Bank Holding Company Supervision Manual

Division of Banking Supervision and Regulation

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

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and Regulation

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This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the January 2008 supplement.

SUMMARY OF CHANGES

Section 1040.0

The section on ''Bank Holding Company Inspection Authority'' discusses the authority of the Federal Reserve to conduct bank holding company (BHC) inspections under section 5 of the BHC Act. This authority includes the review of *all* books and records of the organization by Federal Reserve supervisory staff.

Section 2060.05

The section on the ''Policy Statement on the Internal Audit Function and Its Outsourcing (Management and Information Systems)'' is revised to include a provision of the FDIC's November 28, 2005, rule amendment (effective December 28, 2005) for part 363 of its regulations (12 C.F.R. 363). For insured institutions having total assets of more than $3 billion, the audit committee must have independent members with (1) banking or related financial management expertise, (2) access to legal counsel, and (3) not include any large customers of the institution.

Section 2128.06

This section, ''Valuation of Retained Interests and Risk Management of Securitization Activities (Risk Management and Internal Controls),'' was revised to replace, as appropriate, the references to the Financial Accounting Standards Board's FAS 125 with either FAS 140 or FAS 157. FAS 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' was issued in September 2000. FAS 157, ''Fair Value Measurements,'' was issued in September 2006 (effective November 15, 2007).

Section 3905.0

The section on ''Permissible Activities for FHCs (Section 4(k) of the BHC Act)'' was revised to include brief discussions of several 2007 and 2008 Board orders for FHCs' nonbank activities, those that complement certain financial activities. The Board determined, on September 7, 2007, that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance (see 2007 FRB C133).

The section also discusses the Board's approval of notices by FHCs to provide energy management services under energy management agreements and energy tolling. The Board determined, on December 4, 2007, that an FHC's provision of energy management services is complementary to the financial activities of engaging as principal in limited physical commodity derivatives and the providing of financial and investment advisory services for derivative transactions. (See 2008 FRB C20.) The Board also determined, on March 27, 2008, that an FHC's providing of energy tolling is complementary to the financial activity of engaging in commodity derivatives activities (see 2008 FRB 60).

Section 3906.0

This new section, ''Disease Management and Mail-Order Pharmacy Activities (Section 4(k) of the BHC Act),'' discusses, in more detail, the September 7, 2007, Board order, which concludes that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance (see 2007 FRB C133).

Section 3920.0

The section on ''Limited Physical Commodity Trading Activities (Section 4(k) of the BHC Act)'' was revised to discuss, in more detail, the Board's March 27, 2008, consideration, and approval by order, of an FHC's limited trading in certain physical commodities that are not approved by the Commodities Futures and Trading Commission (CFTC) for trading in the U.S. or on non-U.S. futures exchanges. To trade in

such commodities, the FHC must be able to demonstrate that the derivative contracts on the commodity satisfy the specified standards that are stated in the order. The section also discusses the Board's approval of the same FHC's request to make and take delivery in nickel, a metal that is traded on the London Metal Exchange—a CFTC-comparable regulatory entity.

Included also is an FHC's Board-approved request to permit the refining, blending, or altering of Board-approved commodities by a third party. The same Board order includes the Board's approval of the FHC's request to engage in limited physically settled energy tolling by entering into tolling agreements with power plant owners. The Board determined that the activity is complementary to the financial activity of engaging, as principal, in commodity derivatives transactions. The FHC nonbank activity had *not* been previously approved by the Board. (See 2008 FRB C60.)

For another Board order, this section discusses the Board's December 4, 2007, approval by order of an FHC's request to engage in providing Energy Management Services (EMS) to owners of power generation facilities. The EMS are to be provided under energy management agreements as a complement to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivative transactions. (See 2008 FRB C20.)

Section 4070.5

This section on "Nondislosure of Supervisory Ratings" has been revised to include the Federal Reserve's statement and clarification of its expectations regarding confidentiality provisions that are contained in agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties. See subsection 4070.5.3. (See also SR-07-19 and SR-97-17.)

Section 4080.0

This section on "Federal Reserve System BHC Surveillance Program" was revised to reflect the Federal Reserve's adoption of an econometric framework, which is referred to as the Supervision and Regulation Statistical Assessment of Bank Risk model, or SR-SABR. This model replaced the former SEER (the System to Estimate Examination Ratings) surveillance model. The SR-SABR model assigns a two-component surveillance rating to each subsidiary bank of the BHC. The first component is the current composite CAMELS rating assigned to the bank. The second component is a letter (A, B, C, D, or F) that reflects the model's assessment of the relative strength or weakness of the bank compared with other institutions within the same CAMELS rating category. (See SR-06-2.)

Section 5000.0

This section on "BHC Inspection Program (General)" has been revised to incorporate new supervisory guidance on the written communication of inspection findings. (See SR-08-01.) To improve the consistency and clarity of written communications, Federal Reserve staff is to use the prescribed standardized terminology and definitions, to differentiate among (1) Matters Requiring Immediate Attention (MRIA), (2) Matters Requiring Attention (MRA), and (3) Observations. See subsection 5000.0.9.3.

Section 5010.4

This section on "Procedures for Inspection Report Preparation (Core Page 1—Examiner's Comments; Matters Requiring Special Board Attention)" incorporates and references the guidance in SR-08-01, which may involve this inspection report page or section (continuous flow reporting). To improve the consistency and clarity of written communications, Federal Reserve staff is to use the prescribed standardized terminology and definitions, to differentiate among any (1) MRIA, (2) MRA, and (3) Observations. As a general rule, examiners should expect fewer MRIA or MRA among stronger organizations.

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This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the July 2007 supplement.

SUMMARY OF CHANGES

Sections 2020.0

The section on ''Intercompany Transactions'' discusses generally section 23A and 23B of the Federal Reserve Act. The section is revised to incorporate the provisions of Regulation W, which facilitates compliance with those statutes. The regulation applies to transactions between insured depository institutions and their affiliates. The Board approved the regulation on November 27, 2002 (effective April 1, 2003). (See SR-03-2.)

Section 3905.0

This section, ''Permissible Activities for FHCs'' (Section 4(k) of the BHC Act), has been revised to include a brief discussion and reference to an October 12, 2007, Board order authorizing an FHC to engage in the acquisition, management, and operation, in the United Kingdom, of certain defined benefit pension plans established by unaffiliated third parties in stand-alone transactions. This is the only Board order that has been issued, after consultation with the Secretary of the Treasury, which authorized an FHC to engage in activities deemed to be ''financial in nature.'' See the next summary for 3912.0.

Section 3912.0

This new section, ''To Acquire, Manage, and Operate Defined Pension Benefit Plans in the UK Permissible Activities for FHCs (Section 4(k) of the BHC Act),'' includes the previously mentioned October 12, 2007, Board order, which was issued after consultation with the Secretary of the Treasury. The order authorized a financial holding company (FHC) to engage in these activities that are deemed to be ''financial in nature,'' which are to be established and maintained by unaffiliated third parties in stand-alone transactions and which are permissible for an FHC. The activity is to be conducted by or through a nonbank subsidiary of the FHC to engage in under section 4 of the Bank Holding Company Act. The nonbank subsidiary of the FHC that directly acquires a third-party UK pension plan would assume the responsibilities of the plan's sponsor under applicable UK law. The order also determined that when a depository institution is secondarily liable for a financial obligation of an affiliate, even if the depository institution's liability is created by statute or regulatory action, the institution has issued a guarantee on behalf of an affiliate for purposes of section 23A of the Federal Reserve Act and the Board's Regulation W.

Section 4060.3

The section on Consolidated Capital (Examiners Guidelines for Assessing the Capital Adequacy of BHCs) was revised to include an exception to the Board's risk-based capital guidelines for capital held against Regulation T margin loans. The first exception was approved by the Board on June 15, 2007. The Board approved the exception, initially, under the reservation-of-authority provision of the guidelines (12 C.F.R. 225, appendix A, III.A). The exception permits a BHC, upon receiving specific Board approval, to apply a 10 percent risk weight to its Regulation T margin loans. To qualify for the capital treatment, Regulation T margin loans must comply with certain specified conditions. Several BHCs subsequently have received approval for this exception.

