amount of ''surplus surplus'' that meets certain conditions. ''Surplus surplus'' is defined as the amount of capital surplus in excess of the amount required under applicable state law, and the regulations provide that a bank may include surplus surplus in undivided profits then on hand only if the bank can demonstrate that surplus surplus is from earnings of prior periods (''earned surplus surplus''). Transfers from surplus surplus to undivided profits must receive prior approval of the Federal Reserve. Bad debts in excess of the allowance for loan and lease losses must be subtracted from undivided profits then on hand in calculating the amount available for dividends. Bad debts are defined as debts due and unpaid for a period of six months unless well secured and in the process of collection.[1]

1. Because for most banks bad debts are less than the allowance for loan and lease losses, this subtraction will not apply to most banks.

Holding companies have turned to employee pension plans and, to a lesser degree, stock option plans as ways to provide added capital for holding company operations. While there may be a number of reasons for implementing such programs, one of the by-products is the flow of working capital into the holding company. The program usually involves a pre-tax contribution by the holding company to an employee benefit plan (e.g., profit sharing plan) and the resulting purchase by such plan of common or preferred shares of the holding company's stock. The holding company benefits through the use of the funds for working capital, and the plan provides for retirement benefits for employees as shareholders in the company. Since ESOPs are administered under the Employees Retirement Income Security Act of 1974 (ERISA), the guidelines delineated in SR 85–21 should be followed in determining whether possible ERISA violations exist. Reference should also be made to Manual section 4010.1.1.

2080.5.1 STOCK OPTION PROGRAMS

Employee stock option programs generate a nominal percentage of a holding company's financing needs to reward key employees for service rendered via the reduced price of the company's stock. While such programs constitute one method of available funding for a holding company, they generally may not be expected to add any capital amounts beyond nominal levels.

2080.5.2 EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Employee Stock Ownership Plans (ESOP) are an alternative holding company funding tool. An ESOP is a tax-qualified employee benefit plan which is designed to be invested primarily in employer stock. The concept of an ESOP is to encourage the establishment of employee benefit programs which expand the employees' share in company stock ownership. Participation in an ESOP may also significantly enhance employee motivation. The essential differences between an ESOP and other qualified stock bonus plans are that an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities, and that an employer may receive additional tax credits for amounts contributed to ESOPs. Under limited circumstances, lenders to ESOP's may also receive benefits that result in reduced borrowing costs to the ESOP. As long as ESOP meets the IRS requirements for a qualified employee plan, it may invest up to 100% of its assets in "qualifying" employer securities. It is exempt from some of the self-dealing limitations applicable to most employee benefit plans, as it is viewed as a means of providing stock ownership interests for employees rather than as strictly a retirement plan. Furthermore, an ESOP may purchase the stock either from the employer company or from shareholders. Therefore, in addition to use as a tool of corporate finance, an ESOP may serve as a ready purchaser for outstanding stock, without a corresponding loss of voting control.

ESOPs are in some ways similar to deferred profit sharing plans. ESOPs are authorized under the same section, namely, section 401 of the Internal Revenue Code. Employer contributions (within limits based on a percentage of eligible payroll) are allowable deductions from the employer's pre-tax income. Contributions are held in trust, and benefits when paid out upon an employee's retirement, death, or termination of service, must be paid in company stock. The distinguishing feature of an ESOP lies in the fact that the direct purpose of the plan is to invest employer contributions in the stock of the company.

2080.5.2.1 Accounting Guidelines for Leveraged ESOP Transactions

Newly issued or existing shares of BHC stock are sometimes sold to the ESOP and paid for with money borrowed from a third party; these types of ESOPs are commonly referred to as "leveraged ESOPs." The borrowings are generally serviced with contributions by the employer, which are a tax deductible expense. The borrowing arrangement by the ESOP often includes a guarantee or commitment by the employer (the BHC or the subsidiary bank) to make future contributions to the ESOP sufficient to meet debt service requirements.

When this occurs, questions arise involving the appropriate accounting for the leveraged ESOP transaction. The Accounting Standards Executive Committee of the American Institute

of CPAs has issued a Statement of Position (SOP) 72–3 which discusses ESOP borrowing situations. Since the Federal Reserve applies generally accepted accounting principles, banks and bank holding companies should follow SOP 76–3. The SOP statement covers cases where the employer either guarantees the ESOP loan or commits to make future ESOP contributions sufficient to service the debt. For such cases, the SOP indicates that the employer should credit a liability account for the amount of the ESOP debt and offset that entry by reducing shareholders' equity. The liability recorded by the employer should be reduced as the ESOP makes payments on the debt. This liability is recorded because the guarantee or commitment is in substance the employer's debt. When there is no guarantee, the ESOP is treated like any other shareholder.

In other words, where there is a leveraged ESOP which has purchased BHC stock, and there is a guarantee, commitment, or other arrangement which is in effect a guarantee relative to the debt service of the ESOP, for analytical purposes the amount of ESOP debt will be considered as parent debt and thus parent equity will be reduced accordingly. This will affect debt to equity ratios as well as consolidated capital ratios, where applicable.

2080.5.2.2 Fiduciary Standards under ERISA Pertaining to ESOPs

There are also general fiduciary standards under ERISA pertaining to ESOPs which have been delineated largely through court decisions rather than issuance of regulations. Although exempted from ERISA's asset diversification requirement, ESOP transactions are still required to meet fiduciary standards of prudence, and must be designed and administered for the ''exclusive benefit'' of plan employees. (ERISA § 404(a) and 29 CFR 2550.407d–6). Yet, as stated above, ESOPs may have distinct advantages which inure primarily to the sponsoring company, its management and large shareholders. Due to these potential or actual conflicts of interest, it is important that the sponsoring employer and any other fiduciaries of a plan undertake every effort to assure full consideration of the best interests of plan employees.

The safeguarding of the statutory ''exclusive'' interests of plan employees pursuant to ERISA is within the jurisdiction of the IRS and the Department of Labor. The bank regulatory agencies also have some responsibility in their review and examination activities where employee benefit plans such as ESOPs are involved. In this connection, a Uniform Interagency Referral Agreement mandated by statute, has been in effect since 1980 whereby certain possible violations of the provisions of ERISA are referred to the DOL by the Division of Banking Supervision and Regulation, pursuant to delegated authority. SR 81–697 (SA) contains the procedures for making referrals to the Department of Labor. Attached to the SR letter is an exhibit, *ERISA Referral Format,* which lists the information necessary when making referrals. Holding company examiners can expedite the ERISA referral process by including that information in their reports.

2080.5.3 STATUS OF ESOP'S UNDER THE BHC ACT

On August 6, 1985, the Board determined (1985 FRB 804) that an ESOP that controls more than 25 percent of the voting shares of a bank or bank holding company is a bank holding company. The Board determined that the underlying trust which held the shares of the bank holding company is a ''business trust'' as defined in the BHC Act and was thus not excluded from the definition of a ''company'' under the terms of the Act.

2080.5.4 INSPECTION CONSIDERATIONS

Examiners should review unfunded pension liabilities of the BHC to determine their potential impact on the organization. In addition, examiners should review the soundness of any borrowings used to fund ESOP purchases of BHC stock. ESOP borrowings from an affiliated bank used to purchase BHC shares may result in an apparent increase in BHC capital which in fact turns out to have been funded with subsidiary bank funds, a practice considered suitable for in-depth review by examination staff. Section 401 (of the Internal Revenue Code) plan holdings of BHC stock need to be evaluated under the ''content'' provisions of the BHC Act, change in Bank Control Act, and Regulation Y.

When an ESOP is subject to the Change in Bank Control Act, this fact should be brought to the attention of a BHC's management. Section 225.41 of Regulation Y specifies transactions—acquisitions—that would require providing the

Board with 60 days prior written notice before acquiring control of a bank holding company (or a state member bank), unless the transaction is exempt under section 225.42 of the Regulation. In addition to the above, a determination should be made as to whether the ESOP is a bank holding company. The examiner may also refer to the Financial Accounting Standards Board's Statement No. 87, "Employers' Accounting for Pensions."

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.6.1 FUNDING BY SWEEPING DEPOSIT ACCOUNTS

A principal objective of a bank holding company's funding strategy should be to maintain an adequate degree of liquidity at the parent company and its subsidiaries. Funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in an organization's viability. In developing and carrying out funding programs, bank holding companies should give special attention to the use of overnight or extremely short-term liabilities since a loss of confidence in the issuing organization could lead to an immediate funding problem. Accordingly, bank holding companies relying on overnight or extremely short-term funding sources should maintain a level of superior quality assets, namely, assets that can be immediately liquidated or converted to cash with minimal loss, that is at least equal to the amount of those funding sources.

A potential source of funding mismatch arises from the use of what has been commonly referred to as deposit sweeps. This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts) which permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company. These obligations include such instruments as commercial paper, program notes, and master notes.

In view of the extremely short-term maturity of most sweep arrangements, banking organizations should exercise great care when investing the proceeds. Appropriate uses of the proceeds of 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.[1] Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems at the parent company and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Reserve Bank supervisory and examination personnel are to ensure that bank holding companies and their state member banks are in compliance with this section and related supervisory letters addressing the marketing of uninsured debt instruments, including master notes and other sweep arrangements (refer to Manual sections 2080.05 and 2080.1). Banking organizations not in compliance should take the necessary steps to achieve full compliance within a reasonable period of time. Reserve Banks should provide copies of the supervisory letter SR 90–31 to any bank holding company engaged in sweep arrangements with their subsidiary banks, or to any other organization if necessary to facilitate compliance.

1. Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in this supervisory letter and prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep arrangements. Banking organizations employing sweep arrangements are expected to ensure that these arrangements conform with the policies contained in this section and in the Manual section 2080.05 on bank holding company funding.

The control provisions of the Bank Holding Company Act (the act) are found in section 2(a)(1) and (2) (see 12 U.S.C. 1841(a)) under the definition of a bank holding company. A bank holding company is defined as ''any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of the Act.''

The term ''company'' means any corporation, partnership, business trust, association, or similar organization, or any other trust.[1] Any corporation in which the majority of the shares are owned by the United States or by any state is not considered a company.

A ''company covered in 1970'' means a company that became a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date.

2090.0.1 CONCLUSIVE PRESUMPTIONS OF CONTROL

The conclusive presumptions of control are established in section 2(a)(2)(A) and (B) of the act when—

1. a company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or company or
2. a company controls in any manner the election of a majority of the directors or trustees of the bank or company.

''Acting through one or more other persons'' could include—

1. acting through the executive officer of a company, or a relative or business associate of that officer;
2. financing the purchase of shares of a bank or company when—
   a. the amount of credit approximates the purchase price,
   b. there is no definite maturity on the credit extended,
   c. the credit is obtained at a favorable rate of interest, and
   d. the bank whose shares are held as collateral maintains an excessive balance with the lending company;
3. by a resolution of a company's board of directors, guaranteeing an individual against any loss in relationship to his ownership in a bank or company when such ownership represents 25 percent or more of any voting class;
4. recognizing earnings from another company; or
5. participating in policy formation or daily operations of another company.

The ''power to vote'' includes the right to vote, to direct the voting of shares, or to immediately transfer shares to the name of the holder of such rights or the holder's nominee, pursuant to any proxy, contract, or agreement. However, when stock is held as collateral for a loan under an agreement which enables the lender to transfer the stock into the name of the lender or its nominee without the power to vote, the right to have the shares transferred does not in itself constitute control. To constitute control, the power to vote must be perfected along with the transfer of the stock into the name of the lender or its nominee.

2090.0.2 DIRECT CONTROL

Direct control exists when a company (as defined in section 2(b) of the act) owns 25 percent or more of any one class of voting securities of a bank (as defined in section 2(c) of the act) or company. ''Voting securities'' includes potential as well as actual voting authority.

2090.0.3 INDIRECT CONTROL

Indirect ownership or control is defined in section 2(g) of the act in subsections 1 and 2 as follows:

''(1) Shares owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company; and

''(2) Shares held or controlled directly or indirectly by trustees for the benefit of (A) a company, (B) the shareholders or members of a company, or (C) the employees

1. Unless the terms of the trust require it to terminate within 25 years or not later than 21 years and 10 months after the death of individuals living on the effective date of the trust.

(whether exclusively or not) of a company, shall be deemed to be controlled by such company."

To assist in the interpretation of the above subsections the following explanations are provided.

1. All shares owned by a subsidiary of a bank holding company are deemed to be controlled by the parent's ownership interest in the directly owned subsidiary.
2. Shares held in a trust for the benefit of a company are deemed to be controlled by such company regardless of whether the trustee or company votes the shares. A company is deemed to be the beneficial owner of shares which it does not vote if all other shareholders' rights are retained by such company (that is, dividends, or other rights).
3. Shares owned by a trustee for the benefit of a company's subsidiary (or the subsidiary's shareholders, members, or employees) are deemed to be controlled by both the subsidiary and its parent.
4. Shares held in a trust for the benefit of an individual "stockholder, member, or employee" are not deemed to be controlled by a company because such shares are held for the individual regardless of his or her relationship with the company. For a company to have control over the shares held for the benefit of a company's "stockholders, members, or employees," the shares must be held as a class.
5. If a trust meets the definition of a company, it is possible for such a trust to be a bank holding company. In addition, it is possible for a bank through the administration of a trust(s)(which does not meet the definition of a company) to become a bank holding company (that is, a bank which has control over various trusts whose shares aggregate to 25 percent or more of a bank or bank holding company could be deemed a bank holding company; a bank which administers a trust that owns 25 percent or more of a bank or bank holding company (and such trust does not meet the definition of a company) could be a bank holding company.

In addition to the above determinants involving conclusive presumptions of control, the Board has determined that whenever the transferability of 25 percent or more of any class of voting securities of a company is restricted, in any manner, upon the transfer of 25 percent or more of any class of voting securities of another company, the holders of the two securities affected by the restriction constitute a company for the purposes of the act. This determination applies unless one of the issuers of such securities is a subsidiary of the other and is so identified in a Board order or in a registration statement or report accepted by the Board under the act.

In any administrative or judicial proceedings regarding conclusive presumptions of control, a company would not be considered to control a bank or company at any given time unless that company, at the time in question, directly or indirectly owned, controlled, or had power to vote 5 percent or more of any class of voting securities of the bank or company.

2090.0.4 REBUTTABLE PRESUMPTIONS OF CONTROL

A rebuttable presumption of control exists when the Board determines, after notice and opportunity for hearings, that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or company (section 2(a)(2)(C) of the act). With regard to the above, there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 percent of any class of voting securities of a given bank or company does not have control over that bank or company (section 2(a)(3) of the act). This 5 percent presumption does not prohibit the Board from determining that a company exercises a "controlling influence" when such company owns, controls, or has power to vote less than 5 percent of any class of voting securities of another company or bank. However, in overcoming the presumption, the Board bears the burden of proving that such a controlling influence exists.

2090.0.4.1 Regulation Y Determinants of Control

The Board has established the following rebuttable presumptions of control in section 225.31 of Regulation Y for use in proceedings:

1. Control of voting securities.
   a. *Securities convertible into voting securities.* A company that owns, controls, or holds securities that are immediately convertible, at the option of the holder or owner, into voting securities of a bank

or other company controls the voting securities.

b. *Option or restriction on voting securities.* A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner controls the securities. This presumption does not apply where the agreement or understanding—
   (1) is a mutual agreement among shareholders granting to each other a right of first refusal with respect to their shares;
   (2) is incident to a bona fide loan transaction; or
   (3) relates to restrictions on transferability and continues only for the time necessary to obtain approval from the appropriate federal supervisory authority with respect to acquisition by the company of the securities.

2. Control over company.
   a. *Management agreement.* A company that enters into any agreement or understanding with a bank or other company (other than an investment advisory agreement), such as a management contract, under which the first company or any of its subsidiaries directs or exercises significant influence over the general management or overall operations of the bank or other company controls the bank or other company.
   b. *Shares controlled by company and associated individuals.* A company that, together with its management officials or principal shareholders (including members of the immediate families of either (as defined in 12 C.F.R. 206.2(k)) owns, controls, or holds with power to vote 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   c. *Common management officials.* A company that has one or more management officials in common with a bank or other company controls the bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company, and no other person controls as much as 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   d. *Shares held as fiduciary.* The presumptions of control in paragraphs 225.31(d)(2)(ii) and (iii) of Regulation Y do not apply if the securities are held by the company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

2090.0.4.2 Other Presumptions of Control

In addition to the rebuttable presumptions, there are a number of other circumstances that are indicative of control and may call for further investigation to uncover facts that support a determination of control. Such circumstances include the following:

1. A company owns at least 10 percent of each of two banks or at least 5 percent of each of three or more banks.
2. A company owns 5 percent or more of a bank or bank holding company and has been instrumental in the hiring or firing of one or more persons; establishing policies or places for branches; establishing hours of business; deciding on rates, terms, or acceptance of loans or deposits; following uniform advertising practices or using a common telephone system; or any other respects directing the activities of management or establishing the policies of the bank or company.
3. A company lends to a borrower on more favorable terms than it would have for a borrower of comparable credit standing to enable the borrower to acquire voting shares of a bank or other company.

If the Board proposes to make a determination based on the above indicators of control, the Board bears the burden of providing evidence that such a control situation exists.

2090.0.5 PROCEDURES FOR DETERMINING CONTROL

The question of whether a control situation exists may arise from information coming to the Board's attention or from a company's seeking to obtain the Board's opinion regarding a specific situation. When this question arises, the Board has instructed each Reserve Bank to make every effort to resolve the matter with the company without resorting to the procedures

outlined in this section. However, if the Reserve Bank is unsuccessful in resolving the matter, it is referred to the Board staff. If the Board staff feels the matter warrants Board consideration, it will recommend that the Board make a preliminary determination of control based on the available facts and so inform the company. (See section 225.31(a).) Following the preliminary determination of control, the company must, within 30 days (or longer as may be permitted by the Board), submit the information required by section 225.31(b).

If the company contests the Board's determination, it is entitled to a formal hearing at its request. (See section 225.31(c).)

