Foreword

Section 1000.0

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

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

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

The inspection process commences with a preliminary risk assessment. The risk assessment highlights the strengths and weaknesses of the holding company and is the basis for determining the procedures to be conducted during an inspection. Risk assessments identify the organization's principal business activities and the types and quantities of risks associated with the activities (including those conducted off-balance-sheet). The quality of management and the control of risks are factored into the initial risk profile of the holding company. Sources of information for the risk assessment include prior bank and BHC inspection reports and workpapers, surveillance program reports, and regulatory reports. In addition, other relevant supervisory materials derived from within the Federal Reserve System or other federal and state banking supervisors, as well as from other responsible regulatory agencies (for example, the Securities and Exchange Commission and state insurance authorities) are used. Other sources for the risk assessment may include the banking organization's publicly available reports, such as annual and other periodic reports and informational releases; strategic plans and budgets; internal management reports; information packages for the board of directors; correspondence; the board of directors executive and audit committee minutes; internal audit workpapers and reports; and stock-analysis reports. The activities, transactions, and identified areas having the most significant risks, inadequate risk-management processes, or rudimentary internal controls will represent the banking organization's highest risks. The risk-assessment process culminates in a formalized and structured supervisory strategy, which examination staff will follow when conducting an inspection.

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

The full-scope inspection may be conducted at a point in time or through a series of targeted or limited-scope reviews conducted on an ongoing or continuous basis for the largest and most complex banking organizations. Irrespective of the duration of the inspection, planned supervisory activities should be coordinated well in advance with other responsible bank, thrift, and functional regulators in order to avoid duplication of effort and to minimize burden on the banking organization. Supervisory findings of inspections should be communicated to the banking organization's management or boards of directors, as well as to the banking organization's other bank supervisors and functional regulators, when relevant.

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

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

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

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

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

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

1020.0.1 INTRODUCTION

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

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

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

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

Bank holding companies were created for essentially the same reasons that holding companies were created in other industries; to expand geographically, to move into other product markets, and to obtain greater financial flexibility and tax benefits. The primary use of the bank holding company device prior to the late 1960's was to expand banking operations geographically. The holding company form was needed because many States either prohibited or sharply curtailed branching within the State. Moreover, banks generally did not have the authority to branch beyond the geographic limits of the State in which the bank was chartered. By employing the holding company form of organization, several banking organizations had succeeded by the 1950's in expanding over an entire region of the country, operating banks in several States.

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

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

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

1020.0.2 POSSIBLE CONSEQUENCES OF HOLDING COMPANY FORMATION

There are two primary ways that a holding company can have an adverse effect on the financial condition of a regulated subsidiary. The first is for the holding company (or its unregulated-regulated subsidiaries) to take excessive risks and fail. This failure could have a "ripple effect" on the regulated firm, impairing its access to financial markets. The classic case is the Insull empire in the electric utility industry, which involved the pyramiding of numerous highly leveraged holding companies. The collapse of this pyramid during the Depression of the 1930's severely impacted the regulated electric utility operating companies and impaired their ability to service the public.

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

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

1020.0.3 REGULATORY RESPONSE TO THE HOLDING COMPANY

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

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

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

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

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

The period prior to 1980 marked a gradual decline in the ratio of equity capital to total assets within the United States Commercial banking system, particularly for the nation's largest banking organizations. In an effort to reverse that trend, the Federal Reserve System and the Comptroller adopted guidelines for national and state member banks and bank holding companies in December 1981. The guidelines established minimum capital levels and capital zones. The guidelines provided state member banks and bank holding companies with targets or objectives to be reached over time. As a result, many of the banks and bank holding companies improved their capital positions. However, other developments, including deregulation of interest rates on bank liabilities, weakening of loan portfolios (asset quality) of some banking institutions occasioned by economic shocks in certain industries or geographical areas, and increased competition in the financial services areas, combined to place additional pressures on the profitability of banking institutions and accentuate the potential demands on the capital positions of those institutions.

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

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

The strengthening of supervision over banks and bank holding companies is an equally imposing supervisory concern. The Federal Reserve System adopted a number of supervisory policies in 1985 that directly affected the supervision of bank holding companies, such as the increased frequency and scope of inspections and the communicating of the results of inspections (refer to Manual section 5000). In addition, the scope of the inspection was expanded to provide for a comprehensive analysis of management's ability to direct and control the organization utilizing the basic assumption that the bank holding company is responsible for the direction and vitality of the organization. Overseeing the supervision of banking organizations entails evaluating management's policies and procedures, wherever they are established within the corporate structure, as part of the examination/inspection process. Such policy areas include the consolidated planning process, risk management, funding, liquidity, lending, management information systems, loan review, and audit and internal controls.

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

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

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

In an effort to further strengthen the capital position in banks and bank holding companies, the Board of Governors of the Federal Reserve System, on January 19, 1989, issued final guidelines to implement risk-based capital requirements for state member banks and bank holding companies. The guidelines are based on the framework adopted July 11, 1988, by the Basle Committee on Banking Regulations and Supervisory Practices, which includes supervisory authorities from 12 major industrial countries. The guidelines are designed to achieve certain important goals:

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

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

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

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

Banking organizations must have at least 4 percent Tier 1 capital, which consists of core capital elements, including common stockholder's equity, retained earnings, and noncumulative and limited amounts of cumulative perpetual preferred stock, to weighted risk assets. The other half of required capital (Tier 2), can include, among other supplementary capital elements, the non-Tier 1 portion of cumulative perpetual preferred stock, limited-life preferred stock and subordinated debt, and loan loss reserves up to certain limits.

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

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

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

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

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

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

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

With the FIRREA and FIDICIA legislation, Congress re-emphasized the need for continued strengthening of the supervision over financial institutions. The strengthening of supervision over banks and bank holding companies will continue to be a primary objective of the Federal Reserve. As it is now, it will be continuously emphasized during the examination/inspection of member banks and bank holding companies during the 1990's and beyond.

Use of the Manual

Section 1030.0

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

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

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

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

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

These procedures were designed for a full-scope, comprehensive inspection. It is recognized that in some instances the procedures may not apply in their entirety to all bank holding companies.

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

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

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

1030.0.2 NUMBERING SYSTEM

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

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

1030.0.3 ABBREVIATION

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

1030.0.4 AMENDMENTS TO THE MANUAL

Amendments will be published periodically as needed.

WHAT'S NEW IN THIS REVISED SECTION

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

1040.0.1 BHC INSPECTIONS

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

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

1040.0.1.1 Authority for Bank Holding Company Inspections

Section 5 of the BHC Act of 1956 authorizes the Board to require reports and to conduct inspections of bank holding companies and their affiliates.[1] Subject to the limitations discussed below, Section 5 authorizes the Board to examine each bank holding company and nonbank subsidiary thereof. Within those limitations, the Federal Reserve System's supervisory staff (includes BHC inspection and examination staff) may review *all* books and records of a banking organization that is subject to Federal Reserve Supervision.[2]

1. See 12 U.S.C. 1844.

1040.0.2 FOCUS AND SCOPE OF BHC INSPECTIONS

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

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

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

1040.0.3 EXAMINATIONS OF FUNCTIONALLY REGULATED SUBSIDIARIES

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

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

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

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

The continuing growth in the size and complexity of many banking organizations exposes these firms to a wide array of potential risks, while at the same time making it more challenging for a single supervisor to have a complete view of firmwide risks and controls. In response to these trends, and to better fulfill both its responsibilities as consolidated supervisor and its other central bank objectives, the Federal Reserve continues to refine and enhance its programs for the consolidated supervision of bank holding companies (BHCs) and the combined U.S. operations of foreign banking organizations (FBOs).