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This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the January 2007 supplement.

SUMMARY OF CHANGES

Section 2010.2

The "Supervision of Subsidiaries" section has been revised to include a new subsection, "Oversight of Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices." It sets forth the December 6, 2006, interagency supervisory guidance, which was issued jointly by the Federal Reserve and the other federal bank regulatory agencies. The guidance, effective December 12, 2006, is applicable to state member banks and also broadly applicable to bank holding companies and their nonbank subsidiaries. For the purposes of the section, references to banks, institutions, or banking organizations is confined to these entities for which the Federal Reserve System has supervisory authority.

The guidance was developed to reinforce sound risk-management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets. As part of a bank holding company inspection, the examiner should make an assessment of the parent company's supervision and control over its subsidiaries, which includes administering, monitoring, and assuring adherence to its lending policies and practices for controlling "concentration risk." An institution's strong risk-management practices and its maintenance of appropriate levels of capital are important elements of a sound commercial real estate (CRE) lending program, particularly when an institution has a concentration in CRE or a CRE lending strategy leading to a concentration.

The guidance applies to concentrations in CRE loans sensitive to the cyclicality of CRE markets. For purposes of this guidance, CRE loans include loans where repayment is dependent on the rental income or the sale or refinancing of the real estate held as collateral. The guidance does not apply to loans secured by owner-occupied properties and loans where real estate is taken as a secondary source of repayment or through an abundance of caution.

The guidance notes that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary depending on the portfolio risk characteristics and the quality of risk-management processes. The guidance, therefore, does not establish a CRE concentration limit that applies to all institutions. Rather, the guidance encourages institutions to perform ongoing risk assessments to identify and monitor CRE concentrations.

The guidance provides numerical indicators as supervisory monitoring criteria to identify institutions that may have CRE concentrations that warrant greater supervisory scrutiny. The monitoring criteria should serve as a starting point for a dialogue between the supervisory staff and an institution's management about the level and nature of the institution's CRE concentration risk. (See SR-07-1 and its attachments.)

Section 2050.0

The "Extensions of Credit to BHC Officials" section was revised as the result of the Financial Services Relief Act of 2006 (Relief Act) and the Board's approval of the December 6, 2006, interim rule amendment and the May 25, 2007, final rule (without change) amendment to Regulation O, which were effective on December 11, 2006, and June 1, 2007, respectively. The Relief Act eliminated certain statutory reporting and disclosure requirements pertaining to insider lending by federally insured financial institutions. Sections 215.9 and 215.10 and subpart B of Regulation O were deleted as a result of the rule's changes. (See 71 *Fed. Reg.* 71,472, December 11, 2006, and 72 *Fed. Reg.* 30,470, June 1, 2007.)

Section 2065.3

This "Maintenance of an Appropriate Allowance for Loan and Lease Losses" section has been fully revised to incorporate the December 13, 2006, Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL). (See SR-06-17.) The guidance updates the 1993 Interagency Guidance on the ALLL (SR-93-70). The revised policy statement emphasizes that each banking organization (including bank hold-

ing companies and their subsidiaries) is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. Each banking organization should ensure that the adequate controls are in place to consistently determine the appropriate balance of the ALLL in accordance with (1) GAAP, (2) its stated policies and procedures, and (3) management's best judgment and relevant supervisory guidance. The policy emphasizes also that a banking organization should provide reasonable support and documentation of its ALLL estimates, including adjustments to the allowance for qualitative or environmental factors and unallocated portions of the allowance.

Section 2128.09

This new section, "Elevated-Risk Complex Structured Financing Activities," sets forth the January 11, 2007, Interagency Statement on Sound Practices Concerning Elevated-Risk Complex Structured Finance Activities. This statement sets forth supervisory guidance that addresses risk-management principles that should assist institutions to identify, evaluate, and manage the heightened legal and reputational risks that may arise from their involvement in complex structured financing transactions (CSFTs). The guidance is focused on those CSFTs that may present heightened levels of legal or reputational risk to the institution and are defined as "elevated-risk CSFTs." Such transactions are typically conducted by a limited number of large financial institutions. (See SR-07-5 and 72 *Fed. Reg.* 1,372, January 11, 2007.)

Sections 4060.3

The "Consolidated Capital (Examiners' Guidelines for Assessing the Capital Adequacy of BHCs)" section was revised to include an interim interagency decision on the impact of the Financial Accounting Standards Board's issuance of its September 2006 Statement of Financial Accounting Standards No. 158 (FAS 158), "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans." The decision was announced in a December 14, 2006, press release that was issued by the Federal Reserve Board and the other federal banking and thrift regulatory agencies (the agencies). FAS 158 provides that a banking organization that sponsors a single-employer defined benefit postretirement plan, such as a pension plan or health care plan, must recognize the overfunded or underfunded status of each such plan as an asset or a liability on its balance sheet with corresponding adjustments recognized as accumulated other comprehensive income (AOCI). The agencies issued an interim decision, which conveyed that banks and bank holding companies should exclude from regulatory capital any amounts recorded in AOCI that have resulted from their adoption and application of FAS 158.

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This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the July 2006 supplement.

SUMMARY OF CHANGES

Section 2050.0

The ''Extensions of Credit to BHC Officials'' section has been revised to incorporate a May 22, 2006, Board staff interpretation of Regulation O pertaining to the use of bank-owned or bank-issued credit cards by bank insiders for the bank's business purposes. The interpretation also is concerned with the extension of credit provisions and the market-terms requirement of Regulation O when a bank insider uses the bank-owned or bank-issued credit card to acquire goods and services for personal purposes. The inspection procedures have been revised to include provisions of this interpretation.

Section 2126.0

The ''Nontrading Activities of Banking Organizations'' section involving risk management and internal controls has been deleted. This section was based on SR-95-17, which was superseded by SR-98-12 (section 2126.1).

Section 2128.03

The ''Credit-Supported and Asset-Backed Commercial Paper'' section has been revised to incorporate the August 4, 2005, Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper (ABCP) Liquidity Facilities and the Resulting Risk-Based Capital Treatment. The guidance clarifies the application of the asset-quality test for determining the eligibility or ineligibility of an ABCP liquidity facility and the resulting risk-based capital treatment of such a facility for banking organizations. The guidance also re-emphasizes that the primary function of an eligible ABCP liquidity facility should be to provide *liquidity*—not credit enhancement.

An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are 90 days or more past due, in default, or below investment grade, because the institution providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets. The interagency statement indicates that an ABCP liquidity facility will meet the asset-quality test if, at all times throughout the transaction, (1) the liquidity provider has access to certain types of acceptable credit enhancements that support the liquidity facility and (2) the notional amount of such credit enhancements exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade for which the liquidity provider may be obligated to fund under the facility. (See SR-05-13.)

Section 2231.0

The ''Real Estate Appraisals and Evaluations'' section has been revised to incorporate the June 22, 2006, interagency statement, The 2006 Revisions to Uniform Standards of Professional Appraisal Practice (USPAP), issued by the federal banking agencies. Under the appraisal regulations, institutions must ensure that their appraisals supporting federally related transactions adhere to USPAP. The interagency statement provides an overview of the USPAP revisions and the ramifications of these revisions to regulated institutions. The 2006 USPAP, effective July 1, 2006, incorporates certain prominent revisions made by the Appraisal Standards Board. These revisions include a new Scope of Work Rule as well as the deletion of the Departure Rule and some of its associated terminology. (See SR-06-9.)

Section 3070.3

This new section, ''Nontraditional Mortgages—Associated Risks'' pertaining to section 4(c)(8) of the BHC Act, has been developed based on the September 29, 2006, Interagency Guidance on Nontraditional Mortgage Product Risks. (See SR-06-15.) The guidance addresses both the risk-management and consumer disclosure practices that institutions (Federal Reserve System-supervised state member banks and their subsidiaries, and bank holding companies and their nonbank subsidiaries) should

employ to effectively manage the risks associated with closed-end residential mortgage loan products that allow borrowers to defer payment of principal and, sometimes, interest. The section includes safety-and-soundness-oriented inspection objectives and inspection procedures to be used when conducting inspections of bank holding companies and their nonbank subsidiaries that are engaged in this type of lending.