Notwithstanding any other provision of the act, a company is not deemed to be a bank holding company by virtue of its control of—

1. ". . . shares [held] in a fiduciary capacity, except as provided in paragraphs (2) and (3) of subsection (g)" (section 2(a)(5)(A) of the act);
2. ". . . shares acquired by it in connection with its underwriting of securities if such shares are held only for such period of time as will permit the sale thereof on a reasonable basis" (section 2(a)(5)(B) of the act);
3. "[a] company formed for the sole purpose of participating in a proxy solicitation if the voting rights of the shares acquired by such company are acquired in the ordinary course of such a solicitation" (section 2(a)(5)(C) of the act);
4. ". . . shares acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition" (section 2(a)(5)(D) of the act);

   (The Board is authorized upon application by a company to extend, from time to time for not more than one year at a time, the two-year period referred to herein for disposing of any shares acquired by a company in the regular course of securing or collecting a debt previously contracted in good faith, if, in the Board's judgment, such an extension would not be detrimental to the public interest, but no such extension shall in the aggregate exceed three years.)
5. ". . . any State-chartered bank or trust company which
   (i) is wholly owned by thrift institutions or savings banks; and
   (ii) is restricted to accepting—
      (I) deposits from thrift institutions or savings banks;
      (II) deposits arising out of the corporate business of thrift insitutions or savings banks that own the bank or trust company; or
      (III) deposits of public moneys." (section 2(a)(5)(E) of the act); and
6. ". . . a single . . . bank, if such . . . company is a trust company or mutual savings bank located in the same State as the bank and if . . . (i) such ownership or control existed on the date of enactment of the Bank Holding Company Act Amendments of 1970 and is specifically authorized by applicable State law, and (ii) the trust company or mutual savings bank does not after that date acquire an interest in any company that, together with any other interest it holds in that company, will exceed 5 percentum of any class of the voting shares of that company, except that this limitation shall not be applicable to investments of the trust company or mutual savings bank, direct and indirect, which are otherwise in accordance with the limitations applicable to national banks under section 5136 of the Revised Statutes (12 U.S.C. 24)" (section 2(a)(5)(F) of the act).

2090.0.6 INSPECTION OBJECTIVES

1. To determine whether any change in control of a bank holding company has resulted in a company (as defined by section 2(b) of the act) becoming a bank holding company in violation of section 3(a)(1) of the act.
2. To ascertain whether an existing bank holding company has acquired either directly or indirectly additional banking assets in violation of section 3(a)(3) of the act.
3. To establish whether a company which has purchased its own stock is in compliance with section 225.4(b) of Regulation Y. (See section 2090.3.)

2090.0.7 INSPECTION PROCEDURES

1. Review the company's stock records and the company's investment portfolio.
2. If there are any subsidiaries that are indirectly owned or controlled as defined in section 2(g) of the act, determine if such shares are held in a trust and, if so, whether the trust agreement contains any provisions that could potentially expose the holding company or any of its subsidiaries to financial or other liabilities.

2090.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Regulation Y		225		
Direct control voting securities				1978 FRB 121
Indirect control as trustee			Ltr. 1/14/76 to W. Lloyd, Chicago Fed Ltr. 10/16/73 to W. Lloyd, Chicago Fed	
Acting through others				1970 FRB 350 1974 FRB 865 1972 FRB 717 1974 FRB 130 1974 FRB 131
Transfer of shares				1974 FRB 875
Rebuttable presumption of control				
• nonvoting stock				1972 FRB 487
• other indicators of control				136 *Fed. Reg.* 18945 (Sept. 24, 1971)
Procedures for determining control			S-2173 (Sept. 17, 1971) (at 4–191.1)	Patogonia vs. BOG 517 F. 2d 803 (9th Cir. 1975)
Nonvoting equity investments by BHCs		225.143		1982 FRB 413

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 2 (o) of the Bank Holding Company Act (the act) (as amended by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996) exempts ''qualified family partnerships'' from the definition of ''company'' in the act.[1] Under this change to the act, a qualified family partnership would be able to own and control a bank holding company without the partnership becoming subject to the registration, source of strength, approval, reporting, or other requirements imposed on a bank holding company.

To qualify for the exemption, a qualified family partnership must have as partners only individuals who are related by blood, marriage, or adoption, or trusts for the primary benefit of those individuals. In addition, the partnership must—

- control any bank through a company that is itself a registered bank holding company subject to all of the provisions of the act;
- control only one registered bank holding company;
- not engage in any business activity except indirectly through ownership of other business entities (that is, the partnership must be an investment vehicle for the family and may not be an operating company);
- limit its investments to those permitted for a bank holding company under section 4 of the act; and
- not be obligated on any debt, either directly or as a guarantor.

Any partnership requesting qualification as a qualified family partnership must commit (1) to be subject to Federal Reserve Board examination to ensure compliance with the conditions for eligibility and (2) to be treated as a bank holding company for purposes of enforcement actions by the Board. In addition, while a qualified family partnership is exempt from the prior-approval requirements of section 3 of the act in connection with a bank acquisition, the partnership continues to be subject to the notice provisions of the Change in Bank Control Act.

As noted above, the primary benefits to becoming a qualified family partnership are (1) exemption from the capital requirements applicable to bank holding companies, (2) exemption from the reporting requirements applicable to a bank holding company, and (3) the freedom to make permissible nonbanking investments without prior Board approval. Because the qualified family partnership must use a single registered bank holding company to hold all of its bank investments, there continues to be a bank holding company subject to the requirements of the act in every case. This structure ensures that the cross-guarantee provisions of the Federal Deposit Insurance Act continue to apply to all banks controlled by a qualified family partnership.

1. Pub. L. 104-2089, section 2610; 110 Stat. 3009.

The Change in Bank Control Act of 1978 (CBC Act), title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, gives the federal bank supervisory agencies the authority to disapprove changes in control of insured depository institutions.[1] The Federal Reserve Board is the responsible federal banking agency for changes in control of bank holding companies and State member banks, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are responsible for insured State nonmember and national banks, respectively.

The CBC Act requires any person (individual, partnership, corporation, trust, association, joint venture, pool, sole proprietorship, unincorporated organization) seeking to acquire control of any insured depository institution or bank holding company to provide 60 days' prior written notice to the appropriate federal banking agency. This requirement applies to all covered transactions that will be consummated after March 9, 1979. The act specifically exempts transactions that are subject to section 3 of the Bank Holding Company Act of 1956 or section 18 of the Federal Deposit Insurance Act, since these transactions are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and changes in control of insured depository institutions resulting from mergers, consolidations, or other similar transactions are not covered by the CBC Act.

The CBC Act describes the factors that the Federal Reserve and the other federal banking agencies are to consider in determining whether a transaction covered by the CBC Act should be disapproved. These factors include the financial condition, competence, experience, and integrity of the acquiring person (or persons acting in concert), the effect of the transaction on competition, the failure to provide all required information, and whether the proposed transaction would result in an adverse effect on the Bank Insurance Fund or the Savings Insurance Fund. The Federal Reserve Board's objectives in its administration of the CBC Act are to enhance and maintain public confidence in the banking system by preventing identifiable serious adverse effects resulting from anticompetitive combinations of interests, inadequate financial support, and unsuitable management in these institutions. The Board will review each notice to acquire control of a state member bank or bank holding company and will disapprove transactions that are likely to have serious harmful effects. It is the Board's intention to administer the CBC Act in a manner that will minimize delays and government regulation of private-sector transactions.

If the Board disapproves a change in control, the Board will notify the proposed acquiring party in writing within three days after its decision. The notice of disapproval will contain a statement of the basis for disapproval. The CBC Act provides that the acquiring party may request a hearing by the Board in the event of a disapproval and provides a procedure for further review by the courts.

Forms for filing notices of proposed transactions covered by the CBC Act are available from the Federal Reserve Banks. When a substantially complete notice is received by the Federal Reserve Bank, a letter of acknowledgement will be sent to the acquiring person indicating the date of receipt. The transaction may be completed 61 days or more after that date unless the acquiring person has been notified by the Board that the acquisition has been disapproved or that the 60-day period has been extended as provided for in subparagraph (j)(1) of the CBC Act. To avoid undue interference with normal business transactions, the Board may issue a notice of its intention not to disapprove a proposal, after consulting the relevant state banking authorities as the CBC Act requires.

2090.1.1 INFORMATION TO BE CONTAINED IN NOTICES

The CBC Act requires a "person" proposing to acquire control of a bank holding company or state member bank to file a notice with the Federal Reserve Board containing personal and biographical information, detailed financial information, details of the proposed acquisition, information on any structural or managerial changes contemplated for the institution, and other relevant information required by the Board.

1. The term "insured depository institution" includes any depository institution holding company and any *other* company which controls an insured depository institution. FIRREA substituted this term for banks in 1989. The CBC Act is found in 12 U.S.C. 1817(j)(1)–(18).

In order to be filed properly in accordance with the act, a notice must be substantially complete and responsive to every item specified in paragraph 6 of the CBC Act. When the acquiring party is an individual, or a group of individuals acting in concert, the requirement for five years' personal financial data is deleted in favor of a current statement of assets and liabilities, a brief income summary, and a statement of any material changes since the date thereof, but the Board reserves the right to require up to five years of financial data from any acquiring person. For complete details on the informational requirements of a change in control, see the System's "Notice of Change in Control" form.