The Federal Reserve has set forth its consolidated supervision program for bank holding companies and the combined U.S. Operations of Foreign Banking Organizations in SR-08-9/CA-08-12 and its attachments. (See sections 1050.1 for the consolidated supervision of large complex banking organizations and see 1050.2 for the consolidated supervision of regional banking organizations.) The primary objectives of this supervisory guidance are to specify principal areas of focus for consolidated supervision activities and thereby provide for consistent Federal Reserve supervisory practices and assessments across organizations with similar activities and risks. Consistent with these objectives, the SR letter and its attached guidance detail specific expectations for Federal Reserve staff for understanding and assessing primary governance functions and risk controls, material business lines, nonbank operations, financial condition, and other key activities and risks at banking organizations; address unique aspects of supervising the combined U.S. operations of FBOs; and highlight the supervisory attention that should be paid to risk-management systems and internal controls used by BHCs and FBOs that provide core clearing and settlement services (core clearing and settlement organizations) or that have a significant presence in critical or key financial markets.[1] The guidance also reiterates the importance of coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators.

The Federal Reserve's enhanced approach to consolidated supervision emphasizes several elements that should help make the financial system more resilient. These include focus on corporate governance, capital adequacy, funding and liquidity management, and the supervision of material nonbank subsidiaries,[2] as well as other aspects of the Federal Reserve's consolidated supervision activities designed to further the objectives of fostering financial stability and deterring or managing financial crises. In addition, the Federal Reserve continues to work, both independently and in conjunction with other domestic and foreign bank supervisors and functional regulators, on a number of other initiatives to strengthen supervisory approaches and reinforce expectations for sound practices in response to recent lessons learned.

1050.0.1 SUPERVISION AND REGULATION FRAMEWORK FOR COMPANIES THAT CONTROL A BANK AND THE SUBSIDIARIES OF SUCH COMPANIES

The Bank Holding Company Act (BHC Act), originally enacted in 1956, provides a federal framework for the supervision and regulation of all domestic and foreign companies that control a bank and the subsidiaries of such companies. Among the principal purposes of the BHC Act is to protect the safety and soundness of corporately controlled banks. Financial trouble in one part of an organization can spread rapidly to other parts of the organization; moreover, large BHCs increasingly operate and manage their businesses on an integrated basis across corporate boundaries. Risks that cross legal entities or that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one of the legal entity subsidiaries within the overall organization.

The BHC Act provides for all BHCs, including financial holding companies formed under the Gramm-Leach-Bliley Act (GLBA), to be supervised on a consolidated basis by the Federal Reserve. Consolidated supervision of a BHC encompasses the parent company and its subsidiaries, and allows the Federal Reserve to understand the organization's structure, activities, resources, and risks, as well as to address financial, managerial, operational, or other defi-

1. See Attachment C to SR-08-9/CA-08-12 or this section's appendix for the definitions of "core clearing and settlement organizations," "critical financial markets," and "key financial markets."

2. The term "nonbank subsidiaries" as used in SR-08-9/CA-08-12 and its attachments does not include savings associations.

ciencies before they pose a danger to the BHC's subsidiary depository institutions.

To carry out these responsibilities, the BHC Act grants the Federal Reserve broad authority to inspect and obtain reports from a BHC and its subsidiaries concerning, among other things, the company's financial condition, systems for monitoring and controlling financial and operational risks, and compliance with the BHC Act and other federal law (including consumer protection laws) that the Board has specific jurisdiction to enforce. In addition, federal law authorizes the Federal Reserve to take action against a BHC or nonbank subsidiary to prevent these entities from engaging in unsafe or unsound practices or to address violations of law that occur in connection with their own business operations even if those operations are not directly connected to the BHC's subsidiary depository institutions. Using its authority, the Federal Reserve also has established consolidated capital standards for BHCs, helping to ensure that a BHC maintains adequate capital to support its groupwide activities, does not become excessively leveraged, and is able to serve as a source of strength for its depository institution subsidiaries.

The Federal Reserve's consolidated supervision program has served as the benchmark for many of the current and evolving international standards for the consolidated supervision of financial groups. Key concepts that have been part of the Federal Reserve's approach to consolidated supervision for many years are reflected in the Basel Committee on Banking Supervision's *Minimum Standards for Internationally Active Banks* (1992), capital accords (1988 and 2006), and *Core Principles for Effective Banking Supervision* (1997 and 2006), and are now used by the International Monetary Fund and the World Bank in connection with their assessments of countries' bank supervisory regimes.

In addition to its role as consolidated supervisor of BHCs, the Federal Reserve also is responsible for the overall supervision of the U.S. operations of foreign banks that have a banking presence in the United States. This role was established by the International Banking Act of 1978, which introduced a policy of national treatment[3] promoting competitive equality between FBOs operating in the United States and domestic banking organizations. The Foreign Bank Supervision Enhancement Act of 1991 established uniform federal standards for entry, expansion, and supervision of FBOs in the United States and increased the Federal Reserve's supervisory responsibility and authority over the U.S. operations of FBOs. This act also introduced the requirement that the Federal Reserve approve the establishment of all U.S. banking offices of foreign banks and, in that regard, take into account whether the foreign bank is subject to comprehensive, consolidated supervision by its home-country supervisor.

The Federal Reserve's consolidated supervision activities closely complement its other central bank responsibilities, including the objectives of fostering financial stability and deterring or managing financial crises. The information, expertise, and powers that the Federal Reserve derives from its supervisory authority enhance its ability to help prevent financial crises and to manage such crises (in consultation and conjunction with the Treasury Department and other U.S. and foreign authorities) should they occur. Similarly, the supervisory responsibilities of the Federal Reserve benefit from its responsibilities for financial stability. For example, knowledge gained about financial market developments through interactions with primary dealers in government securities and capital market expertise derived from nonsupervisory activities improve the Federal Reserve's ability to understand and evaluate the activities of banking organizations and otherwise enhance its contributions to supervisory and regulatory policy initiatives.

Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant primary supervisors and functional regulators.[4] These relationships respect the individual statutory authorities

3. "National treatment" refers to a policy that generally gives foreign banks operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations.

4. The term "primary supervisor" as used in this document refers to the primary federal banking or thrift supervisor (for example, the Office of the Comptroller of the Currency for a nationally chartered bank) of a depository institution subsidiary of a BHC, or of a U.S. banking office of an FBO. For state-chartered depository institutions or banking offices, this term also includes the relevant bank supervisory authority of the institution's chartering/licensing state. Where a BHC has multiple depository institution subsidiaries or an FBO has multiple U.S. banking offices, there may also be multiple primary banking supervisors, depending on how the subsidiaries are chartered/licensed. The term "functional regulator" as used in this document refers to the appropriate federal (examples include the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission) or state regulator for a functionally regulated nondepository subsidiary or affiliate of a BHC or FBO. (See SR-00-13, "Framework for Financial Holding Company Supervision.") For U.S. operations of FBOs, the U.S. supervisor of a U.S. banking office is referred to as a domestic primary supervisor.

and responsibilities of the respective supervisors and regulators and provide for appropriate information flows and coordination so that individual responsibilities can be carried out effectively, while limiting the potential for duplication or undue burden. Information sharing among domestic and foreign supervisors, consistent with applicable law and the jurisdiction of each supervisor, is essential to ensure that a banking organization's global activities are supervised on a consolidated basis.

These concepts underlie the provisions of the GLBA governing the interaction between the Federal Reserve, as consolidated supervisor, and the other primary supervisors or functional regulators that may be involved in supervising one or more subsidiaries of a BHC.[5] Under these provisions, the Federal Reserve, in conducting its consolidated supervisory responsibilities, relies to the fullest extent possible on (1) the reports that a BHC or subsidiary has provided to another federal or state supervisor or to an appropriate self-regulatory organization, (2) information that is otherwise required to be reported publicly, and (3) externally audited financial statements. In addition, the Federal Reserve relies to the fullest extent possible on the reports of examination of a depository institution made by its appropriate federal or state bank supervisor, of a broker–dealer or investment adviser made by or on behalf of the SEC or relevant state regulatory authority, or of a licensed insurance company made by or on behalf of its appropriate state regulatory authority. In developing its overall assessment of a BHC or the combined U.S. operations of an FBO, the Federal Reserve also relies to the fullest extent possible on the information gathered and assessments developed by these other supervisors and regulators.