Section 3600.7

The section ''Acting as a Certification Authority for Digital Signatures (Permissible Activities by Board Order)'' has been amended to include a summary of a recent Board order in which the Board approved a notice for a foreign bank to act, under sections 4(c)(8) and 4(j) of the BHC Act, as a certification authority (CA) in connection with financial and nonfinancial transactions and to engage in related data processing activities. The foreign bank planned to engage in the CA activities by entering into an agreement with a newly organized, wholly owned indirect subsidiary of the bank. (See 2006 FRB C150.) The proposed CA nonbanking activities are slightly different, but are consistent with the CA nonbanking activities previously approved by the Board. (See 2000 FRB 56.)

Section 3920.0

The ''Limited Physical-Commodity-Trading Activities'' section, pertaining to section 4(k) of the BHC Act, has been revised to include additional Board orders for financial holding companies engaging in limited physical-commodity-trading activities, including energy-related commodities such as natural gas, crude oil, electricity, and emissions allowances. (See 2006 FRB C54, 2006 FRB C57, and 2006 FRB C113.)

Section 4060.3

This section, ''Examiners' Guidelines for Assessing the Capital Adequacy of BHCs,'' pertains to consolidated capital and has been revised to include discussions of the May 14, 2003, and August 15, 2006, Board interpretations that were issued in response to separate inquiries received from the same bank. To lessen the risk-based capital treatment for certain indemnified securities-lending arrangements, the bank sought the Board's permission to apply a loan equivalent methodology to the arrangements using its internal value-at-risk (VaR) model, subject to the certain specified conditions. The May 14, 2003, interpretation concerned an inquiry regarding the risk-based capital treatment of certain European agency securities-lending arrangements that the bank had acquired. For these transactions (the cash-collateral transactions), the bank, acting as agent for its clients, lends its clients' securities and then receives cash collateral in return. The bank then reinvests the cash collateral in a reverse-repurchase agreement and receives securities collateral in return. The August 15, 2006, interpretation was issued regarding the bank's risk-based capital treatment of certain other securities-lending transactions. For these transactions, the bank, acting as agent for clients, lends its clients' securities and receives liquid securities collateral in return (the securities-collateral transactions).

For both types of transactions, the Board, using its reservation of authority, determined that under its current risk-based capital guidelines the capital charge for these specific types of securities-lending arrangements would exceed the amount of economic risk posed to the bank, which would result in capital charges that would be significantly out of proportion to the risk. The Board separately approved these exceptions to its risk-based capital guidelines. The bank is to compute its regulatory capital for these transactions using its internal VaR model by assigning the risk weight of the counterparty to the exposure amount of all such transactions with the counterparty. The bank will calculate the exposure amount as the sum of its current unsecured exposure on its portfolio of transactions with the counterparty, plus an add-on amount for potential future exposure.

Section 4060.8

A new section titled ''Consolidated Risk-Based Capital—Direct-Credit Substitutes Extended to ABCP Programs'' consists of March 2005 interagency guidance that is based on the Board's adoption of the November 29, 2001, amended risk-based capital standards. The standards established a new capital framework for banking organizations that are engaged in securitization activities. The interagency guidance clarifies how banking organizations are to use internal ratings that they assign to asset pools purchased by their ABCP programs in order to appropriately risk weight any direct-credit substitutes

(for example, guarantees) that are extended to such programs.

The guidance provides an analytical framework for assessing the broad risk characteristics of direct-credit substitutes that a banking organization provides to an ABCP program it sponsors. Specific information is provided within the guidance on evaluating direct-credit substitutes issued in the form of program-wide credit enhancements. (See SR-05-6.)

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This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the January 2006 supplement.

SUMMARY OF CHANGES

Section 2060.05

This revised section, ''Policy Statement on the Internal Audit Function and Its Outsourcing (Management Information Systems),'' incorporates the FDIC's November 28, 2005, amendment (effective December 28, 2005) to part 363 of its regulations (12 C.F.R. 363). The amendment raised the asset-size threshold from $500 million to $1 billion for internal control assessments by management and the institution's external auditors. For institutions between $500 million and $1 billion in assets, only a majority, rather than all, of the members of the audit committee—who must be outside directors—must be independent of management.

Section 2060.1

The section ''Audit (Management Information Systems)'' has been revised to incorporate the February 9, 2006, Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters. The advisory informs financial institutions that it is unsafe and unsound to enter into external audit contracts (that is, engagement letters) for the performance of auditing or attestation services when the contracts (1) indemnify the external auditor against all claims made by third parties, (2) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution (other than claims for punitive damages), or (3) limit the remedies available to the client financial institution (other than punitive damages). Such limits on external auditors' liability weaken the auditor's independence and performance, thus reducing the supervisory agency's ability to rely on the auditor's work. The inspection objectives and inspection procedures incorporate certain key provisions of the advisory.

The section also provides examples of unsafe and unsound limitation-of-liability provisions, and it discusses frequently asked questions and answers that were posed to the Securities and Exchange Commission (Office of the Chief Accountant). The answers confirm that an accountant (auditor) is *not* independent when an accountant and a client enter into an agreement of indemnity, directly or through an affiliate, that seeks to assure the accountant immunity from liability for the accountant's own negligent acts, whether they are acts of omission or commission. (See SR-06-4.)

Section 2090.2

The section ''Control and Ownership (BHC Formations)'' has been revised to incorporate the Board's February 22, 2006, revisions of its Small BHC Policy Statement—Policy Statement on Assessment of Financial and Managerial Factors (12 C.F.R. 225, appendix C). The revised rule increases the applicable consolidated asset-size threshold to less than $500 million from less than $150 million and also included other criteria for determining whether a BHC may qualify for the policy statement, including an exemption from the capital guidelines. For BHCs that are under the qualifying asset-size threshold, the revised rule also (1) modified certain qualitative criteria for determining when a BHC would *not* qualify for the policy statement or the exemption from the capital guidelines and (2) clarified the treatment under the policy statement of subordinated debt associated with trust preferred securities. The inspection objectives and inspection procedures have been revised to incorporate key provisions of this policy statement.

Section 2090.7

''Control and Ownership (Nonbank Banks)'' has been revised to include a March 21, 2006, Board staff legal opinion. The opinion confirms that a direct conversion from a state-chartered bank to a national bank and its merger with a newly formed limited-purpse trust company that would not be a bank for purposes of the BHC Act, would not, by itself, cause a parent company to

lose its grandfather rights maintained under section 4(f) of the BHC Act.

Section 3072.0

This new section, ''Activities Related to Extending Credit,'' provides a list of sections in the manual that discuss permissible nonbanking activities related to extending credit, provided for in section 225.28(b)(2) of Regulation Y. Each listed section includes a description of the activity and any supervisory guidance or requirements that should be considered. Several of the sections include inspection objectives and inspection procedures.

Section 3072.8

This new section, ''Real Estate Settlement Services,'' discusses those activities that are related to extending credit, as found in Regulation Y, section 225.28(b)(2). Included is a February 9, 2006, Board staff legal opinion on the permissibility of providing services to customers that are seeking to make exchanges of real property through a ''section 1031 exchange subsidiary,'' pursuant to section 1031 of the U.S. Internal Revenue Code. Section 1031 provides a U.S. taxpayer with a deferred gain when the taxpayer exchanges his or her property for another property of ''like kind.'' A BHC planned to acquire a subsidiary that would act as a qualified intermediary in forward section 1031 exchange transactions.

Board staff concluded that this section 1031 exchange subsidiary's proposed activities would be permissible real estate settlement services under section 225.28(b)(2)(viii) of Regulation Y. (See 12 C.F.R. 225.28 (b)(2)(viii).) Also, the activities would be considered permissible Regulation Y trust company functions (12 C.F.R. 225.28(b)(5)) and financial advisory services, including tax-planning and tax-preparation services (12 C.F.R. 225.28(b)(6)).