2090.1.2 TRANSACTIONS REQUIRING SUBMISSION OF NOTICE

The CBC Act defines "control" as the power, directly or indirectly, to vote 25 percent or more of any class of voting securities, or to direct the management or policies of a bank holding company or insured depository institution. Therefore, any transaction, unless exempted by the CBC Act, that results in the acquiring party having voting control of 25 percent or more of any class of voting securities or that results in the power to direct the management or policies of such an institution would trigger the notice requirement. However, any person who on March 9, 1979, controls a bank holding company or state member bank shall not be required to file a notice to maintain or increase control positions in the same institution. In addition, the Board's regulations allow persons who on March 9, 1979, fall within a presumption described in the next paragraph to acquire additional shares of an institution without filing notice so long as they will not have voting control of 25 percent or more of the institution. In connection with transactions that would result in greater voting control, such persons may file the required notice or request that the Board make a determination that they already control the institution.

With respect to persons who have the power to vote less than 25 percent of an institution's shares, the Board has established the following rebuttable presumptions for purposes of the notice requirements under the CBC Act:

1. Where a transaction involving any class of voting securities of a bank holding company or state member bank would result in a person (or group of persons acting in concert) having voting control of 10 percent or more, and after the transaction the acquiring person would be the largest shareholder of that institution, the transaction results in control.

2. Where an institution has issued any class of securities subject to registration under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) (Regulation H banks) and a transaction would result in a person (or group of persons acting in concert) having voting control of 10 percent or more of any class of voting securities of that institution, the transaction results in control.

Other transactions resulting in a person's control of less than 25 percent of a class of voting shares of a bank holding company or state member bank would not result in control for purposes of the CBC Act. In addition, customary one-time proxy solicitations and the receipt of pro rata stock dividends are not subject to the CBC Act's notice requirements.

In some cases, corporations, partnerships, certain trusts, associations, and similar organizations that are not already bank holding companies may be uncertain whether to proceed under the CBC Act or under the Bank Holding Company Act with respect to a particular acquisition. These organizations should comply with the notice requirements of the CBC Act if they are not required to secure prior Board approval under the Bank Holding Company Act. However, some transactions, particularly foreclosures by institutional lenders, fiduciary acquisitions by banks, and increases of majority holdings by bank holding companies, described in sections 2(a)(5)(D) and 3(a)(A) and (B) of the Bank Holding Company Act, do not require the Board's prior approval, but they are considered subject to section 3 of the Bank Holding Company Act and, therefore, do not require notices under the CBC Act.

Persons contemplating an acquisition that would result in a change in control of a bank holding company or state member bank should request appropriate forms and instructions from the Federal Reserve Bank in whose district the affected institution is located. If there is any doubt whether a proposed transaction requires a notice, the acquiring person should consult the Federal Reserve Bank for guidance. The act places the burden of providing notice on the prospective acquiring person and substantial civil penalties can be imposed for willful violations.

2090.1.3 CONTROL TRANSACTIONS EXEMPT FROM PRIOR NOTICE REQUIREMENTS

The Board's regulations exempt the following transactions from the prior notice requirements of the Act:

1. A foreclosure of a debt previously contracted in good faith;
2. Testate or intestate succession; and
3. A bona fide gift.

Under these regulations, a person acquiring control in the situations described above is required to furnish certain information to the Federal Reserve Bank promptly after the transaction, and the affected institution must report promptly any changes or replacement of its chief executive officer or of any director, in accordance with paragraph 12 of the CBC Act.

Under these regulations, acquisitions of control of foreign bank holding companies are also exempt from the prior notice requirements of the Act, but this exemption does not extend to the reports and information required under paragraphs 9, 10, and 12 of the CBC Act.

2090.1.4 DISAPPROVAL OF CHANGES IN CONTROL

The CBC Act sets forth various factors to be considered in the evaluation of a proposal. The Board is required to review the competitive impact of the transaction, the financial condition of the acquiring person, and the competence, experience, and integrity of that person and the proposed management of the institution. In assessing the financial condition of the acquiring person, the Board will weigh any debt servicing requirements in light of the acquiring person's overall financial strength, the institution's earnings performance, asset condition, capital adequacy, future prospects, and the likelihood of an acquiring party making unreasonable demands on the resources of the institution.

2090.1.5 ADDITIONAL REPORTING REQUIREMENTS

As mentioned briefly above, paragraph 12 of the CBC Act requires that whenever a change in control of a bank holding company occurs, each insured depository institution is required to report promptly to the approporiate Federal banking agency any changes or replacement of its chief executive officer or of any director occurring in the next twelve-month period, including in its report a statement of the past and current business and professional affiliations of the new chief executive officer or directors.

Paragraph 9 of the CBC Act indicates that whenever any insured depository institution makes a loan secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company), the president or other chief executive officer of the lending bank shall promptly report such fact to the appropriate federal banking agency of the bank (or bank holding company) whose stock secures the loan. However, no report need be made where the borrower has been the owner of record of the stock for a period of one year or more or where the stock is that of a newly organized bank prior to its opening. Reports required by this paragraph shall contain information similar to the informational requirements of the Change in Control Notification form.

2090.1.6 STOCK REDEMPTIONS

A stock redemption by a BHC may result in an existing shareholder(s) then owning 25 percent or more of a class of voting securities which would require the filing of both a change in control and treasury stock notification. Furthermore, a stock redemption by a BHC may result in an existing shareholder(s) then owning between 10 percent and 25 percent of the outstanding shares and also being the largest shareholder thereby resulting in a rebuttable presumption of control. For additional information, see Manual section 2090.3 "Treasury Stock Redemptions."

2090.1.7 CORRECTIVE ACTION

Violations of the CBC Act are addressed through the same type of investigative and enforcement authority, and other formal corrective actions used in other administrative remedies (those specified in 12 U.S.C. 1818(b) through 1818(n)). The CBC Act also authorizes the assessment of civil money penalties for any violation of the CBC Act (see 12 U.S.C. 1817(j)(16)), and allows the Board to seek divestiture of a BHC or bank from any person or company who violates the CBC Act (12 U.S.C. 1817(j)(15)).

2090.1.8 INSPECTION OBJECTIVES

1. To determine that the BHC has complied with the prior notification requirements of the CBC Act and that changes in ownership between 10 percent and 25 percent have been reviewed for "rebuttable presumption" considerations.

2. To determine that the BHC has complied with the reporting requirements of paragraph 12 of the CBC Act regarding changes in its board of directors or its chief executive officer that occur within 12 months of a change in control.

3. To determine that the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act regarding loans made directly by the BHC secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company).

2090.1.9 INSPECTION PROCEDURES

1. Review the BHC's stock certificate register or log to determine if any person (or group of persons acting in concert) has acquired 10 percent or more of any class of voting securities.

2. Review changes in control of between 10 percent and 25 percent of any class of voting securities to determine if the controlling party is the single largest shareholder.

3. When inspecting a BHC which was the subject of a change in control and a prior notification was filed, review the notification to determine that information submitted on management of the BHC is still valid. In cases where changes in directors or the chief executive officer occurred within 12 months of the change in control, determine if the BHC has reported such changes in compliance with paragraph 12 of the CBC Act.

4. When inspecting a BHC which has redeemed any of its own shares subsequent to March 9, 1979, thereby lowering the number of shares outstanding, determine whether the holdings of any individual shareholder has increased proportionally to greater than 10 percent, which might trigger the rebuttable presumption of control which in turn might have required prior notification of a change in control.

5. Review any loans made directly by the BHC that are secured by 25 percent or more of the outstanding shares of a bank (or bank holding company) and determine if the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act.

2090.2.1 FORMATION OF A BANK HOLDING COMPANY AND CHANGES IN OWNERSHIP

The formation of a bank holding company and certain changes in the ownership of banks owned by a bank holding company come under the provisions of section 3 of the BHC Act. Section 3(a)(1) prohibits the formation of a bank holding company without prior Board approval. A company may receive approval pursuant to section 3(a)(1) to become either a one-bank holding company or a multibank holding company.

A primary reason for the formation of a one-bank holding company is to obtain income tax benefits.[1] These benefits include offsetting operating/capital losses of one corporation against the profits/capital gains of another.

Once a company becomes a bank holding company, either by the formation of a one-bank or multibank holding company, section 3(a)(3) of the act prohibits the direct or indirect acquisition of over 5 percent of any additional bank's or bank holding company's shares without prior Board approval. In addition to the above, section 3(a)(3) serves to prevent, without prior Board approval, an existing bank holding company from increasing its ownership in an existing subsidiary bank unless greater than 50 percent of the shares is already owned (section 3(a)(B)). A bank holding company which owns more than 50 percent of a bank's shares may buy and sell those shares freely without Board approval, provided the ownership never drops to 50 percent or less. If a bank holding company owns 50 percent or less of a bank's shares, prior Board approval is required before each additional acquisition of shares takes place until the ownership reaches more than 50 percent.

1. A corporation is entitled to a special deduction from gross income for dividends received from a taxable domestic corporation. There is (1) a 70 percent deduction for dividends received from a corporation that is less than 20 percent owned; (2) an 80 percent deduction for dividends received from a corporation that is 20 to less than 80 percent owned; (3) a 100 percent deduction for dividends received from members of the same affiliated group (i.e., a corporation that is 80 percent or more commonly owned); and (4) a 100 percent deduction for dividends received from small business investment corporations. There is also an overall limitation on dividends received. The recipient's aggregate amount is limited to 70 percent (80 percent for those corporations that are 20 to less than 80 percent owned) of taxable income. The manner in which the deduction is computed is also subject to further limitation.