Similarly, the Federal Reserve seeks to assist relevant primary supervisors and functional regulators in performing their supervisory responsibilities with respect to regulated subsidiaries by sharing pertinent information that relates to these regulated subsidiaries consistent with each agency's supervisory responsibilities and applicable law. Examples include shared information relating to the financial condition, risk-management policies, and operations of a banking organization that may have a material impact on regulated subsidiaries, as well as information concerning transactions or relationships between regulated subsidiaries and their affiliates.

5. See SR-00-13.

1050.0.2 KEY OBJECTIVES FOR, AND APPROACHES TO, CONSOLIDATED SUPERVISION

The Federal Reserve uses a systematic approach to develop an assessment of a BHC on a consolidated basis and of the combined U.S. operations of an FBO. These assessments are reflected in the RFI (Risk-Management, Financial Condition, and Impact) rating assigned to a BHC[6] and the combined U.S. operations rating assigned to an FBO with multiple U.S. operations.[7] The Federal Reserve utilizes three principal processes to understand, supervise, and assess BHCs and FBOs: continuous monitoring activities,[8] discovery reviews,[9] and testing.[10]

6. The RFI rating system for BHCs is discussed in SR-04-18, "Bank Holding Company Rating System" and section 4070.0. RFI ratings are assigned at least annually for BHCs with $1 billion or more in consolidated assets, and are communicated via a comprehensive summary supervisory report that supports the BHC's assigned ratings and encompasses the results of the entire supervisory cycle (as described in SR-99-15, "Risk-Focused Supervision of Large Complex Banking Organizations" and section 2124.04).

7. SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations," discusses the U.S. combined operations rating for an FBO and other aspects of the FBO Supervision Program. The Federal Reserve's rating and assessment, as well as a summary of condition analysis describing the strengths and weaknesses of the FBO's combined U.S. operations, are provided to the head office of each FBO. This information is also shared with the FBO's home-country supervisor so that it may assess the impact of U.S. operations on the parent banking organization in its role as consolidated supervisor of the banking organization's global operations.

8. "Continuous monitoring activities" are nonexamination/inspection supervisory activities primarily designed to develop and maintain an understanding of the organization, its risk profile, and associated policies and practices. These activities also provide information that is used to assess inherent risks and internal control processes. Such activities include meetings with banking organization management; analysis of management information systems (MIS) and other internal and external information; review of internal and external audit findings; and other efforts to coordinate with, and utilize the work of, other relevant supervisors and functional regulators (including analysis of reports filed with, or prepared by, these supervisors or regulators, or appropriate self-regulatory organizations, as well as related surveillance results).

9. A "discovery review" is an examination/inspection activity designed to improve the understanding of a particular business activity or control process—for example, to address a knowledge gap identified during the risk assessment or other supervisory process.

10. "Testing" is an examination/inspection activity to assess whether a control process is appropriately designed and achieving its objectives or to validate a management assertion about an organization's operations. Activities may include the review and validation of internal MIS, such as business records related to an internal control process; audit findings and processes; or a sample of transactions that have been

The Federal Reserve's supervisory objectives are the same for all BHCs and FBOs. However, the type and amount of information and the scope and extent of Federal Reserve supervisory and examination[11] work that are necessary to understand, supervise, and develop an assessment of an individual BHC or the U.S. operations of an individual FBO vary. Federal Reserve supervisory activities are tailored for each organization based on a variety of factors, including the organization's legal entity and regulatory structure;[12] the risks posed by the organization's specific activities and systems; and the potential effect of weaknesses in control functions on the organization, its subsidiary depository institutions, or key financial markets. For example, additional supervisory activities, including transaction testing in appropriate circumstances, may be conducted when there are information gaps relating to material risks or activities, indications of weaknesses in risk-management systems or internal controls, or indications of violations of consumer protection or other laws, or when a consolidated organization or subsidiary depository institution is in less-than-satisfactory condition.

1050.0.2.1 Key Supervisory Objectives

In fulfilling its responsibilities for supervising a BHC on a consolidated basis and the combined U.S. operations of an FBO, the Federal Reserve is guided by the following key supervisory objectives.

1050.0.2.1.1 Understanding the Bank Holding Company on a Consolidated Basis and the Combined U.S. Operations of an FBO

Supervisory Objective: The Federal Reserve develops a comprehensive understanding of each BHC and the combined U.S. operations of each FBO. Key elements in developing this understanding include

- corporate strategy and significant activities;
- business line, legal entity, and regulatory structure, including interrelationships and dependencies across multiple legal entities;
- corporate governance, risk management, and internal controls for managing risks; and
- for certain organizations, presence in critical or key financial market activities.

1050.0.2.1.2 Assessing the Bank Holding Company on a Consolidated Basis and the Combined U.S. Operations of an FBO

Supervisory Objective: The Federal Reserve supervises each BHC on a consolidated basis and assigns an RFI rating through an evaluation and assessment of the following areas

- key corporate governance, risk management, and control functions (including, where applicable, such functions as they relate to core clearing and settlement activities and activities where the organization has a significant presence in critical or key financial markets);
- the adequacy of the financial condition of the consolidated organization; and
- the potential negative impact of nonbank entities on subsidiary depository institutions.

The Federal Reserve also supervises and assesses the combined U.S. operations of each FBO and assigns a U.S. combined operations rating based on analysis of these same elements.

1050.0.2.1.3 Interagency Coordination

Supervisory Objective: As noted earlier, effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant domestic and foreign supervisors and functional regulators. To achieve this objective, while limiting the potential for duplication or undue burden, the nature and scope of Federal Reserve work is tailored to the organization's legal entity and regulatory structure as well as the risks associated with the organization's activities. In this regard, the Federal Reserve

- relies to the fullest extent possible on assessments and information developed by other relevant domestic and foreign supervisors and functional regulators;

entered into by a banking organization.

11. While by definition "examination" activities are applicable to the supervision of banks and other depository institutions, as well as U.S. banking offices of FBOs, and "inspection" activities are applicable to the supervision of BHCs and nonbank subsidiaries and affiliates, the term "examination" is generally used throughout this guidance to refer to both examination and inspection activities.

12. An organization's "regulatory structure" refers to the various legal entities within the organization that are subject to oversight by different domestic and foreign supervisors or functional regulators.

- focuses supervisory attention on material risks from activities that are not supervised by another supervisor or regulator or that cut across legal entities; and
- participates in the sharing of information among domestic and foreign supervisors and functional regulators, consistent with applicable law, to provide for the comprehensive, consolidated supervision of each banking organization's global activities.

Since coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators is so central to the Federal Reserve's conduct of consolidated supervision, direction for achieving these objectives is closely integrated into the attached guidance for understanding and assessing consolidated BHCs and the combined U.S. operations of FBOs.

1050.0.2.2 Risk-Focused Approach to Consolidated Supervision

The Federal Reserve uses a risk-focused approach to supervision of banking organizations in general and to each organization individually. In this regard, the Federal Reserve focuses supervisory activities on identifying the areas of greatest risks to a banking organization and assessing the ability of the organization's management to identify, measure, monitor, and control these risks. In addition, the Federal Reserve typically is more actively and comprehensively engaged in the supervision of the largest and most complex BHCs and FBOs, as well as those with the most dynamic risk profiles. By paying particular attention to these organizations, the Federal Reserve aims to minimize significant adverse effects on the public (including consumers), the financial markets, and the financial systems in the United States and abroad, as well as on taxpayers, who provide the ultimate resources behind the federal safety net.