Section 3610.1

This new section, ''Financing Customers' Commodity Purchase and Forward Sales,'' consists of a May 15, 2006, Board staff legal interpretation that responded to a request from a BHC. The BHC sought confirmation that certain proposed ''commodity purchase and forward sale'' (CPFS) transactions are a form of lending activity permissible for BHCs under section 225.28(b)(1) of the Board's Regulation Y. The BHC inquired whether it would be permissible under the BHC Act and the Board's Regulation Y for the BHC to engage in proposed CPFS transactions in a manner that provided for the financing of its customers' commodity inventories. Board legal staff noted that the Board previously found a three-party commodity financing arrangement (similar to the proposed three-party CPFS transactions) to be within the scope of permissible lending activities for BHCs under Regulation Y. (See 1973 FRB 698.) Based on the BHC's representations and the information it provided, the cited Board precedents, and the limitations included within the Board staff's response (interpretation), Board legal staff opined that the proposed CPFS transactions are within the scope of permissible lending activities for BHCs under section 225.28(b)(1) of Regulation Y.

Section 3610.2

This new section, ''Certain Volumetric-Production-Payment Transactions Involving Physical Commodities,'' consists of a May 15, 2006, Board staff legal opinion that responded to a request from a foreign bank (a foreign bank that qualifies as a financial holding company under section 4(k) of the BHC Act and also under section 4(c)(9) of the BHC Act) that sought confirmation that certain volumetric-production-payment (VPP) transactions involving physical commodities would be permissible extensions of credit for a bank holding company under section 225.28(b)(1) of the Board's Regulation Y (12 C.F.R. 225.28(b)(1)).

The Board had approved a previous proposal by the BHC to engage in physical commodity trading as an activity that is complementary to the BHC's commodity derivatives activities (See 2004 FRB 215, section 3920.0, and section 3905.0.) In response to the current request, Board staff noted that the Board had previously concluded that ownership of commodities in connection with a financing transaction does not prevent the transaction from being treated as a form of credit extension permissible for a BHC—as long as the economics of the transaction are substantially the same as those of a loan. (See 1973 FRB 698.) Based on the information provided by the BHC, Board legal staff opined that the described VPP transactions are a form of permissible lending activity for BHCs

under section 225.28(b)(1) of Regulation Y when entered into and for the purpose of providing financing to a third-party customer. The opinion also stated that any commodities that the BHC receives pursuant to a VPP transaction, and that are not sold immediately to third parties, *would be* subject to a limit of 5 percent of tier 1 capital on the value of commodities that the BHC may hold under its physical commodity trading authority.

Section 4060.3

"Consolidated Capital (Examiners' Guidelines for Assessing Capital Adequacy of BHCs)" was revised to incorporate the Board's February 22, 2006, revision of Regulation Y (12 C.F.R. 225). The rule's appendix A was revised to raise the asset threshold to which the risk-based capital guidelines apply on a consolidated basis. The asset threshold was raised for BHCs having consolidated assets of $500 million or more from $150 million or more. The risk-based capital guidelines also apply to any bank holding company with consolidated assets of less than $500 million if the holding company (1) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (2) conducts significant off-balance-sheet activities (including securitization and asset management or administration), either directly or through a nonbank subsidiary; or (3) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission (SEC). BHCs with consolidated assets of less than $500 million would generally be exempt from the calculation and analysis of risk-based capital ratios on a consolidated holding company basis, subject to certain terms and conditions.

This section also was revised for the Board's February 6, 2006, revision (effective February 22, 2006) to the market risk measure in Regulation Y (12 C.F.R. 225, appendix E), which reduced the capital requirements for certain cash collateralized securities borrowing transactions of BHCs that have adopted the market risk rule. This action aligns the capital requirements for those transactions with the risk involved. It provides a capital treatment for U.S. banking organizations that is more in line with the capital treatment to which their domestic and foreign competitors are subject. (See 71 *Fed. Reg.* 8,937, February 22, 2006.)

This section has also been revised to include a January 23, 2006, Board staff legal interpretation. The interpretation conveys the Board's determination that qualifying mandatory convertible preferred securities (that convert to noncumulative perpetual preferred securities) qualify for inclusion in the tier 1 capital of internationally active BHCs (and other BHCs) in excess of the 15 percent limit applicable to the restricted core capital elements of internationally active BHCs, if all other terms and conditions of the securities meet the Board's requirements.

Section 4060.4

"Consolidated Capital (Leverage Measure)" was revised to incorporate revisions to Regulation Y for the tier 1 leverage measure. (See 12 C.F.R. 225, appendix D.) The changes were included in the Board's February 22, 2006, revision to the Small Bank Holding Company Policy Statement (12 C.F.R. 225, appendix C). The tier 1 leverage measure's asset threshold was raised for those BHCs having consolidated assets of $500 million or more from $150 million or more. The tier 1 leverage guidelines also apply to any BHC that has consolidated assets of less than $500 million if the BHC (1) is engaged in *significant* nonbanking activities, either directly or indirectly through a nonbank subsidiary *(a new provision)*; (2) conducts significant off-balance-sheet activities (including securitization and asset management or administration); or (3) has a material amount of debt securities outstanding (other than trust preferred securities) that are registered with the SEC. (*Previously, the rule referred only to debt outstanding held by the general public; SEC-registered equity securities were not included.*) The Federal Reserve may apply the tier 1 leverage guidelines at its discretion to any BHC, regardless of asset size, if such action is warranted for supervisory purposes.

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This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the July 2005 supplement.

SUMMARY OF CHANGES

Section 2010.11

"Supervision of Subsidiaries—Private-Banking Functions and Activities" has been revised to incorporate the USA Patriot Act's new and enhanced statutory requirements, which are designed to prevent, detect, and prosecute money laundering and terrorism. For banking organizations, the act's provisions are implemented through regulations issued by the U.S. Department of the Treasury (31 C.F.R. 103). Section 326 of the Patriot Act (codified in the Bank Secrecy Act [BSA] at 31 U.S.C. 5318(*l*)) requires financial institutions to have customer identification programs that collect and maintain certain records and documentation on customers. Institutions also should develop and use identity verification procedures to ensure the identity of their customers. SR-04-13 describes the BSA examination procedures for customer identification programs; examiners should follow these procedures when evaluating an institution's compliance with the regulation. (See also SR-03-17 and SR-01-29.) Relevant interagency interpretive guidance, in a question-and-answer format, addresses the customer identification rules. (See SR-05-9.) This section also has been revised to include general and specific references to the relevant supervisory guidance in the Federal Financial Institutions Examination Council's *Bank Secrecy Act/Anti–Money Laundering Examination Manual*, which was issued in June 2005. (See SR-05-12 and its attachments.)

Section 2124.01

"Risk-Focused Supervision Framework for Large Complex Banking Organizations" reaffirms the definition of the responsible Reserve Bank (RRB) and specifies the RRB's responsibilities for conducting inter-District inspection and supervision activities for a banking organization. The section highlights and clarifies the role of the RRB with respect to inter-District coordination of banking supervision. (See SR-05-27/CA-05-11.)

Section 2124.4

"Interagency Guidelines Establishing Standards for Information Security" has been revised to conform it to the December 21, 2004, interagency rules that implement section 216 of the Fair and Accurate Credit Transactions Act of 2003. (See 12 C.F.R. 225, appendix F.) To address the risks associated with identity theft, the information security standards generally require each financial institution to develop, implement, and maintain, as part of its existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports. The amendments to the information security standards were effective July 1, 2005.

The section has also been revised to incorporate the Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice (the guidance). The federal banking agencies jointly issued the guidance on March 23, 2005 (effective March 29, 2005). The guidance, which interprets section 501(b) of the Gramm-Leach-Bliley Act, amended the information security standards. (See 12 C.F.R. 225, appendix F, supplement A.) The guidance describes the response programs, including customer notification procedures, that certain banking organizations should develop and implement to address unauthorized access to or the use of customer information that could result in substantial harm or inconvenience to a customer. (See SR-05-23/CA-05-10.)