2090.2.2 HISTORY OF APPLYING THE CAPITAL ADEQUACY GUIDELINES TO THE POLICY STATEMENT ON THE FORMATION OF SMALL BANK HOLDING COMPANIES

On March 28, 1980, the Board issued a policy statement with regard to the formations of small one-bank holding companies. The policy statement was included with the revision of Regulation Y (12 C.F.R. 225, appendix C) on January 5, 1984. Subsequent to this policy statement, capital adequacy standards were adopted for large multibank holding companies (on a consolidated basis[2]) in December 1981 (amended in June 1983, April 1985, and November 1986) that set minimum capital levels and capital zones relating to primary and total capital.[3] These were replaced in January 1989 (amended in October 1991) by the current minimum capital adequacy standards that use the risk-based capital and leverage capital measures.

Typically, a small bank holding company's capital position has not been evaluated on a consolidated basis. The evaluation of applications of small bank holding company formations for capital adequacy initially followed an 8 percent gross capital to total assets standard.[4] Subsequently, the 1981 guidelines established minimum 5.5 percent primary and 6.0 percent total capital ratios and the concept of capital zones above the minimum capital ratios. When analyzing bank capital for small bank holding company formations, December 1981's 7 percent (zone 1) total capital to assets leverage ratio (after adjusting for the addition of the allowance for loan and lease losses to the ratio's numerator and denominator) became the financial equivalent of 1980's 8 percent gross capital standard. For the bank, the change resulted in evaluating applications for capital adequacy based on a 7 percent total capital to total assets

2. Capital adequacy is evaluated on a bank-only basis for small bank holding companies.

3. Primary capital included common stockholders' equity, contingency and other capital reserves, the allowances for loan and lease losses, and the minority interest in the equity accounts of consolidated subsidiaries. It also included limited amounts of perpetual preferred stock, mandatory convertible securities, and perpetual debt.

4. The allowance for loan and lease losses was not added back to total assets. In other words, the ''total assets'' were net of the allowance for loan and lease losses, a contra asset.

ratio. Since most small banks did not have qualifying secondary capital, the practical effect of the change was that both the zone 1 primary and total capital ratios were at least 7 percent. In September 1990, a minimum tier 1 leverage ratio became effective. A tier 1 to total assets leverage ratio of 6 percent was applied as the financial equivalent of the former 7 percent total capital ratio.

Even though the components of the various capital ratios have changed over time, the capital standards used to evaluate capital positions of banks for small bank holding formations have not. The fundamental policy is still the same. In both instances, approximately the same percentage of small banks meets both ratios. It also should be noted that, if at any time, state or federal banking authorities or loan agreements require the banks of small bank holding company formations to satisfy higher capital standards, those standards will be used when evaluating capital adequacy.

Effective April 21, 1997, revisions to Regulation Y included revisions to the Board's one-bank holding company policy statement. The policy statement was revised to generalize its applicability beyond the formation of a bank holding company to include acquisitions by qualifying small bank holding companies. The policy statement incorporates previous informal policies that have evolved since the original publication of the statement. It also provides for streamlined processing of proposals that result in parent company debt-to-equity of less than 1.0 to 1 for small bank holding companies that are "well managed" and "well capitalized."

2090.2.3 SMALL BANK HOLDING COMPANY POLICY STATEMENT

In acting on applications filed under the act, the Board follows the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely on the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect on the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company level impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank or banks, and, in some cases, the servicing requirements on such debt may be a significant drain on the bank's resources. For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board therefore has permitted the formation and expansion of small bank holding companies with debt levels that are higher than what would be permitted for larger bank holding companies. Approval of these applications has been given on the condition that the small bank holding companies demonstrate the ability to service the acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary bank within a relatively short period of time.

In the interest of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has adopted the procedures and standards for the formation and expansion of small bank holding companies subject to the small bank holding company policy statement.

The policy focuses on the relationship between debt and equity at the parent holding company. The holding company has the option of improving the relationship of debt-to-equity by repaying the principal amount of its debt or through the retention of earnings, or both. Under these procedures, newly organized small one-bank holding companies are expected to reduce the relationship of their debt-to-equity over a reasonable period of time to a level that is comparable to that maintained by many large and multibank holding companies.

In general, this policy is intended to apply only to bank holding companies with pro forma consolidated assets of less than $150 million that (1) do *not* have significant leveraged nonbank activities and (2) do *not* have a significant amount of outstanding debt that is held by the general public. Although the policy statement applies to the formation of small bank holding companies, it also applies to existing bank holding companies that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions. The criteria are described below.

In evaluating applications filed pursuant to section 3(a)(1) of the act, as amended, when the applicant intends to incur debt to finance the

acquisition of a small bank, the Board will take into account a full range of financial and other information, including the recent trend and stability of earnings of the bank, prospective growth of the bank, asset quality, the ability of the applicant to meet debt-servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the minimum requirements set forth below. As a general rule, failure to meet any of these requirements will result in denial of an application; however, the Board reserves the right to make exceptions if the circumstances warrant.

1. *Minimum down payment.* The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incur debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the bank holding company, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank(s) or bank holding company.
2. *Maintenance of adequate capital.* Each insured depository subsidiary of a small bank holding company is expected to be well capitalized. Any institution that is not well capitalized is expected to become well capitalized within a brief period of time.
3. *Reduction in parent company leverage.* Small bank holding companies are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board expects these bank holding companies to reach a debt-to-equity ratio of .30 to 1 or less within 12 years after incurrence of the debt. The bank holding company must also comply with debt-servicing and other requirements imposed by its creditors.

   The term "debt," as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds. The term "equity," as used in the ratio of debt to equity, means total stockholders' equity of the bank holding company as defined in accordance with generally accepted accounting principles.[5] In determining the total amount of stockholders' equity, the bank holding company should account for its investments in the common stock of subsidiaries by the equity method of accounting.

   Ordinarily, the Board does not view redeemable preferred stock as a substitute for common stock in a small bank holding company. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) the preferred stock is redeemable only at the option of the issuer, and (2) the debt-to-equity ratio of the holding company would be at or remain below 30 percent following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.
4. *Dividend restrictions.* The bank holding company is not expected to pay any corporate dividends on common stock until such time as its debt-to-equity ratio is at 1.0 to 1 or less and it otherwise meets the requirements in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y. However, some dividends may be permitted, provided all of the following conditions are met: the dividends are (1) reasonable in amount, (2) do not adversely affect the ability of the bank holding company to service its debt in an orderly manner, and (3) do not adversely affect the ability of the subsidiary banks to be well capitalized.[6] Also, it is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt-to-equity ratio be reduced to 30 percent within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

5. Goodwill is defined as the excess of cost of any acquired company over the sum of the fair market values assigned to identifiable assets acquired less the fair market values of the liabilities assumed, in accordance with generally accepted accounting principles.

6. For bank holding companies with consolidated assets under $150 million, "well-capitalized" means that the bank holding company maintains a total risk-based capital ratio of 10.0 percent or greater and a tier 1 risk-based capital ratio of 6.0 percent or greater, and it is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board to meet and maintain a specific capital level for any capital measure.

2090.2.4 CAPITAL CONSIDERATIONS IN SMALL MULTIBANK AND CHAIN BANK HOLDING COMPANY APPLICATIONS

Multibank holding companies and chain banking organizations (whether or not the chain members are banks or bank holding companies) with less than $150 million in combined assets that meet certain conditions will not be consolidated or combined for capital adequacy purposes. Rather, such organizations will be analyzed in the context of the standards described in the Board's policy statement on small bank holding companies (appendix C of Regulation Y) discussed previously in this section. A bank holding company application that seeks to expand a small bank holding company with or without creating or expanding a chain controlling assets of less than $150 million would be evaluated on the basis of the policy statement in the same manner as if the proposed bank holding company was not part of a chain.

The above application would be evaluated on the basis of the financial and managerial condition of the entire organization. Although the policy statement would generally be applied, the focus of the analysis would be as much on the organization as an operating entity as on the instant proposal. For example, it would be expected that the condition of the applicant organization and that of its subsidiaries would be consistent with expansion, one aspect of which is that each banking subsidiary generally would be expected to maintain capital well above the minimum levels. The policy statement would generally govern the payment of dividends by the applicant organization and any prospective use of preferred stock. The bank to be acquired would be expected to maintain above-minimum capital ratios consistent with those contemplated by the Board's capital adequacy guidelines.

An acquisition debt retirement period would apply with respect to each proposal and the acquisition debt/purchase price ratio limitation of 75 percent would generally apply to the instant application. A specific parent only debt/equity limit would not be applied. However, it would be expected that the ratio would decline over time.