The Federal Reserve also focuses special supervisory attention on the risk-management systems and internal controls used by core clearing and settlement organizations or organizations that have a significant presence in key financial markets. In light of the potential for problems in these areas to transmit an adverse impact across the banking and financial system, these activities pose special legal, reputational, and other risks to the banking organization and its depository institution subsidiaries. The Federal Reserve has unique expertise and perspective in these areas based on its broader central bank responsibilities and functions.

Unlike banks, nonbank subsidiaries of a banking organization may not accept FDIC-insured deposits and do not have routine access to the Federal Reserve's discount window and payment system. As a result, certain laws and supervisory policies that apply to banks (e.g., the prompt-corrective-action framework[13]) do not apply to nonbank subsidiaries, and the manner in which the Federal Reserve supervises the nonbank subsidiaries of a banking organization reflects these differences. The Federal Reserve's supervision of nonbank subsidiaries under the BHC Act is primarily directed toward, and focused on, ensuring that the nonbank subsidiary does not present material financial, legal, or reputational risks to affiliated depository institutions or to the BHC's or FBO's ability to support these depository institutions. The Federal Reserve also may interact with nonbank entities, such as primary dealers in government securities, in connection with its other central bank functions and responsibilities, including conducting monetary policy, fostering financial stability, and deterring or managing financial crises.

As part of the supervisory process, the Federal Reserve reviews the systems and controls used by BHCs and the U.S. operations of FBOs to monitor and ensure that the organization, including its nonbank subsidiaries, complies with applicable laws and regulations, including those related to consumer protection. The Federal Reserve develops and maintains an understanding and assessment of consumer compliance risk at nonbank subsidiaries of a BHC or FBO primarily through continuous monitoring activities, relying to the fullest extent possible on work performed by the relevant functional regulator, if any. While the Federal Reserve routinely conducts examinations of the compliance function at the BHC, including its systems for monitoring and ensuring compliance with consumer and other applicable laws, the Federal Reserve currently does not routinely conduct examinations for the purpose of determining compliance with specific consumer laws enforced primarily by other supervisors regarding nonbank subsidiaries of BHCs and FBOs. When consumer compliance-related deficiencies are noted as part of the ongoing supervision of a BHC or FBO, however, consumer compliance examiners may conduct onsite examinations

13. For more information on the prompt-corrective-action framework for banks, see section 4133.1 of the Federal Reserve's *Commercial Bank Examination Manual*, or see 12 C.F.R. 208, Subpart D.

(including transaction testing, if appropriate) of nonbank subsidiaries to resolve significant issues that have the potential for widespread violations or harm to consumers.[14]

The Federal Reserve also seeks to reinforce market discipline by encouraging public disclosures that balance quantitative and qualitative information with clear discussions about risk-management processes and that reflect evolving disclosure practices for peer organizations.

1050.0.2.3 Supervisory Portfolios

An important aspect of the Federal Reserve's consolidated supervision programs for BHCs and the combined U.S. operations of FBOs is the assessment and evaluation of practices across groups of organizations with similar characteristics and risk profiles. This ''portfolio approach'' to consolidated supervision facilitates greater consistency of supervisory practices and assessments across comparable organizations and enhances the Federal Reserve's ability to identify outlier organizations among established peer groups. The supervisory portfolios that the Federal Reserve currently uses in structuring its supervisory programs for BHCs and the U.S. operations of FBOs are as follows:

BHC Portfolios:

- large complex banking organizations (LCBO BHCs)
- regional bank holding companies (regional BHCs)
- community bank holding companies (community BHCs)

FBO Portfolios:

- large complex foreign banking organizations (LCBO FBOs)
- multi-office foreign banking organizations (multi-office FBOs)
- single-office foreign banking organizations (single-office FBOs)

In 1999, the Federal Reserve formally established its supervision program for both domestic and foreign LCBOs (see SR-99-15 and section 2124.04). LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structures, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market.

Banking organizations that are not designated as LCBOs belong to the portfolios of regional or community BHCs, or multi-office or single-office FBOs. While there is considerable variety among organizations across these portfolios, the simpler regulatory structure of most non-LCBO organizations increases the likelihood that a single primary supervisor has a substantially complete view of, and ability to address, significant areas of firmwide (or combined U.S. operations for FBOs) activities, risks, risk management, and controls.

1050.0.3 SUPERVISORY GUIDANCE

The guidance attached to SR-08-9/CA-08-12 (e.g., sections 1050.1 and 1050.2) describes how Federal Reserve staff will develop an understanding and assessment of a BHC or the U.S. operations of an FBO through continuous monitoring activities, discovery reviews, and testing activities, as well as through interaction with, and reliance to the fullest extent possible on, other relevant primary supervisors and functional regulators. Because the Federal Reserve's supervisory activities are tailored in the manner described above, separate guidance documents are provided for four different supervisory portfolios to promote appropriate and consistent supervision of organizations that broadly share similar characteristics and risk profiles. The documents' guidance addresses

- consolidated supervision of LCBO BHCs (Attachment A.1) (See section 1050.1);
- consolidated supervision of regional BHCs (Attachment A.2) (See section 1050.2);
- supervision of the combined U.S. operations of LCBO FBOs (Attachment B.1); and
- supervision of the combined U.S. operations of multi-office FBOs (Attachment B.2).

As a supplement to these four guidance documents, definitions of key terms for consolidated supervision are provided in Attachment C to

14. See SR-03-22/CA-03-15, ''Framework for Assessing Consumer Compliance Risk at Bank Holding Companies,'' and section 2124.01.6.1.2.

SR-08-9/CA-08-12 (See appendix, section 1050.0.4).

Consolidated supervision of community BHCs follows the procedures contained in SR-02-1 and section 5000.0.4.3, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less," while supervision of single-office FBOs follows the procedures contained in SR-00-14.

1050.0.3.1 Overview of Significant Federal Reserve Supervisory Activities

The Federal Reserve will maintain for each BHC and the combined U.S. operations of each FBO

- an understanding of key elements of the banking organization's strategy, primary revenue sources, risk drivers, business lines, legal entity structure, governance and internal control framework, and presence in key financial markets; and
- an assessment of (1) the effectiveness of risk-management systems and controls over the primary risks inherent in the organization's activities, (2) the organization's financial condition, and (3) the potential negative impact of nonbank operations on affiliated depository institutions.

This understanding and assessment will encompass both prudential and consumer compliance supervision and reflect judgments developed by Federal Reserve staff drawing from all available sources, including the work of other relevant primary supervisors and functional regulators and the organization's internal control functions. Primary areas of focus will include

1. key corporate governance functions, including internal audit;
2. risk management and internal control functions for primary risks of the consolidated organization (or combined U.S. operations for FBOs), and supporting MIS;
3. where applicable, core clearing and settlement activities and related risk management and internal controls of firms that are large-value payment system operators and market utilities;
4. for LCBOs, activities in critical or key financial markets in which the organization plays a significant role, as well as related risk management and internal controls;
5. where applicable, areas of emerging interest with potential financial market consequences;
6. consolidated financial strength (in the case of FBOs, the financial strength of combined U.S. operations);
7. risk management and financial condition of significant nonbank subsidiaries; and
8. parent company and nonbank funding and liquidity (in the case of FBOs, funding and liquidity of U.S. operations).

By their nature, understanding and assessing some areas—such as the risk management and financial condition of significant nonbank subsidiaries that are not functionally regulated—will typically require more independent Federal Reserve supervisory work. Other areas—such as primary firmwide risk management and control functions—typically will require a greater degree of coordination with other relevant primary supervisors or functional regulators, who will likely have information or assessments upon which the Federal Reserve can draw.