Section 2231.0

"Real Estate Appraisals and Evaluations" has been revised to include a summary of the interagency responses to questions on both the agencies' appraisal regulations and the October 2003 interagency statement titled Independent Appraisal and Evaluation Functions. The agencies' March 22, 2005, interpretive responses address common questions on the requirements of the appraisal regulations and the October 2003 interagency statement. (See SR-05-5 and its attachment.) The section also has been updated

to include a summary of the September 8, 2005, interagency interpretive responses to frequently asked questions; the agencies jointly issued the responses to help regulated institutions comply with the agencies' appraisal regulation and real estate lending requirements when financing residential construction in a tract development. (See SR-05-14 and its attachment.)

Section 3005.0

"Section 2(c)(2)(F) of the BHC Act—Credit Card Bank Exemption from the Definition of a Bank" has been revised to add a table of laws, regulations, interpretations, and orders concerning the credit card bank exemption found in section 2(c)(2)(F) of the BHC Act.

Section 3071.0

"Section 4(c)(8) of the BHC Act (Mortgage Banking—Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans)" is a new section that has been added to incorporate the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans, which was issued by the Federal Reserve and the other federal bank and thrift supervisory agencies. The advisory provides guidance on the appropriate accounting and reporting for both derivative loan commitments (commitments to originate mortgage loans that will be held for resale) and forward loan-sales commitments (commitments to sell mortgage loans). When accounting and reporting for derivative loan commitments, institutions (and bank holding companies) are expected to use generally accepted accounting principles. Institutions (and bank holding companies) also must correctly report derivative loan commitments in accordance with their federal bank and thrift supervisory agency's forms and instructions. (See SR-05-10.) An inspection objective and inspection procedures were also developed to incorporate the interagency guidance.

Section 3111.0

"Section 4(c)(8) of the BHC Act—Acquisition of Savings Associations" has been revised to indicate that bank holding companies acquiring savings associations under this statutory provision must conform the acquired associations' nonbanking activities to those that are permissible under section 4 of the BHC Act. (See also section 225.28(b)(4)(ii) of Regulation Y.) The revised section discusses a more recent Board order and lists other Board orders that have authorized the acquisition of savings associations.

Section 5000.0

"BHC Inspection Program—General" has been revised to briefly discuss the reconfirmation of the Federal Reserve's policy on the coordination of inspection and supervisory activities among the Reserve Banks. When banking organizations operate in more than one District, it is important that (1) inspection and supervisory staff assess and weigh all relevant and significant supervisory findings when evaluating the consolidated banking organization and (2) a consistent and coordinated supervisory message is communicated to the banking organization. To achieve this objective, the System follows the principle that there is one RRB for each fully consolidated banking organization (i.e., each top-tier consolidated banking organization). Section 5000.0.6 defines the RRB for a banking organization, highlights the role of the RRB in inter-District coordination of banking supervision, and briefly discusses the roles and duties of the RRBs in conducting multi-District inspection and supervision activities. The classification of out-of-District nonbank subsidiary assets is also discussed. See also section 5000.0.7. (See SR-05-27/CA-05-11.)

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Bank Holding Company Supervision Manual
Supplement 28—July 2005

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 2004 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.2	2010.2	The section ''Supervision of Subsidiaries—Loan Administration and Lending Standards'' has been revised to include the May 16, 2005, interagency Credit Risk Management Guidance for Home Equity Lending. The federal supervisory agencies issued the guidance to promote greater focus on sound risk-management practices at banking organizations (that is, at credit-extending bank and nonbank subsidiaries of bank holding companies) with home equity lending programs, including open-end home equity lines of credit and closed-end home equity loans. The agencies are concerned that some banking organizations' credit-risk management practices for home equity lending have not kept pace with the product's rapid growth and the easing of underwriting standards. The guidance highlights the sound risk-management practices that a banking organization should follow to align the growth with the risk within its home equity portfolio. The guidance should be considered in the context of existing regulations and supervisory guidelines. (See SR-05-11 and its attachment.) The inspection objectives and procedures have been revised to incorporate this interagency guidance.
2124.01	2124.01	The section ''Risk-Focused Supervision Framework for Large Complex Banking Organizations'' has been revised to incorporate the risk-management rating definitions, as they are discussed in SR-99-15, SR-97-24, and SR-95-51. SR-04-18 (and its attachment) made revisions to the rating definitions for risk management. A banking organization's risk-management assessment is deemed to be strong, acceptable, or weak. The central point of contact or designated examiner(s) should use the revised risk-management assessment definitions to develop a risk matrix, which should be used primarily for planning supervisory activities. The risk matrix does not have the fine gradations involved in rating a risk-management system on a function-by-function or activity basis, an approach that would be used in conducting and completing a bank holding company inspection.
2129.05	2129.05	The ''Risk and Capital Management—Secondary-Market Credit Activities'' section has been revised to incorporate the new bank holding company RFI/C(D) rating system. Other previously issued risk-management-oriented SR-letters are also referenced. In addition, the Board's July 17, 2004, approval of revisions to the

New Section Number	*Previous Section Number*	*Description of the Change*
		risk-based capital rule (effective September 30, 2004) provides for a limited exclusion from risk-weighted assets for an asset-backed commercial paper (ABCP) program. A banking organization's ABCP program may be excluded from risk-weighted assets (1) when the banking organization is the program's sponsor and (2) when it must consolidate under generally accepted accounting principles (GAAP) its ABCP program that is defined as a variable interest entity. (See section 2128.03.)
3005.0		A new section, "Credit Card Bank Exemption from the Definition of a Bank," discusses the February 18, 2005, Board staff interpretation involving the credit card bank exemption under section 2(c)(2)(F) of the BHC Act. This statutory provision sets forth the criteria that an institution must meet to qualify for the so-called credit card bank exemption. The Board staff's interpretation concluded that no BHC application to the Board would be required for a proposed acquisition of a credit card bank if the company (1) met the statutory criteria and (2) complied with the representations and commitments it made, including those that were required by the Board. Board staff also concluded that a related stock redemption did not require a filing with the Board.
3040.0	3040.0	The "Section 4(c)(4) of the BHC Act—Interests in Nonbanking Organizations" section has been revised to include a qualifying foreign banking organization's (FBO's) November 24, 2004, request for a Board staff determination, which is based on section 4(c)(4) of the BHC Act and on the availability of a fiduciary exemption that is found in the Board's Regulation K, section 211.23(f)(4) (12 C.F.R. 211.23(f)(4)) and in Regulation Y, section 225.22(d)(3) (12 C.F.R. 225.22(d)(3)). Two of the FBO's asset-management subsidiaries proposed to serve as trustee for foreign-based investment trusts that would invest in U.S. real estate. As part of this asset-management activity, the two subsidiaries would each take title to U.S. real estate on behalf of the investment trusts and exclusively for the account of each trust for the benefit of the investors in the trusts. The foreign jurisdiction's law requires the two subsidiaries to obtain a banking license in order to serve as trustee for the investment trusts, and the two subsidiaries are subject to supervision and regulation by the bank supervisory authority in the foreign jurisdiction. Under the arrangement, the two subsidiaries are subject to fiduciary duties that closely resemble those of a trustee in the United States. Under the law of the foreign jurisdiction, the investment trusts would not be legal entities separate from the two subsidiaries. In addition, the FBO committed that neither it nor its subsidiaries or employee benefit plans would own any beneficial interests in the investment trusts. (See *Federal Reserve Regulatory Service* 4–305.2)
3250.0	3250.0	The "4(c)(8)—Agency Transactional Services (Futures Commission Merchants and Futures Brokerage)" section has been revised to amend the inspection-scope guidance to emphasize the need for