In addition, the financial and managerial condition of the members of any chain thereby formed or expanded (including compliance considerations and general consistency with the capital adequacy guidelines, giving consideration to the need to maintain capital positions well above the minimum ratios) would be evaluated. The chain would not have to meet a specific combined, parent only debt/equity standard. However, there would be a general presumption that the debt/equity level of the chain would tend to decline after the initial leveraged approval. Although individual bank holding companies might be leveraged up to 3 to 1, over time the combined leverage of the chain would tend to be less than this level through increases in the equity or reductions in the debt of the organization. Proposals by banking organizations whose combined banking assets exceed $150 million would be evaluated for capital adequacy on the basis of an analysis of the consolidated organization. (The term "consolidated" as used with the analysis of large chains would involve actually consolidating each parent bank holding company with its subsidiary (or subsidiaries), and then combining each such consolidated entity as well as any other bank in the chain). An analysis of the capital adequacy of each constituent entity in a large banking organization would also continue to be assessed to determine whether the holding company would serve as a source of strength to its subsidiary banks.

2090.2.5 INSPECTION OBJECTIVE

To determine compliance with all commitments made in the application/notification process.

2090.2.6 INSPECTION PROCEDURE

Review all commitments made by the company and its shareholders to determine compliance therewith.

2090.2.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Capital adequacy guidelines Regulation Y—appendixes A and D		225	4–797 4–798 4–855	
Small BHC policy statement—appendix C			4–856	1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

"Bootstrapping" is the term generally used to describe a treasury stock transaction in which a company incurs debt to purchase or redeem its own outstanding shares. Bootstrapping is often used to facilitate a change in control whereby a shareholder or shareholder group need only buy few or no shares in order to gain control. The repurchase or redemption is often made in accordance with a written agreement made between a former controlling shareholder(s) and the new controlling shareholder(s).

Section 225.4(b) of Regulation Y requires a bank holding company to file prior written notice with the Board before a purchase or redemption of any of its own equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. (Net consideration is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period other than as a part of a new issue.)

Each notice shall furnish the following information:

- The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms of any debt incurred in connection with the transaction.
- A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions.
- A current and pro forma consolidated balance sheet if the bank holding company has total assets of over $150 million, or a current and pro forma parent-company-only balance sheet if the bank holding company has total assets of $150 million or less.

2090.3.1 CHANGE IN CONTROL ACT CONSIDERATIONS

As indicated earlier, treasury stock redemptions are often intended to facilitate a change in control of a bank holding company. By redeeming the shares held by an existing shareholder(s), the remaining shareholder(s) increases his proportionate ownership. If a "person's" share ownership should rise above 25 percent or more of the remaining outstanding shares (subsequent to March 9, 1979), that person would then "control" the BHC. Under these circumstances, a change in control notification would have to be filed. If the treasury stock redemption is for an amount sufficient to trigger the requirement for a prior notification of redemption, then dual notifications are called for (change in control and redemption of treasury shares).

Similarly, prior notification is also required if a treasury stock redemption should result in a shareholder's holdings rising to between 10 percent and 25 percent of the remaining outstanding shares, and if (a) that shareholder is the firm's largest single shareholder immediately after the acquisition; or (b) the institution is registered under section 12 of the Securities Exchange Act of 1934 (i.e., corporations having assets exceeding $1 million, more than 500 shareholders, and securities that are publicly traded). For additional information on change in control notification requirements, see section 2090.1.

Additional notices under the CIBC Act do not have to be filed if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a bank holding company, and subsequent treasury stock redemptions resulted in ownership of between 10 and 25 percent of the shares of the bank holding company. Refer to section 225.41(a)(2) of Regulation Y.[1]

2090.3.2 INSPECTION OBJECTIVES

1. To determine that a BHC that has redeemed shares of its own stock has complied with section 225.4(b) of Regulation Y.

2. To determine that any new controlling shareholder of a BHC that has redeemed shares of its own stock has complied with section 225.41(a) of Regulation Y.

3. To determine if a treasury stock transaction has taken place for the purpose of depleting the original 25 percent equity investment in the purchase price.

1. Revised by the Board, effective November 9, 1990.

2090.3.3 INSPECTION PROCEDURES

1. Review the BHC's reconcilement of stockholders' equity to determine if shares have been redeemed.
2. If shares have been redeemed, review for compliance with treasury stock redemption approval and reporting requirements.
3. Determine whether the BHC is using, repeatedly, the less than 10 percent ownership exemption to avoid notice requirements, thus undermining the capital position of the banking organization, resulting in an unsafe and unsound practice.
4. Determine if the less than 10 percent ownership exemption is being used by the bank holding company when it does not satisfy the requirements of the Board's capital guidelines for redemptions.

   The exemption should not be used by a bank holding company that does not meet the Board's capital guidelines for redemptions. Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Use of the exemption could significantly reduce its capital. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.

   The exemption should not be used by a small one-bank holding company if it would increase its debt-to-equity ratios significantly above those relied on by the Board in approving its application to become a bank holding company.
5. If shares have been redeemed, determine if any shareholder's holdings have risen to 25 percent or more of the outstanding shares.
6. If shares have been redeemed, determine if any shareholder's holdings have risen to between 10 percent and 25 percent of the outstanding shares. Furthermore, determine whether the shareholder is then the largest shareholder or the institution has registered securities under section 12 of the Securities Exchange Act of 1934.
7. If a stock redemption occurred recently in a bank holding company, determine if the shareholders have maintained a 25 percent equity investment.

On July 8, 1982, the Board issued a policy statement setting forth its concerns and providing guidance with respect to investments by bank holding companies in nonvoting shares of other bank holding companies or banks (refer to F.R.R.S. 4–172.1, 1982 FRB 413, and 12 C.F.R. 225.143). The statement notes considerations the Board will take into account in determining whether such investments are consistent with the Bank Holding Company Act, and describes the general scope of arrangements to be avoided in these agreements. The Board's statement was occasioned by the fact that a number of bank holding companies have made substantial equity investments in banks or bank holding companies located across state lines, in expectation of statutory changes that might make interstate banking permissible. The following is the text of the Board's statement:

In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the "acquiree") located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the "Act"), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

2090.4.1 STATUTORY AND REGULATORY PROVISIONS

Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 percent of the voting shares of a bank without the Board's prior approval (12 U.S.C. Para. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: that is, in the words of the statute, "for any action to be taken that causes a bank to become a subsidiary of a bank holding company" (12 U.S.C. Para. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

1. The company directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting shares of the bank;
2. The company controls in any manner the election of a majority of the board of directors of the bank; or
3. The Board determines, after notice and opportunity for hearing that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank (12 U.S.C. Para. 1841(d)).

In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to "acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank" (12 U.S.C. 1842(d)(1)).

2090.4.2 REVIEW OF AGREEMENTS

In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 percent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

1. Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);
2. Merger or asset acquisition agreements

with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;

3. Provisions that limit or restrict major policies, operations or decisions of the acquiree; and
4. Provisions that make acquisitions of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

After a careful review of a number of these arrangements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities (12 C.F.R. Para. 225.31(d)(2).

Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[1] Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

2090.4.3 PROVISIONS THAT AVOID CONTROL

In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

As a first step towards avoiding control, covenants in any agreement should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to "call" the equity investment and options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

A measure to avoid problems of control aris-

1. See Board letter dated March 18, 1982, to C.A. Cavendes, Sociedad Financiera.

ing through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of those rights if the right of first refusal is not exercised.

In this connection, the Board believes that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreement involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control. These are:

1. Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 percent of the voting shares of the acquiree;
2. Agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and
3. The acquisition of more than 5 percent of the voting shares of the acquiree that "simultaneously" with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

2090.4.4 REVIEW BY THE BOARD

This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

Pursuant to Section 3 of the Bank Holding Company Act, a bank holding company, directly or through its subsidiary banks, may not acquire more than 5 percent of the shares of an additional bank without the Board's prior approval. However, it is recognized that banks acting as trustee may acquire such shares without prior notice. Therefore, the Act requires a bank or banks which are subsidiaries of bank holding companies and acquire in excess of the 5 percent threshold limit, to file an application with the Board within 90 days after the shares exceeding the limit are acquired. The limit generally applies *only* to other bank shares over which the acquiring fiduciary exercises sole discretionary voting authority. Nevertheless, the Board has waived this application requirement under most circumstances in Section 225.12 of Regulation Y, unless—

1. the acquiring bank or other company has sole discretionary authority to vote the securities and retains the authority for more than two years; or
2. the acquisition is for the benefit of the acquiring bank or other company, or its shareholders, employees, or subsidiaries.

In determining whether the threshold limits have been reached, shares acquired prior to January 1, 1971 can ordinarily be excluded. On the other hand, shares of another bank held under the following circumstances should, in certain instances, be included in the 5 percent threshold, even though sole discretionary voting authority is not held:

1. Shares held by a trust which is a "company", as defined in Section 2(b) of the Bank Holding Company Act; and,
2. Shares held as trustee for the benefit of the acquiring bank or bank holding company, or its shareholders, employees or subsidiaries.

A bank holding company should have procedures for monitoring holdings of the stock of other banks and bank holding companies for compliance with the foregoing application requirements of the Act, for compliance with reporting requirements on form Y–6, and for compliance with certain similar reporting requirements under the federal securities laws. A general 5 percent threshold applies in all three situations, although differing requirements and exemptions apply.

Examiners specifically trained in trust examinations may need to conduct this portion of an inspection and, in appropriate circumstances, the examiner may need to consult with Federal Reserve Bank legal counsel. Trust examiners routinely review such matters in connection with individual trust examinations. The inspection objectives will be to determine whether the holdings of shares of other banks or bank holding companies, in a fiduciary capacity, are appropriately monitored to comply with section 3(a) of the Bank Holding Company Act with other reporting requirements for such holdings.