The guidance in the attachments to SR-08-9/CA-08-12 outlines when the Federal Reserve will conduct (i.e., participate in or lead) testing activities in order to determine whether a control process is appropriately designed and achieving its objectives or to otherwise validate management assertions. Testing activities are an important element of the Federal Reserve's consolidated supervision program for BHCs and the combined U.S. operations of FBOs. They supplement ongoing continuous monitoring activities and periodic discovery reviews necessary to maintain an understanding and assessment for each of these key functions.

The guidance in the SR letter's attachments also discusses in greater detail control processes for several areas subject to testing on at least a three-year cycle, supplemented by a reassessment on at least an annual basis to identify whether changes in inherent risk or control structures, or potential concerns regarding controls, merit interim targeted testing activities. These areas are

- internal audit infrastructure;
- parent company and nonbank funding and liquidity (in the case of FBOs, funding and liquidity of U.S. operations);
- where applicable, core clearance and settlement activities; and,
- where applicable, activities in critical finan-

cial markets in which the organization plays a significant role.[15]

There may also be instances when additional supervisory activities are necessary to improve the understanding and/or to assess the adequacy of key corporate governance functions or risk management or internal control functions for primary risks due to significant changes, potential concerns, or the absence of recent testing.

All cycle times set forth in the guidance for testing represent maximum periods between testing activities. Shorter cycle times should be utilized whenever significant changes occur in, or material concern exists regarding, a key governance, risk-management, or internal control function.

In conducting the activities described in the guidance, the Federal Reserve will rely to the fullest extent possible on the information and assessments of relevant primary supervisors and functional regulators, and will work with such supervisors and regulators to align each agency's assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of consolidated BHC or combined U.S. FBO operations, as applicable. In addition, because of the specific statutory limitations that apply with respect to functionally regulated subsidiaries of a BHC or FBO, the Federal Reserve will continue to adhere to the procedures and limits described in SR-00-13 (see sections 3900.0 and 1040.0) in conducting any examination of, or requesting a specialized report from, a functionally regulated subsidiary of a BHC or FBO.[16] Under these provisions, for example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it reasonably determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.

15. For these activities, the three-year testing cycle focuses on adherence with expectations of the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* (see SR-03-9), including the geographic diversity and resiliency of data centers and operations, and testing of recovery and resumption arrangements.

16. For these purposes, a "specialized report" means a report that the functionally regulated subsidiary is not required to prepare for another federal or state regulatory authority or an appropriate self-regulatory organization. Consistent with the GLBA, if the Federal Reserve seeks to obtain a specialized report from a functionally regulated subsidiary, the Federal Reserve will first request that the subsidiary's appropriate regulatory authority or self-regulatory organization obtain the report and make it available to the Federal Reserve.

1050.0.3.2 Application of Supervisory Guidance

As a general matter, the supervisory expectations and processes of the guidance documents that are attached to SR-08-9/CA-08-12 are intended for use in supervising BHCs and the combined U.S. operations of FBOs in circumstances where both the banking organization and its subsidiary depository institutions are in at least satisfactory condition and there are no indications of material weakness in the organization's risk management or internal controls. Additional Federal Reserve supervisory activities may be necessary or appropriate if the banking organization is facing, or is expected to face, material financial, managerial, operational, legal, or reputational difficulties, or is the subject of an investigation or formal or informal enforcement action.

Section IV of each of the documents attached to SR-08-9/CA-08-12 (see sections 1050.1.4 and section 1050.2.4) provides additional guidance on the steps the Federal Reserve will take to coordinate with other supervisors in certain special situations. This guidance does not limit any authority that the Federal Reserve may have under applicable law and regulations, including the authority to obtain reports or conduct examinations or inspections. Moreover, because this guidance relates to supervisory practices, it does not address or limit the circumstances under which the Federal Reserve may take formal or informal enforcement action against a banking organization or other person.

This supervisory guidance is not intended to comprehensively describe all elements of an effective supervision program for BHCs or U.S. operations of FBOs. Rather, the guidance supplements, and should be used in conjunction with, existing Federal Reserve guidance, including among others the *Bank Holding Company Supervision Manual;* the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*; SR-04-18; SR-03-22/CA-03-15; SR-00-14; and SR-00-13.

1050.0.4 APPENDIX—DEFINITIONS OF KEY TERMS FOR CONSOLIDATED SUPERVISION

1050.0.4.1 Supervisory Objectives

Assessing: To go beyond developing an *understanding* by making supervisory judgments regarding the degree of inherent risks or evaluating whether risk-management and internal control practices are functioning as intended, and whether they are adequate relative to the risk taken. It is often necessary for bank supervisors or *functional regulators* to conduct *testing* activities as a means to arrive at an assessment.

Understanding: To gain comprehensive insight into the nature of a business activity, its related risks, and the design of risk-management and compensating controls. Understanding also involves comprehending the significance of such activities, risks, and controls for the institution's safety and soundness. *Continuous monitoring* or *discovery reviews* are often utilized to develop an understanding of a banking organization's operations and the related inherent risk and controls.

1050.0.4.2 Supervisory Activities

Active participation: When the Federal Reserve has input into determining the objectives, final conclusions, and related communications to institution management for an *examination* led by another *relevant primary supervisor* or *functional regulator*.

Continuous monitoring: Non-*examination/inspection* supervisory activities primarily designed to develop and maintain an *understanding* of the organization, its risk profile, and associated policies and practices. These activities also provide information that is used to *assess* inherent risks and internal control processes. Such activities include meetings with banking organization management; analysis of management information systems (MIS) and other internal and external information; review of internal and external audit findings; and other efforts to coordinate with, and utilize the work of, other relevant supervisors and *functional regulators*, including analysis of reports filed with, or prepared by, these supervisors or regulators, or appropriate self-regulatory organizations, as well as related surveillance results.

Discovery review: An *examination/inspection* supervisory activity designed to improve the *understanding* of a particular business activity or control process—for example, to address a knowledge gap identified during the risk assessment or other supervisory process. If questions regarding the adequacy of practices or sufficiency of information are raised during this review, it will likely be necessary to conduct further and more in-depth *examination* activity (e.g., *testing*).

Examination/inspection: Examination activities are applicable to the supervision of banks and other depository institutions, as well as *U.S. banking offices* of FBOs, and inspection activities are applicable to the supervision of BHCs and nonbank subsidiaries and affiliates. Examination and inspection activities are generally described as examinations throughout this guidance.

Testing: An *examination/inspection* supervisory activity designed to go beyond a *discovery review*, as it will result in an *assessment* of whether a control process is appropriately designed and achieving its objectives, or validation of a management assertion about an organization's operations. Such activities may include the review and validation of internal MIS, such as business records related to an internal control process; audit findings and processes; or a sample of transactions that have been entered into by a banking organization.

1050.0.4.3 Foreign Banking Organization Supervision

Booked in: Recorded on the books and records of the legal entity in question. For supervisory purposes, the U.S. operations of FBOs include activities that are booked in or *traded through* U.S. operations.

Comprehensive, consolidated supervision: An FBO is supervised or regulated in such a manner that its home-country supervisor receives sufficient information on the worldwide operations of the FBO (including the relationship of the bank to any affiliate) to assess the FBO's overall financial condition and compliance with law and regulation. The Foreign Bank Supervision Enhancement Act of 1991 introduced the requirement that the Federal Reserve approve the establishment of all *U.S. banking offices* of FBOs, and in that connection, take into account whether the FBO is subject to comprehensive, consolidated supervision by its home-country supervisor.

Multi-office foreign banking organizations: All FBOs except for (1) those that are designated as being part of the portfolio of LCBOs and (2) FBOs whose U.S. operations consist solely of a single *U.S. banking office*.

National treatment: As established by the International Banking Act of 1978 (IBA), a policy that requires nondiscrimination between domestic and foreign firms or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. This policy generally gives foreign banks operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations.

Net due to / from positions: Net due to and from positions refer to the flow of funds between a U.S. branch or agency and its parent FBO (including other affiliated depository institutions). For example, a U.S. branch is in a net due from position with its parent FBO if the parent owes funds to the branch once all transactions between the branch and the parent are netted.