New Section Number	*Previous Section Number*	*Description of the Change*
		examiners to apply a functional-regulatory approach, consistent with section 111 of the Gramm-Leach-Bliley Act, to conduct a BHC inspection of a futures commission merchant subsidiary. (See section 1040.0 and 12 U.S.C. 1844(c).) The section also references the new bank holding company RFI/C(D) rating system.
3905.0, 3920.0	3905.0, 3920.0	The section "Permissible Activities for FHCs—Section 4(k) of the BHC Act" and the section "Limited Physical-Commodity-Trading Activities—Section 4(k) of the BHC Act" have been revised to discuss or reference additional Board orders (see 2004 FRB 215 and 2004 FRB 511) that authorized engaging in limited amounts and types of commodity-trading activities that complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on a particular commodity. A financial holding company must submit, through the filing of a notice under section 4 of the BHC Act, a written request to the Federal Reserve Board in order to engage in a complementary activity.
4060.3	4060.3	The section "Consolidated Capital—Examiners' Guidelines for Assessing the Capital Adequacy of BHCs" incorporates the Board's February 28, 2005, revision of its risk-based capital rule that allows the continued limited inclusion of trust preferred securities in the tier 1 capital of bank holding companies. Until March 31, 2009, the aggregate amount of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities that a banking organization may include in tier 1 capital is limited to 25 percent of the sum of the following *core capital elements*: qualifying common stockholders' equity, qualifying noncumulative and cumulative perpetual preferred stock (including related surplus), qualifying minority interests in the equity accounts of consolidated subsidiaries, and qualifying trust preferred securities. The rule limits restricted core capital elements to 25 percent of the sum of the core capital elements (this limit includes the restricted core capital elements) net of goodwill and any associated deferred tax liability. The *restricted core capital elements* are defined in the rule as qualifying cumulative perpetual preferred stock (including related surplus), minority interest relating to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary, minority interest related to qualifying common stockholders' equity or perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank, and qualifying trust preferred securities. Internationally active BHCs, defined as those having consolidated assets of $250 billion or more or having on-balance-sheet foreign exposure of $10 billion or more, will be subject to a 15 percent limit, effective March 31, 2009. However, internationally active BHCs may include qualifying mandatory convertible preferred

New Section Number	*Previous Section Number*	*Description of the Change*
		securities up to the generally applicable 25 percent limit. Amounts of restricted core capital elements that are in excess of these limits generally may be included in tier 2 capital. The revised rule also addresses supervisory concerns, competitive equity considerations, and the qualifying terms for trust preferred securities included in tier 1 capital. The rule strengthens the definition of regulatory capital by incorporating long-standing Board policies regarding the acceptable terms of capital instruments included in banking organizations' tier 1 or tier 2 capital. (See the Board's March 1, 2005, press release. The final rule was published in the *Federal Register* on March 10, 2005.)
4060.4	4060.4	The ''Consolidated Capital—Leverage Measure'' section has been revised to incorporate the changes made to allow and accommodate in the tier 1 leverage measures (12 C.F.R. 225, appendix D) the continued limited inclusion of trust preferred securities in the tier 1 capital of bank holding companies. The previous definition of tier 1 capital was deleted. For the purposes of the leverage measure, the definition of tier 1 capital relies on the tier 1 capital definition that is found in the risk-based capital rule (12 C.F.R. 225, appendix A).
4070.0	4070.0	The ''Bank Holding Company Rating System'' section has been totally revised. The section now includes the bank holding company RFI/C(D) rating system. Approved by the Board on December 1, 2004 (effective January 1, 2005), the rating system is described in the attachment to SR-04-18. Each inspected BHC is assigned a ''C'' composite rating, which is based on an evaluation and rating of the BHC's managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The other main components of the rating system are Risk management (R); Financial condition (F); and potential Impact (I) of the parent company and nondepository subsidiaries (collectively nondepository entities) on the subsidiary depository institution(s). Several component ratings have subcomponent ratings. The composite, component, and subcomponent ratings are assigned to BHCs on the basis of a numeric scale. A 1 is the highest rating; a 5 is the lowest. All of the BHC's numeric ratings, including the composite, component, and subcomponent ratings, should be presented in the inspection report in accordance with Federal Reserve supervisory practices.
4070.1	4070.1	The section ''Rating the Adequacy of Risk-Management Processes and Internal Controls of Bank Holding Companies,'' which was derived from SR-95-51, has been amended for the risk-management rating classifications and definitions described in the attachment to SR-04-18. The attachment outlines the Board-approved RFI/C(D) bank holding company rating system, which was effective January 1, 2005.

New Section Number	*Previous Section Number*	*Description of the Change*
4070.5	4070.0.9	A new section, ''Nondisclosure of Supervisory Ratings,'' describes the Federal Reserve's long-standing policy of disclosing to the board of directors and senior management the confidential composite numeric rating and the alphabetic component ratings assigned under various supervisory rating systems. (See SR-88-37 and SR-96-26.) The section now references the bank holding company RFI/C(D) rating system (see section 4070.0 and SR-04-18 and its attachment), which replaced the BOPEC rating system for BHCs. Also, the section includes the February 28, 2005, Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information. The advisory reminds banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to insurers or other nonrelated third parties without the permission of the appropriate federal banking agency. (See SR-05-4.)
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Bank Holding Company Supervision Manual
Supplement 27—December 2004

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 2004 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2010.13		The new section ''Establishing Accounts for Foreign Governments, Embassies, and Political Figures'' conveys the June 15, 2004, interagency advisory ''Guidance on Accepting Accounts from Foreign Governments, Foreign Embassies, and Foreign Political Figures.'' The advisory was issued by the federal banking and thrift agencies (the agencies) and the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). The advisory responds to inquiries the agencies and FinCEN received on whether financial institutions should do business and establish account relationships with those foreign customers cited in the advisory. Banking organizations are advised that the decision to accept or reject such foreign-account relationships is theirs alone to make. Financial institutions, including a bank holding company's bank and thrift subsidiaries, should be aware that there are varying degrees of risk associated with these accounts, depending on the customer and the nature of the services provided. Institutions should take appropriate steps to manage these risks, consistent with sound practices and applicable anti-money-laundering laws and regulations. The advisory is primarily directed to financial institutions located in the United States. The boards of directors of bank holding companies, however, should consider whether the advisory should be applied to their other U.S. subsidiaries' financial and other services. (See SR-04-10.)
2128.03	2128.03	The section ''Credit-Supported and Asset-Backed Commercial Paper'' has been revised to incorporate the Board's July 17, 2004, approval (effective September 30, 2004) of a revision to the risk-based capital requirements for state member banks and bank holding companies (collectively banking organizations) that sponsor asset-backed commercial paper (ABCP) programs. For more details, see the summary for section 4060.3. The inspection objectives and inspection procedures were also revised to incorporate the revised rule for ABCP programs.
3140.0	3140.0	The section ''Leasing Personal or Real Property'' has been revised to incorporate a Board staff legal opinion that was requested by a foreign banking organization (FBO) that is treated as a bank holding company (BHC). The FBO, as a BHC, engages in leasing activities that the Board has authorized in Regulation Y, section 225.28(b)(3) (12 C.F.R. 225.28(b)(3)). The FBO asked if a BHC