The spin-off or sale of property by a bank holding company may not sever the bank holding company's control relationship over such property for purposes of the Bank Holding Company Act. The factors which are normally considered in determining whether control has ceased include the presumptions of control listed in section 225.31(a) of Regulation Y and in sections 2(a)(2) and 2(g) of the Act, and certain ownership and voting rights.

Most of the irrebuttable and rebuttable presumptions of control were written to establish initially a control relationship between two companies. Only the provisions of section 2(g)(3) relate solely to a continued control relationship after an attempt has been made to end that control. However, all of the presumptions of control must be considered before presuming that a divestiture is effective. Irrebuttable control relationships are established, or continue to be recognized, when any of the conditions listed in section 225.2(e) of Regulation Y or sections 2(a)(2)(A), 2(a)(2)(B), 2(g)(1), or 2(g)(2) of the Act exist. Thus, a company is assumed to have irrebuttable control over a bank or another company without a Board determination if:

1. The company directly or indirectly owns, controls, or has power to vote 25 percent or more of the voting securities of the bank or other company;
2. The company controls in any manner the election of a majority of the directors or trustees of the bank or other company;
3. Trustees directly or indirectly hold or control shares of the bank or other company for the benefit of the company, the shareholders or members of the company, or the employees of the company.

Rebuttable presumptions of control are listed in section 225.31(d) of Regulation Y and in sections 2(a)(2)(C) and 2(g)(3) of the Act. These sections describe situations which are not as clearly defined as the irrebuttable presumptions. For example, a company which enters into a management contract that gives the company significant control over the operations or management of a bank or other company may be deemed to exercise a controlling influence over that bank or other company. Section 225.31(c) of Regulation Y and section 2(a)(2)(C) of the Act require a Board determination to establish that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or other company. Thus, it is assumed that no control exists unless the Board determines that it does. Section 2(g)(3) of the Act, however, is "automatic" in the sense that an effective control relationship is assumed to continue without the need for a determination by the Board if certain conditions are met. This presumption is "rebuttable" because, at the request of the company, the Board later may determine that the control relationship in fact does not exist.

Section 2(g)(3) was added to the Act with the 1966 Amendments to provide the Board with an opportunity to consider the consequences of a transfer before it is deemed to be effective. It states that:

> "shares transferred after January 1, 1966, by any bank holding company (or by any company which, but for such transfer, would be a bank holding company) directly or indirectly to any transferee that is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor, shall be deemed to be indirectly owned or controlled by the transferor unless the Board, after opportunity for hearing, determines that the transferor is not in fact capable of controlling the transferee."

Section 2(g)(3) contains the factors most commonly cited as reasons for a control determination; i.e., the purchaser is indebted to the divesting company or has officers or directors in common with the divesting company. If the transferee is indebted to or has personnel in common with the transferor, an effective control relationship is assumed to continue at the date of the transfer without the need for an order or a determination by the Board. Control will continue to be presumed until either the condition causing the presumption is removed or the Board determines, that "the transferor is not in fact capable of controlling the transferee."

Although section 2(g)(3) refers to transfers of "shares" it is not limited to the disposition of corporate stock, but includes any transfer of a "significant volume of assets." Thus, when the transfer constitutes the disposition of all or substantially all of the assets of a subsidiary or a separate activity of the company, it is deemed to represent a transfer of "shares." General or limited partnership interests are included in this definition. A determination of whether the vol-

ume of assets transferred is ″significant'' will be made on an *ad hoc* basis. Included in the definition of ''shares'' are shares or other assets acquired in satisfaction of a debt previously contracted, or acquired as an incident to an essentially separate transaction.

The term ''transferor'' includes the bank holding company, its parent, and its subsidiaries. Likewise, ''transferee'' includes the parent and subsidiaries of any company to which assets are transferred. Thus, when the transferee, its parent, or its subsidiary is indebted to or has common personnel with the transferor, its parent, or its subsidiary, a presumption under section 2(g)(3) arises. For example, if a subsidiary of the transferee is indebted to the parent of the transferor, the presumption arises.

The term ''transferee'' has been interpreted also to include individuals. Thus, if property is transferred to an individual who holds a position with or is indebted to the transferor, its parent, or its subsidiaries, the presumption arises.

The indebtedness to which section 2(g)(3) refers may be debt incurred in connection with the transfer, or pre-existing debt. For instance, if a bank holding company transfers to an outside individual a subsidiary to which it had made a working capital loan, the presumption of control arises as a result of that debt. Although a presumption arises even when the debt was previously in existence, this factor may not be viewed as an indication of control in determinations pursuant to section 2(g)(3).

The statutory presumption of control in section 2(g)(3) will not apply in certain cases if the indebtedness of the transferee to the transferor or a subsidiary involves certain routine loans to companies (as defined in section 2(b) of the Act) in an aggregate amount not exceeding 10 percent of the total purchase price of the transferred asset; or certain personal loans to an individual such as a credit card balance, student loan or home mortgage loan. Such loans must have been made on normal terms in the ordinary course of business, and may not be secured by the transferred asset.

The phrase ''officers, directors, trustees, or beneficiaries'' has been interpreted to include policy-making employees or consultants, general partners in a partnership, or limited partners having a right to participate in management, and any person who performs (directly or through an agent, representative, or nominee) functions comparable to those normally associated with the foregoing offices or positions. The presumption is valid even if the position is held in an honorary or advisory capacity. The presumption is also valid even if the person involved does not hold the same type of position with the transferor as with the transferee or the transferred company. For example, if a bank holding company sells assets to a trust whose trustee is an officer of the holding company, the presumption is applicable.

When a divestiture takes place through the distribution of shares, quite often officers and directors will receive a portion of the shares. Because these individuals are considered to be transferees and because they are officers or directors of the transferor, a presumption of control under section 2(g)(3) results. However, the presumption will be of legal significance only when the shares subject to this presumption constitute more than 5 percent of the voting stock of a nonbanking company or 25 percent or more of the voting stock of a bank (5 percent if the transferor continues to be a bank holding company without reference to the shares transferred).

Finally, section 2(g)(3) provides that a Board determination will be made after opportunity for hearing. When the Board's General Counsel, acting under delegated authority, has determined that a control situation does continue to exist, the case will be referred to the Board for a decision and an opportunity for hearing will be made through publication of a notice in the *Federal Register.*

In addition to the review of the applicability of each of the conclusive and rebuttable presumptions of control, a review of certain ownership and voting rights will be made before a divestiture is considered effective. Generally, the Board has not regarded a divestiture of holdings of voting shares to less than 25 percent, but more than 5 percent, as effective though in most cases an acquisition of less than 25 percent of a company would not result in that company being regarded as a subsidiary. This policy pertains because the retention of such an economic interest in such a company could provide an incentive for the transferor to influence the management of the company. However, the reduction of ownership to less than 5 percent of the outstanding voting stock of a company usually is considered to be an effective divestiture. In addition, due to its continuing economic interest, a bank holding company cannot effectively divest of a company by converting its holdings of the company's voting shares to nonvoting shares or by agreeing not to vote the shares.

2090.6.1 INSPECTION OBJECTIVES

1. To determine whether or not the divesting company retained a significant voting or ownership interest in the divested property.
2. To determine whether section 2(g)(3) of the Act or any of the rebuttable presumptions of control listed in section 225.31(d) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.
3. To determine whether section 2(g)(2) of the Act or any of the other irrebuttable presumptions of control listed in section 225.2(e) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.

2090.6.2 INSPECTION PROCEDURES

The examiner should review the stock records of the transferor, the transferee, and the transferred entity, if possible. Management contracts, trust agreements, and any pertinent agreements among these parties also should be reviewed for any evidence of a control relationship. When following these procedures for a bank holding company which has divested or will divest of property, the examiner should be aware that the criteria for establishing a continuing control relationship are more stringent than those for establishing an initial control relationship. Thus, the examiner should review all ownership and voting rights rather than just those above 5 or 25 percent.

The examiner should review the records of the bank holding company, its parents, and its subsidiaries as well as the records of the company being divested and the company (and its parent and subsidiaries) acquiring the divested property for evidence of a continuing control relationship as described in section 2(g)(3) of the Act. If the transferee is an individual or if the records of the transferee are not available, the examiner should inquire whether any of the specific control relationships exist. Specifically, the examiner should determine whether the transferee, its parent, or its subsidiaries, are indebted to or have common personnel (officers, directors, trustees, beneficiaries, policy making employees, consultants, etc.) with the transferor, its parent, or its subsidiaries.