Qualifying foreign banking organizations (QFBOs): FBOs that are entitled to certain exemptions from the nonbanking activities restrictions of the Bank Holding Company Act, including for certain limited commercial and industrial activities in the United States. The Federal Reserve does not *examine* or supervise these commercial/industrial activities. The Federal Reserve monitors the extensions of credit by *U.S. banking offices* of foreign banks to U.S. companies held directly under this authority to ensure that such loans are made on market terms.

Traded through: Transacted or arranged by the personnel of the institution in question (in an agent role), but booked at a different related legal entity. For supervisory purposes, the U.S. operations of FBOs include activities that are *booked in* or traded through U.S. operations.

U.S. banking offices: U.S. depository institution subsidiaries of FBOs and branches/agencies of FBOs.

U.S. nonbank affiliates of U.S. banking offices: U.S. BHC parent companies and their nonbank subsidiaries, as well as other U.S. nonbank affiliates and representative offices held directly by the FBO.

1050.0.4.4 Other Terms

Banking Organization National Desktop (BOND): A Federal Reserve information technology platform providing secure interagency access to documents, supervisory and financial data, and other information utilized in the *consolidated supervision* of individual BHCs and FBOs, and in developing comparative analyses of institutions with similar business lines and risk characteristics.

College of supervisors: A multilateral group of supervisors that discusses issues related to specific internationally active banking organizations. The Federal Reserve participates in colleges of supervisors as both a home-country supervisor of internationally active U.S. BHCs and as a host-country supervisor of the U.S. operations of FBOs.

Consolidated supervision (also known as "umbrella" or "groupwide" supervision): Supervision of a BHC on a groupwide basis, including its nonbanking subsidiaries, providing important protection to its subsidiary banks and to the federal safety net beyond that afforded by supervision of a bank individually. Consolidated supervision allows the Federal Reserve to *understand* the financial and managerial strength and risks within the consolidated organization as a whole, providing the ability to address significant management, operational, capital, or other deficiencies within the overall organization before they pose a threat to subsidiary banks.

Core clearing and settlement organizations: As defined in the "Interagency Paper on Sound Practices to Strengthen the Resilience of the U. S. Financial System" (SR-03-9), two groups of organizations that provide clearing and settlement services for *critical financial markets* or act as large-value payment system operators, and present the potential for *systemic risk* should they be unable to perform. The first group consists of market utilities (government-sponsored services or industry-owned organizations), whose primary purpose is to clear and settle transactions for *critical markets* or transfer large-value wholesale payments. The second group consists of those private-sector firms that provide clearing and settlement services that are integral to a *critical market* (i.e., their aggregate market share is significant enough to present the potential for *systemic risk* in the event of their sudden failure to carry out those activities because there are no viable immediate substitutes).

Critical financial markets: As defined in the "Interagency Paper on Sound Practices to Strengthen the Resilience of the U. S. Financial System," the markets for federal funds, foreign exchange, and commercial paper; U.S. government and agency securities; and corporate debt and equity securities.

Domestic BHC: A BHC incorporated in the United States that is not controlled by an FBO.

Double leverage: Situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

Financial instability: When external events or market behavior in the financial system are substantial enough to significantly distort or impair national or global financial markets or to create significant risks for real aggregate economic performance. Banking organizations with a considerable presence in activities that are potentially vulnerable to such externalities—or that are capable of contributing to financial instability if not adequately managed—require supervisors to develop an *understanding* of these activities and their risk profile.

Functional regulator: With respect to domestic authorities, the appropriate federal (examples include the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission) or state regulator for a functionally regulated nondepository subsidiary or affiliate of a BHC or FBO.

Key corporate governance functions: Primary firmwide governance mechanisms relied upon by the board of directors and senior management. This includes the board and its committees, senior management and its executive committees, internal audit, and other functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining the consolidated organization as well as a firm's business resiliency and crisis management capabilities.

Key financial markets: Includes *critical financial markets* as well as (1) broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading; (2) retail financial services; and (3) international financial markets.

Key models and processes: Those where evaluation of the model/process will influence the Federal Reserve's *assessment* of the activity or control area that is supported by the model/process.

Large complex banking organizations (LCBOs): LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their *regulatory structure*, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one *key financial market.*

Material portfolios or business lines: Portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as mortgage lending or leveraged lending) that are primary drivers of risk or revenue for the BHC, or that otherwise materially contribute to *understanding* inherent risk or *assessing* related controls for a broader corporate function (such as consolidated credit-risk management). When identifying these areas during the development of the institutional overview and risk assessment, as well as during other supervisory processes, consideration is given to all associated risk elements, including legal and compliance risks.

Net debit cap: The maximum dollar amount of uncollateralized daylight overdrafts that an institution may incur in its Federal Reserve account.

Nonmaterial business lines: Business lines that are not primary drivers of risk or revenue for the BHC, and are not principal contributing factors to either *understanding* risk inherent in a broader corporate function or to *assessing* related controls.

Nontraditional BHCs: BHCs in which most or all of the organization's significant nondepository subsidiaries are regulated by a *functional* *regulator*, and subsidiary depository institution(s) are small in relation to nondepository subsidiaries.

Other relevant primary supervisors: Primary bank or thrift supervisors of BHC subsidiaries, including host-country supervisors (or home-country supervisors for FBOs), whose understanding and assessments are key to effective firmwide *consolidated supervision*.

Primary firmwide risk management and control functions: Mechanisms relied upon by the board of directors and senior management for identifying, measuring, monitoring, and controlling primary risks to the consolidated organization. This includes risk management and control functions for primary credit, legal and compliance, liquidity, market, operational, and reputational risks for the consolidated organization.

Primary supervisor: The primary federal banking or thrift supervisor (for example, the Office of the Comptroller of the Currency for a nationally chartered bank) of a depository institution subsidiary of a BHC, or of a *U.S. banking office* of an FBO. For state-chartered depository institutions or banking offices, this term also includes the relevant bank supervisory authority of the institution's chartering/licensing state. Where a BHC has multiple depository institution subsidiaries, or an FBO has multiple *U.S. banking offices*, there may also be multiple primary banking supervisors, depending on how the subsidiaries are chartered/licensed. For U.S. operations of FBOs, the U.S. supervisor of a *U.S. banking office* is referred to as a domestic primary supervisor.

Regional bank holding companies: BHCs with $10 billion or more in consolidated assets (including *nontraditional BHCs*) that are not designated as *LCBOs*.

Regulatory structure: The various legal entities within the organization that are subject to oversight by different domestic and foreign *primary supervisors* or *functional regulators*.

Significant nonbank activities and risks: Where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution affiliate.

Specialized report from a functionally regulated subsidiary: As discussed in the GLBA, a report that the functionally regulated subsidiary is not required to prepare by another federal or state regulatory authority or an appropriate self-regulatory organization.

Systemic risk: The risk that the failure of one participant to meet its required obligations in a transfer system or financial market will cause other participants to be unable to meet their obligations when due, causing significant liquidity or credit problems or threatening the stability of national or global financial markets.

1050.1.1 ACTIVITIES OF THE FEDERAL RESERVE AND OTHER SUPERVISORS AND REGULATORS, AND FUNCTIONAL REGULATION

In 1999, the Federal Reserve established its supervisory program for large complex banking organizations (LCBOs).[1] LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structure, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market.[2]

As outlined in the following sections, a range of continuous monitoring activities is utilized, along with discovery reviews and testing activities (examination/inspection activities),[3] to develop and maintain an understanding and assessment of each domestic bank holding company (BHC) that is an LCBO.[4] These organizations are collectively referred to as large complex BHCs.