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		may provide, as an incidental nonbank activity, fleet-management services to some nonleased vehicles in accordance with its Regulation Y–authorized leasing activities. In a December 19, 2003, opinion, Board staff stated that the provision of fleet-management services to some nonleased vehicles is an activity incidental to the BHC's authorized leasing activities, provided the BHC's leasing subsidiary limits its fleet-management services involving vehicles not subject to a Regulation Y permissible lease to no more than 15 percent of the fleet-management revenues, and to 5 percent of the total leasing revenues of the leasing subsidiary. (See the December 19, 2003, Board staff opinion and Regulation Y, 12 C.F.R. 225.28(b)(3), footnote 5.)
3500.0	3500.0	Section 106 of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from conditioning the availability or price of one product or service (the ''tying product,'' or the ''desired product'') on a requirement that a customer obtain another product or service (the ''tied product'') from the bank or an affiliate of the bank. Section 106 also prohibits a bank from conditioning the availability or price of one product on a requirement that a customer (1) provide another product to the bank or an affiliate of the bank or (2) not obtain another product from a competitor of the bank or from a competitor of an affiliate of the bank. Section 106 contains several exceptions to its general prohibitions, and it authorizes the Board to grant, by regulation or order, additional exceptions from the prohibitions when the Board determines an exception ''will not be contrary to the purposes'' of the statute. The section ''Tie-In Considerations of the BHC Act'' has been revised to include a Board interpretation and a Board staff interpretation of section 106 on tying arrangements, which were issued on August 18, 2003, and February 2, 2004. These two interpretations state that bank customers that receive securities-based credit can be required to hold their pledged securities as collateral at an account of a bank holding company's or bank's broker-dealer affiliate.
4060.3	4060.3	The section ''Examiners' Guidelines for Assessing the Capital Adequacy of BHCs'' has been updated to include the revisions to the Board's risk-based capital requirements for asset-backed commercial paper (ABCP) programs sponsored by state member banks and bank holding companies (collectively, banking organizations). The Board approved the rule changes on July 17, 2004 (effective September 30, 2004). See appendix A of Regulation Y (12 C.F.R. 225, appendix A). In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46, ''Consolidation of Variable Interest Entities'' (FIN 46). FIN 46 required, for the first time, the consolidation of variable interest entities (VIEs) onto the balance sheets of companies deemed to be the primary beneficiaries of those entities. In December 2003, FASB revised FIN 46 as

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		FIN 46-R. (The interpretation (FIN 46 or FIN 46-R) was effective for reporting periods that ended as early as December 15, 2003. However, there are various effective dates, which are determined on the basis of the nature, size, and type of business entity). FIN 46-R requires the consolidation of many ABCP programs onto the balance sheets of banking organizations. Under the Board's revised risk-based capital rule, a banking organization that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under generally accepted accounting principles (FIN 46-R) may exclude the consolidated ABCP program's assets from its risk-weighted assets, provided that it is the sponsor of the ABCP program. Such banking organizations must also hold risk-based capital against eligible ABCP liquidity facilities that have an original maturity of one year or less that provide liquidity support to its ABCP by applying a new 10 percent credit-conversion factor to such facilities. Eligible ABCP liquidity facilities with an original maturity exceeding one year remain subject to the rule's current 50 percent credit-conversion factor. Ineligible liquidity facilities are treated as direct-credit substitutes or recourse obligations, which are subject to a 100 percent credit-conversion factor. When calculating the banking organization's tier 1 and total capital, any associated minority interests must also be excluded from tier 1 capital. The inspection procedures were also revised to incorporate the revised risk-based capital requirements for bank holding companies.
5010.10	5010.10	This section discusses the inspection reporting of consolidated classified and special-mention assets and other transfer-risk problems. It has been revised to include the revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the uniform agreement) that was jointly issued by the federal banking and thrift agencies (the agencies) on June 15, 2004. The revised uniform agreement amends the 1938 classification of securities agreement (the 1938 accord), which was revised on July 15, 1949, and May 7, 1979. The uniform agreement sets forth the definitions of the classification categories and the specific examination procedures and information for classifying bank assets, including securities. The June 2004 revision did not change the classification of loans in the uniform agreement. The revised uniform agreement addresses, among other items, the treatment of rating differences, multiple security ratings, and split or partially rated securities. It also eliminates the automatic classification for sub-investment-grade debt securities. (See SR-04-9.) The uniform agreement's classification categories also apply to the classification of assets held by the subsidiaries of banks and bank holding companies.

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Bank Holding Company Supervision Manual
Supplement 26—June 2004

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new and revised supervisory guidance and instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 2003 supplement.

LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2065.4	2065.4	This section on ALLL methodologies and documentation has been revised to include a reference to the March 1, 2004, interagency Update on Accounting for Loan and Lease Losses. The interagency update discusses recent developments in accounting, current sources of generally accepted accounting principles, and supervisory guidance that applies to the ALLL. Other SR-letters associated with the supervisory guidance for the allowance are referenced in the interagency update. (See SR-04-5.)
2090.1	2090.1	The Control and Ownership (Change in Control) section has been revised to emphasize the importance of understanding the requirements for filing a notice under the Change in Bank Control Act. The complexity of an ownership position sometimes does not lend itself to easy interpretation of the requirements to file a notice. When it is unclear whether a notice is required, the potential filer (or filers) or the affected state member bank or BHC is encouraged to contact staff at a Federal Reserve Bank or the Board for guidance. Prior notice is required by any person (acting directly or indirectly) that seeks to acquire control of a state member bank or BHC. A *person* may include an individual, a group of individuals acting in concert, or certain entities (for example, corporations, partnerships, or trusts) that own shares of banking organizations but that do not qualify as BHCs. A person acquires *control* of a banking organization whenever the person acquires ownership, control, or the power to vote 25 percent or more of any class of voting securities of the institution. See section 225.41 of Regulation Y (12 C.F.R. 225.41), which sets forth the specific types of transactions that require prior notice under the Change in Bank Control Act. Section 225.41 outlines certain other *rebuttable* presumptions of control that may require the filing of a notice, including (under certain circumstances) a proposed acquisition that would result in a person owning or controlling the power to vote 10 percent or more of any class of voting securities. (See SR-03-19.)
2110.0	2110.0	This section on formal corrective actions has been revised to briefly discuss the joint rules adopted by the Board and the other federal bank and thrift regulatory agencies (effective October 1, 2003) for the removal, suspension, and debarment of accountants from performing audit services. (See the Board's August 8, 2003,

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		press release.) Section 36 of the Federal Deposit Insurance Act, as implemented by 12 C.F.R. 363, requires each federally insured depository institution with total assets of $500 million or more to obtain an annual audit of its financial statements prepared by an independent public accountant, as well as an attestation on management's assertions concerning internal controls. The joint rules established the practices and procedures under which each agency can, for good cause, remove, suspend, or bar an accountant or accounting firm from performing audit and attestation services for federally insured depository institutions that have total assets of $500 million or more.
2124.01	2124.01	The Board's Division of Banking Supervision and Regulation and its Division of Consumer and Community Affairs have developed an enhanced framework for the supervision of consumer compliance risk. The section on the risk-focused supervisory framework for large, complex banking organizations (LCBOs) has been revised to incorporate this guidance. For LCBOs and large banking organizations (LBOs) that are subject to the Federal Reserve System's continuous supervision program, safety-and-soundness examiners are to incorporate the consumer compliance risk assessment into the overall risk assessment and planned supervisory activities for LCBOs and LBOs. When performing the consumer compliance risk assessment, consumer compliance examiners are to rely on the work conducted by the dedicated supervisory team, the primary bank regulator, or both. In addition, the consumer compliance examiner is to discuss any identified areas of significant consumer compliance risk with the Federal Reserve's central point of contact (CPC) assigned to the organization. In coordination with the CPC and the supervisory team, the consumer compliance examiner is to evaluate how consumer compliance risk affects the reputational, legal, and operational risk profiles of the LCBO or LBO. For other BHCs that have multiple federally insured depository institution subsidiaries or nonbank subsidiaries, surveillance and other information will be used as the basis for assessing consumer compliance risk. Consumer compliance risk will not be assessed in shell holding companies. (See SR-03-22.)
2178.0		This new section discusses the January 5, 2004, Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or Its Affiliates. The policy alerts banking organizations, including their boards of directors and senior management, to the safety-and-soundness implications of and the legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries, or affiliates (that is, an affiliated investment fund). The interagency policy emphasizes three core principles: A bank should not (1) inappropriately place its resources and reputation at risk for the benefit of an affiliated investment fund's investors and creditors; (2) violate the limits and requirements in