2090.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Presumptions of control	Sections 2(g)(1) and 2(g)(2) of the act	225.31(a) 225.139		
Statement of policy concerning divestitures		225.138		
Divestiture proceedings		225.32		
Rebuttable presumptions of control	Section 2(g)(3) of the act	225.31(d) 225.139		
Requirements placed on transferee and transferor to ensure a complete separation				Alfred I. duPont Testamentary Trust; September 21, 1977
Control is not terminated if a rebuttable presumption of control is applicable				Alfred I. duPont Testamentary Trust; October 3, 1977
Explanation of "transferor," "transferee," "shares," and procedures		225.139(c)(1)		1978 FRB 211

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
"Transferee" includes individuals		225.139 (footnote 4)		Summit Home Insurance Company, Minneapolis, Minnesota; August 30, 1978 The Moody Foundation, Galveston, Texas; January 16, 1968
Presumption of control through common directors, officers, etc.		225.139		GATX Corporation, Chicago, Illinois; February 21, 1978
Reduction of ownership to less than 5 percent of a subsidiary is an effective divestiture				Financial Securities Corporation, Lake City, Tennessee; August 29, 1972
Individual may be a transferee; an insignificant debt relationship may exist		225.139		Mercantile National Corporation, Dallas, Texas; June 2, 1975
Control terminated although shares were pledged as collateral on a note representing part of purchase price				Equimark Corporation, Pittsburgh, Pennsylvania; February 4, 1977
Application to retain control pursuant to rebuttable presumption; approved, but company not authorized to acquire additional shares				First Bancorp, Inc., Dallas, Texas; February 22, 1977
Application to divest control pursuant to rebuttable presumption; approved				Commanche Land and Cattle Company, Commanche, Texas; January 15, 1980
Indebtedness of transferee to transferor		225.139(c)(4)		1980 FRB 237

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2090.7.1 CEBA AND FIRREA PROVISIONS FOR NONBANK BANKS

The Competitive Equality Banking Act (CEBA), effective August 10, 1987, amended section 2(c) of the BHC Act by expanding the definition of "bank" to include all FDIC-insured depository institutions. The definition also includes any other institution that (1) accepts demand deposits or other deposits that the depositor may make payable to third parties ("demand deposits") and (2) is engaged in the business of making commercial loans. The new definition covers institutions that were not previously covered by the BHC Act ("nonbank banks"). Thrift institutions that remain primarily residential mortgage lenders continue to be excepted from the definition of "bank."

CEBA amended section 4 of the BHC Act by adding a grandfather provision that permits a nonbanking company that on March 5, 1987, controlled an institution that became a bank under CEBA to retain the institution and not be treated as a bank holding company. A grandfathered company will lose its exemption, however, if it violates any of several prohibitions governing its activities. Among these prohibitions, a grandfathered company may not acquire control of an additional bank or a thrift institution or acquire more than 5 percent of the assets or shares of an additional bank or thrift.[1] In addition, no bank subsidiary of the grandfathered company may commence to accept demand deposits and engage in the business of making commercial loans. A bank subsidiary of the grandfathered company also may not permit an overdraft[2] (including an interday overdraft) or incur an overdraft on behalf of an affiliate[3] at a Federal Reserve Bank.[4]

If a grandfathered company no longer qualifies for an exemption, the company must divest control of all the banks it controls within 180 days after the date that the company receives notice from the Board that it no longer qualifies for the exemption. The exemption may be reinstated if, before the end of the 180-day notice period, the company (1) corrects the condition or ceases the activity that caused its exemption to end or submits a plan to the Board for approval to correct the condition or cease the activity within one year, and (2) implements procedures reasonably adapted to avoid a recurrence of the condition or activity.

The Board may examine and require reports of grandfathered companies and of the nonbank banks they control, but only to monitor or enforce compliance with the grandfather restrictions. The Board also may use civil enforcement powers, including cease-and-desist orders, to enforce compliance.

Grandfathered companies, their affiliates, and their nonbank banks also are subject to the anti-tying restrictions of the BHC Act and to the insider-lending restrictions of section 22(h) of the FRA and in Regulation O. Thus, for example, a nonbank bank may not condition a grant of credit on the purchase of a product or service from its grandfathered holding company, or vice versa, and it may not extend credit to insiders of the nonbank bank or its grandfathered holding company on preferential terms.

A bank holding company that controls a nonbank bank may retain it as long as the nonbank bank does not (1) engage in an activity[5] that

1. An exception to this prohibition is made for cases involving the acquisition of a failing thrift provided that (1) the thrift is acquired in an emergency acquisition and is either located in a state where the grandfathered company already controls a bank or has total assets of $500 million or more at the time of the acquisition; or (2) the thrift is acquired from the RTC, FDIC, or director of the OTS in an acquisition in which federal or state authorities find the institution to be in danger of default.

2. Section 225.52 of Regulation Y further defines the restrictions on overdrafts.

3. Section 225.52(b)(2)(ii) of Regulation Y provides that a nonbank bank (or industrial bank) incurs an overdraft on behalf of an affiliate when (1) the nonbank bank holds an account at a Federal Reserve bank for an affiliate from which third-party payments can be made, and (2) the posting of an affiliate's transactions to the nonbank bank's or industrial bank's account creates an overdraft or increases the amount of an existing overdraft in the account.

4. The overdraft prohibition does not apply if the overdraft (1) results from an inadvertent computer or accounting error that is beyond the control of both the bank and the affiliate; (2) is permitted or incurred on behalf of an affiliate that is monitored by, reports to, and is recognized as a primary dealer by the Federal Reserve Bank of New York and is fully secured, as required by the Board, by direct U.S. obligations, obligations fully guaranteed as to principal and interest by the United States, or securities or obligations eligible for settlement by the Federal Reserve book-entry system; or (3) is permitted or incurred by or on behalf of an affiliate in connection with an activity that is financial in nature or incidental to a financial activity and does not cause the bank to violate any provision of sections 23A or 23B of the Federal Reserve Act directly or indirectly or by virtue of section 18(j) of the Federal Deposit Insurance Act.

5. Previously, a nonbank bank could accept demand deposits *or* engage in the business of making commercial loans, but could not engage in both activities.

would have caused it to be a bank before the effective date of CEBA, or (2) increase the number of locations from which it does business after March 5, 1987. These limitations do not apply if (1) the nonbank bank is viewed as an additional bank subsidiary of the bank holding company, and (2) the BHC's acquisition of the nonbank bank would be permissible under the interstate banking provisions of the BHC Act.

2090.7.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Limitations on nonbank banks		225.52		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), effective August 9, 1990, provided [12 U.S.C. 1815 (e)] that any insured depository institution will be liable for any actual or reasonably anticipated loss incurred or to be incurred by the FDIC in connection with:

1. The default of a commonly controlled[1] depository institution; or
2. Any assistance provided by the FDIC to any commonly controlled insured depository institution.

2090.8.1 FIVE YEAR PROTECTION FROM LIABILITY (5-YEAR TRANSITION RULE)

Sister banks, for five years from the enactment of the law, are protected against losses due to the default of a thrift acquired before enactment. The law also grants a five- year protection to thrifts for loss due to the default of a bank acquired before the law's enactment.

2090.8.2 CROSS-GUARANTEE PROVISIONS

FIRREA contains cross-guarantee provisions. These provisions enable the FDIC to obtain reimbursement from insured depository institutions, in the event that the FDIC incurs a loss due to any assistance provided to, or a default of, a commonly controlled bank or thrift.

The FDIC will provide written notice when an insured depository institution is being held liable for losses sustained by the FDIC in connection with assistance to a commonly controlled bank or thrift. Upon receipt of the written notice from the FDIC, the insured depository institution is required to pay the amount specified. An insured depository institution is not liable for losses incurred by the FDIC, in connection with a commonly controlled institution, if the written notice is not received within two years from the date of the FDIC's loss.

The liability the insured depository institution has to the FDIC is senior to shareholders' claims and any obligation or liability owed to any affiliate of the depository institution.[2] Claims of the FDIC against the depository institution are subordinate to any deposit liabilities, secured obligations and obligations that are subordinated to depositors (i.e. subordinated debt).

The FDIC may grant an insured depository institution a waiver of the cross-guarantee provisions, if it determines that such an exemption is in the best interests of the either the Bank or Savings Association Insurance Funds. Limited partnerships and affiliates of limited partnerships (other than an insured depository institution, which is a majority owned subsidiary of such partnership) may also be exempted from the provisions, if the limited partnership or its affiliate has filed a registration statement with the Securities and Exchange Commission, on or before April 10, 1989. The registration statement must indicate that as of the date of the filing, the partnership intended to acquire one or more insured depository institutions. If an insured depository institution is granted an exemption from the cross-guarantee provisions, then the institution and all of its insured depository institution affiliates must comply with the restrictions of sections 23A and 23B of the Federal Reserve Act without regard to section 23A(d)(1) which provides for certain exemptions.

2090.8.3 EXCLUSION FOR INSTITUTIONS ACQUIRED IN DEBT COLLECTIONS

FIRREA provides an exclusion from the cross-guarantee provisions for an institution acquired in securing or collecting a debt previously contracted in good faith. However, during the entire exclusion period, the controlling bank and all of its insured depository institution affiliates must comply with sections 23A and 23B of the Federal Reserve Act (FRA),[3] for transactions with the insured depository institution involving acquisitions as a result of debts previously contracted in good faith.

1. Depository institutions are commonly controlled if:
   a. Such institutions are controlled by the same depository institution holding company (including any company, such as nonbank banks, that are required to file reports under [12 U.S.C. 1843(f)(6)]; or
   b. One depository institution is controlled by another depository institution.

2. Does not apply to any obligation to affiliates secured as of May 1, 1989.
3. Without regard to section 23A(d)(1) of the FRA.