1050.1.1.1 Federal Reserve Activities and Those Activities of Other Supervisors and Regulators

The nature and scope of independent Federal Reserve supervisory work required to develop and maintain an understanding and assessment of a large complex BHC depends largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. By their nature, understanding and assessing some areas—such as the risk management and financial condition of significant nonbank subsidiaries that are not functionally regulated—typically will require more independent Federal Reserve supervisory work. Other areas—such as primary firmwide risk-management and control functions—typically will require a greater degree of coordination with other relevant primary supervisors or functional regulators, who will likely have information or assessments upon which the Federal Reserve can draw.

The following sections provide further detail on how the Federal Reserve will develop, working in coordination with other relevant primary supervisors and functional regulators, an understanding and assessment of a large complex BHC. In conducting the activities described throughout this document, the Federal Reserve will, to the fullest extent possible

- rely on the information and assessments of relevant primary supervisors and functional regulators, including the information and assessments reflected in the reports of examination of such supervisors and regulators;
- focus its supervisory activities on the bank holding company, as well as on those of its nonbank subsidiaries that could have a direct or indirect materially adverse effect on the safety and soundness of a depository institution subsidiary of the BHC due to the size, condition, or activities of the nonbank subsidiary, or the nature or size of its transactions with the depository institution; and
- use publicly reported information (including externally audited financial statements), as well as reports that a large complex BHC or a subsidiary prepares for other primary supervisors, functional regulators, or self-regulatory organizations.

1050.1.1.2—Functionally Regulated Subsidiaries

As discussed below, in certain situations, the Federal Reserve may find it necessary to conduct an examination of a functionally regulated nonbank subsidiary in order to fulfill the Federal Reserve's responsibilities as supervisor of the consolidated organization. In any such case, the Federal Reserve will continue to adhere to the procedural and other requirements governing

1. See SR-99-15, "Risk-Focused Supervision of Large Complex Banking Organizations," or section 2124.04.

2. See section 1050.0.4, Appendix, for the definitions of terms commonly used in this section and sections 1050.1 and 1050.2.

3. The term "examination" is generally used throughout this guidance to refer to both commercial bank examination and BHC inspection activities.

4. The term "domestic BHC" refers to a BHC incorporated in the United States that is not controlled by a foreign banking organization (FBO). Attachment B.1. to SR-08-9/CA-08-12 addresses—in the context of supervising the combined U.S. operations of FBOs—how the Federal Reserve will develop and maintain an understanding and assessment of a BHC that is, or is controlled by, an FBO that is itself an LCBO.

examinations of, or requests for a specialized report from, a functionally regulated subsidiary as discussed in SR-00-13 and sections 1040.0 and 3900.0. Under these provisions, for example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it reasonably determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.[5]

1050.1.2 UNDERSTANDING THE ORGANIZATION

For each large complex BHC, the Federal Reserve will develop an understanding of the legal, operating, and corporate governance structure of the organization and its primary strategies, business lines, and risk-management and internal control functions.[6] This understanding will inform the development of a risk assessment and supervisory plan for the BHC. Typically, the information necessary to gain this understanding may be obtained from the organization's management, public reports, regulatory reports, surveillance screens, third-party sources (e.g., credit rating agency and market analyst reports), and other relevant primary supervisors or functional regulators. Key elements that should be identified and understood include the following:

- *Corporate strategy*. Primary business strategies; institutional risk tolerance; key changes in strategic direction or risk profile; significant new business activities, areas of growth and emerging areas with potential to become primary drivers of risk or revenue; and plans for expansion through mergers or acquisitions.
- *Significant activities*. Key revenue and risk drivers; primary business lines; product mix; budget and internal capital allocations; market share for revenue and customers served; key external trends, including competitive pressures; and areas that are vulnerable to volatility in revenue, earnings, capital, or liquidity.
- *Structure*. Business line and legal entity structure; domestic and foreign regulatory responsibilities for legal entities and business lines; key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates; material business lines operated across multiple legal entities for accounting or risk-management purposes; and the activities and risk profiles of Edge and agreement corporation subsidiaries.
- *Corporate governance, risk management, and internal controls for primary risks*. Board of directors (board) and executive-level committees; senior management and management committees; key risk-management and internal control functions, and associated management information systems (MIS), relied upon by the board, senior management, and senior risk managers and committees; and consistency of public disclosures with how the board and senior management assess and manage risks.
- *Presence in critical or key financial markets.*[7] Core clearing and settlement activities; business lines with a significant presence in critical or key national or global financial markets; and related risk-management and disclosure practices.

To ensure the quality and consistency of consolidated supervision across the large complex BHC portfolio, it also is necessary to understand

5. The Federal Reserve also may examine a functionally regulated subsidiary of a large complex BHC if, after reviewing relevant reports and other information, it has reasonable cause to believe that the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution, or that the subsidiary is not in compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the subsidiary (and the Federal Reserve cannot determine compliance by examining the BHC or its affiliated depository institutions).

Similarly, before requiring a specialized report from a functionally regulated subsidiary, the Federal Reserve first will request that the subsidiary's appropriate functional regulator obtain the report and make it available to the Federal Reserve. In the event that the report is not obtained or made available as requested, the Federal Reserve may, consistent with the Bank Holding Company Act, obtain the report directly from the functionally regulated subsidiary if the report is necessary to allow the Federal Reserve to adequately assess (1) a material risk to the BHC or any of its depository institution subsidiaries, (2) the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a threat to the safety and soundness of a depository institution subsidiary, or (3) compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the BHC or a subsidiary.

6. This understanding is formally documented during development of the institutional overview, which coincides with creation of the annual risk assessment. SR-99-15 and SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions" (see section 2124.01), describe processes for developing an institutional overview, risk assessment, and supervisory plan. Each of these products is kept current to reflect significant changes in an organization's risks or activities.

7. See sections 1050.1.3.1.6 and 1050.1.3.1.7 for definitions of "critical financial markets" and "key financial markets."

how these key elements compare with industry trends and with evolving practices of well-managed organizations with similar characteristics.

1050.1.3 ASSESSING THE LARGE COMPLEX BHC ON A CONSOLIDATED BASIS

The Federal Reserve uses a systematic approach to develop an assessment of a BHC on a consolidated basis. This assessment is reflected in the RFI (Risk Management, Financial Condition, and Impact) rating assigned to a BHC.[8]

1050.1.3.1 Risk Management

1050.1.3.1.1 Key Corporate Governance Functions

Objectives: One of the primary areas of focus for consolidated supervision of large complex BHCs is the adequacy of governance provided by the board and senior management. The culture, expectations, and incentives established by the highest levels of corporate leadership set the tone for the entire organization and are essential determinants of whether a banking organization is capable of maintaining fully effective risk-management and internal control processes.

The board and its committees should have an ongoing understanding of key inherent risks, associated trends, primary control functions, and senior management capabilities. Primary expectations for the board and its committees include

1. selecting competent senior managers, ensuring that they have the proper incentives to operate the organization in a safe and sound manner, and regularly evaluating senior managers' performance;
2. establishing, communicating, and monitoring (for example, by reviewing comprehensive MIS reports produced by senior management) institutional risk tolerances and a corporate culture that emphasizes the importance of compliance with the law and ethical business practices;
3. approving significant strategies and policies;
4. demonstrating leadership, expertise, and effectiveness;
5. ensuring the organization has an effective and independent internal audit function;
6. ensuring the organization has appropriate policies governing the segregation of duties and avoiding conflicts of interest; and
7. ensuring that public disclosures
   - are consistent with how the board and senior management assess and manage the risks of the organization,
   - balance quantitative and qualitative information with clear discussions about risk-management processes, and
   - reflect evolving disclosure practices for peer organizations.