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		Federal Reserve Act sections 23A and 23B and in Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will support the advised fund (or funds). In addition, bank-affiliated investment advisers are encouraged to establish alternative sources of financial support to avoid seeking support from affiliated banks. A bank's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the risks are not effectively controlled. Bank management is expected to notify and consult with its appropriate federal banking agency before (or immediately after, in the event of an emergency) providing material financial support to an affiliated investment fund. (See SR-04-1.) Inspection objectives and inspection procedures have been developed to address the supervisory concerns set forth in the policy. The objectives and procedures focus on a BHC's oversight responsibilities for its bank and nonbank subsidiaries that advise investment funds.
2231.0	2231.0	The Real Estate Appraisals and Evaluations section has been updated to add the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions as appendix B. A banking institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions. Concerns about the independence of appraisals and evaluations arise from the risk that improperly prepared appraisals may undermine the integrity of credit-underwriting processes. An institution's lending functions should not have undue influence that might compromise the program's independence. Institutions may not use an appraisal prepared by an individual who was selected or engaged by a borrower. Likewise, institutions may not use *readdressed appraisals*—appraisal reports that are altered by the appraiser to replace any references to the original client with the institution's name. Altering an appraisal report in a manner that conceals the original client or intended users of the appraisal is misleading and violates the agencies' appraisal regulations and the Uniform Standards of Professional Appraisal Practice (USPAP). (See SR-03-18.)
3160.0, 3160.2	3160.0, 3160.2	Revisions to these nonbanking sections concern subsidiaries with EDP servicing company activities and electronic benefit transfer, stored-value-card, and electronic data interchange service activities. The changes incorporate the current revenue limit of 49 percent (previously 30 percent) that the Board approved on November 26, 2003 (effective January 8, 2004). An EDP servicing company may provide services to others (outside third parties) if

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		the total annual revenues derived from activities involving data processing, data storage, and data transmission services (that are not financial, banking, or economic related) do not exceed the revised limit. BHCs may request permission to administer the 49 percent revenue test on a business-line or multiple-entity basis. See section 225.28(b)(14) of Regulation Y (12 C.F.R. 225.28(b)(14)).

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Bank Holding Company Supervision Manual
Supplement 25—December 2003

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LIST OF CHANGES

New Section Number	*Previous Section Number*	*Description of the Change*
2060.5	2060.05	This section has been revised to incorporate the May 5, 2003, Statement on Application of Recent Corporate Governance Initiatives to Nonpublic Banking Organizations issued by the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The statement announced that the agencies do not expect to take actions to apply corporate-governance and other requirements of the Sarbanes-Oxley Act to nonpublic banking organizations that are not otherwise subject to them. The agencies, however, encouraged nonpublic banking organizations to periodically review their policies and procedures relating to corporate governance, auditing, and other requirements of the Sarbanes-Oxley Act. Although the act does not require small, nonpublic banking organizations to strictly adhere to its provisions, the agencies expect these banking organizations to ensure that their policies and procedures are consistent with applicable law, regulations, and supervisory guidance and that they remain appropriate for the organizations' size, operations, and resources. (See SR-03-08.)
2110.0	2110.0	This revised section on formal corrective actions discusses the existing restrictions on, and requirements for, severance payments made to institution-affiliated parties (so-called golden parachute payments). The restrictions originated from the Crime Control Act of 1990, which added section 18(k) to the Federal Deposit Insurance Act (12 U.S.C. 1828(k)). The FDIC's regulations on golden parachute payments (or any agreement to make any payment), found in 12 C.F.R. 359, are discussed in this section. The 30-day prior-notice requirement for appointing any new directors or senior executive officers of state member banks and bank holding companies is also discussed. (See section 32 of the FDI Act (12 U.S.C. 1831i) and subpart H of Regulation Y (12 C.F.R. 225.71).) This notice requirement also applies to any change in the responsibilities of any current senior executive officer that proposes to assume a different position. (See SR-03-06.)
3120.0	3120.0	The trust services section is revised to discuss the oversight responsibilities of the board of directors and senior management for operating the fiduciary activities of their financial holding company (FHC) or bank holding company (BHC) in a safe and sound manner. This oversight at the consolidated level is impor-

New Section Number	*Previous Section Number*	*Description of the Change*
		tant because the risks associated with financial activities as well as fiduciary activities can cut across legal entities and business lines. Relying on the examination findings of the appropriate trust activities regulator, the examiner is to review and assess the internal policies, reports, and procedures and the effectiveness of the BHC's or FHC's consolidated risk-management process for trust activities. The revision includes a discussion of the available reported supervisory information and analytical support tools that an examiner can use to evaluate the trust services of the holding company and its subsidiaries. (See SR-00-13.)
3000.0.2 3260.0	3000.0.2 3260.0	Appendix 1 of subsection 3000.0.2 (the detailed list of Board-approved nonbanking activities in section 225.28(b) of Regulation Y) and section 3260.0 have been revised to include the Board's June 27, 2003, approval of a Regulation Y amendment (effective August 4, 2003) to permit BHCs to (1) take and make delivery of title to commodities underlying commodity derivative contracts on an instantaneous, pass-through basis and (2) enter into certain commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset before delivery.
3600.30	3600.30	The nonbanking activities section on real estate title abstracting has been revised to include an October 7, 2002, staff opinion on BHC-conducted title abstracting activities for U.S.-registered aircraft. The title abstracting services are limited to (1) performing a title search of aircraft records and (2) reporting factual information on the ownership history of the relevant aircraft and the existence of liens and encumbrances affecting title to the aircraft. Staff opined that the described title abstracting activities for U.S.-registered aircraft would be within the scope of title abstracting activities for real estate previously determined to be permissible under section 4(c)(8) of the BHC Act on June 30, 1995. (See 1995 FRB 806.)
3920.0		This new section discusses the Board's October 2, 2003, approval of an FHC's notice under section 4(k) of the BHC Act to engage in physical commodity trading activities on a limited basis as an activity that is complementary to the financial activity of engaging regularly as principal in commodity derivative activities. (The effective date of the Board's order is also October 2, 2003.)
3950.0		This new section provides inspection guidance on insurance sales activities and consumer protection in sales of insurance as the guidance pertains to FHCs, BHCs, or state member banks. Examiner guidance is provided on (1) conducting risk assessments of BHC or state member bank insurance and annuity sales activities in accordance with the Federal Reserve's risk-focused supervisory approach and (2) examining a state member bank's compliance with the new Consumer Protection in Sales of Insurance (CPSI) regulation contained in subpart H of the Board's Regulation H (12 C.F.R. 208.81–86). The CPSI regulation (effective October 1,

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		2001) *applies only* to insured depository institutions. It implements section 305 of the Gramm-Leach-Bliley Act (the GLB Act) (12 U.S.C. 1831x). The guidance provides a comprehensive review of these insurance and annuity sales activities as they pertain to a BHC or bank and discusses the Federal Reserve's responsibility for enforcing a depository institution's compliance with the CPSI regulation. Consistent with the GLB Act, the guidance incorporates applicable restrictions on examining a functionally regulated subsidiary. The CPSI regulation's supervisory guidance is provided for the BHC examiner's, the board of directors', and senior management's information. The information is made available in this manual to BHC directors and management so they can fulfill their respective responsibilities in overseeing the operations of the BHC and its insured depository institution subsidiaries. The CPSI regulation requires certain disclosures in connection with the retail sale or solicitation of insurance products and annuities by a bank, any other person at bank offices where retail deposits are accepted from the public, or any person ''acting on behalf of the bank.'' Appendix A summarizes the banking agencies' joint statement in which they responded to a request to clarify whether the disclosure requirements apply to renewals of preexisting insurance policies sold before October 1, 2001. Appendix B is a glossary of terms associated with insurance and annuity sales activities. Inspection objectives, inspection procedures, and an internal control questionnaire are also provided.
4020.4	4020.4	This revised section on bank liquidity incorporates the July 25, 2003, Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management. The interagency advisory provides guidance on the appropriate use of primary credit in effective liquidity management. The board of directors and senior management of BHCs and state member banks are advised to consider the Federal Reserve's primary credit program as part of their contingency funding plans and to provide for adequate diversified potential sources of funds to satisfy liquidity needs, which includes planning for certain significant liquidity events. (See SR-03-15.)

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