A large complex BHC's senior management and its committees should be able to clearly communicate risk tolerances and measures, control risks, hire and retain competent staff, and respond to changes in the organization's risk profile and the external environment. Members of senior management are expected to have qualifications and experience commensurate with the size and complexity of the organization. Primary expectations for senior management include

1. establishing effective oversight and an appropriate risk culture;
2. appropriately delegating authority and overseeing the establishment and implementation of effective policies for the proper segregation of duties and for the avoidance or management of conflicts of interest;
3. establishing and implementing an effective risk-management framework capable of identifying and controlling both current and emerging risks, and effective independent control functions that ensure risk taking is consistent with the organization's established risk appetite;
4. establishing and implementing incentives for personnel that are consistent with institutional risk tolerances, compliance with the law, and ethical business practices;
5. promoting a continuous dialogue between and across business areas and risk-management functions to help align the organization's established risk appetite and risk controls;
6. ensuring that the board and its committees are provided with timely, accurate, and comprehensive MIS reports that are adaptive to

8. The RFI rating system for BHCs is discussed in SR-04-18, "Bank Holding Company Rating System" (see section 4070.0). RFI ratings are assigned for BHCs that are complex or that have $1 billion or more in consolidated assets, and are communicated via a comprehensive summary supervisory report that supports the BHC's assigned ratings and encompasses the results of the entire supervisory cycle (as described in SR-99-15 and section 2124.04).

changing circumstances regarding risks and controls; and
7. ensuring timely resolution of audit, compliance, and regulatory issues.

An effective internal audit function plays an essential role by providing an independent and objective evaluation of all key governance, risk-management, and internal control processes. As the complexity of financial products and supporting technology has grown, in combination with greater reliance on third-party service providers, the importance of internal audit's role in identifying risks and testing internal controls has increased.

In addition, the extent to which supervisors can rely on or utilize the work of internal audit is an essential determinant of the risk-focused supervisory program that is tailored to the activities and risks of each large complex BHC.

Supervisory Activities: For each large complex BHC, the Federal Reserve will understand and assess the adequacy of oversight provided by the board and senior management, as well as the adequacy of internal audit and associated MIS. The Federal Reserve also will understand and assess other key corporate governance functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining consolidated holding company operations, as well as the organization's business resiliency and crisis management capabilities.

- *Board, senior management, and other key corporate governance functions*. Continuous monitoring activities—which draw from all available sources, including internal control functions, the work of other relevant primary supervisors and functional regulators, regulatory reports, and related surveillance results—will be used to understand and assess the effectiveness of board and senior management resources and oversight.

  The results of continuous monitoring activities, as documented in the institutional overview, risk assessment, and other supervisory products, may identify certain corporate governance functions that will require more intensive supervisory focus due to (1) significant changes in corporate strategy, activities, organizational structure, oversight mechanisms, or key personnel; (2) potential concerns regarding the adequacy of a specific governance function; or (3) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another primary supervisor or functional regulator.
- *Internal audit*. Continuous monitoring and examination activities will be used to understand and assess key elements of internal audit governance for the organization on a consolidated basis, including (1) the adequacy and independence of the audit committee; (2) the independence, professional competence, and quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk-assessment process; and (4) the adequacy of audit programs and workpaper standards. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding the adequacy of key elements of internal audit. In addition to this periodic audit infrastructure review, testing activities for specific control functions or business lines should include an assessment of internal audit's recent work in these areas to the extent possible as a means of validating internal audit's findings.
- *Additional supervisory activities*. If continuous monitoring activities identify a key corporate governance function or element of internal audit requiring more intensive supervisory focus due to significant changes, potential concerns, or the absence of sufficiently recent examination activities, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) in developing discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve will participate as actively as appropriate in those activities.[9]

  If the area of concern is not within the oversight of another primary supervisor or functional regulator, or if the supervisor or regulator does not conduct or coordinate the examination activities in a reasonable period

9. Active participation by the Federal Reserve in an examination led by another primary supervisor or functional regulator includes having input into determining the examination objectives, final conclusions, and related communications to the organization's management. In the event that a material aspect of the Federal Reserve's input is not reflected in the examination's objectives, conclusions, or related communications with the organization, the Federal Reserve will review the situation to determine whether additional steps are appropriate to address any remaining concerns.

of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.

- *Additional required audit testing activities.* In all instances, the Federal Reserve will conduct testing activities as part of its audit infrastructure review (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators or participating as actively as appropriate in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that the internal audit program is appropriately designed and achieving its objectives.

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.1.2 Risk Management and Internal Control Functions for Primary Risks to the Consolidated Organization

Objectives: Underlying the risk-focused approach to consolidated supervision of large complex BHCs is the premise that it is each organization's responsibility to develop an appropriate control structure for identifying, measuring, monitoring, and controlling key risks as measured against supervisory standards and expectations, applicable laws and regulations, and evolving practices of well-managed organizations.

The Federal Reserve will understand and assess risk-management and control functions for primary risks to the consolidated organization (primary firmwide risk-management and control functions), and associated MIS, for each large complex BHC. This will include risk-management and control functions for primary credit, legal and compliance,[10] liquidity, market, operational, and reputational risks for the consolidated organization. The Federal Reserve also will understand and assess other risk-management and control functions that, based on the specific characteristics and activities of the individual BHC, relate to primary risks to the organization as a whole.

For example, for large complex BHCs with particularly dynamic corporate strategies, the Federal Reserve will understand and assess the adequacy of the control mechanisms relevant to such strategies, including strategic planning, merger integration, new business approval, and processes for ensuring that risk management and controls keep pace with areas of growing inherent risk. Furthermore, large complex BHCs operating across a range of financial intermediary activities are more likely to face potential conflicts of interest due to their greater likelihood of acting as agents for both issuers and investors. For these holding companies, it is necessary to assess the adequacy of processes for identifying and avoiding or managing conflicts of interest.

In all instances, the adequacy of each primary firmwide risk management or control mechanism depends on the appropriateness of the following:

1. control infrastructure and governance, including degree of oversight by the board and senior management;
2. development, maintenance, and communication of appropriate policies, procedures, and internal controls;
3. risk identification and measurement systems and processes, and associated MIS, that are adaptive to changing circumstances and capable of providing timely, accurate, and comprehensive information to senior management and the board;
4. monitoring and testing the effectiveness of controls;
5. processes for identifying, reporting, and escalating issues and emerging risks;
6. ability to implement corrective actions in a timely manner;
7. appropriate authority and independence of staff to carry out responsibilities; and
8. integration of risk-management and control objectives within management goals and the organization's compensation structure.

Most large complex BHCs have evolved toward comprehensive, consolidated risk management to measure and assess the range of their exposures and the way these exposures interrelate. Nonetheless, a variety of control structures are in place across this portfolio, and in some instances there is not a firmwide mechanism in place to oversee and manage a key control function across the organization's business lines and

10. Federal Reserve processes for understanding and assessing legal and compliance risk management apply to the domestic and international operations of large complex BHCs and, as described in SR-03-22/CA-03-15, "Framework for Assessing Consumer Compliance Risk at Bank Holding Companies," (see section 2124.01) encompass consumer compliance risk inherent in the organization's business activities.

legal entities.

In all instances, the Federal Reserve will focus on individual control structures in place for primary business lines or legal entities as needed to reach an understanding and assessment of the consolidated organization. When applicable, the Federal Reserve also will assess whether a decentralized approach to a key control function is sufficient by evaluating the effectiveness of such an approach in controlling primary risks to the consolidated organization.[11]

Supervisory Activities: The Federal Reserve will use continuous monitoring activities to understand and assess each primary firmwide risk-management or control function. This process begins with the overarching design and architecture of each primary firmwide risk-management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in section 1050.1.3.1.3 below). Activities will verify the sufficiency of fundamental aspects of internal controls in relation to the holding company's current risk profile and in comparison with supervisory expectations and evolving sound practices and assess the capability of these primary functions (whether centralized or decentralized) to remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

The results of continuous monitoring activities, as documented in the institutional overview, risk assessment, and other supervisory products, may identify certain primary firmwide risk-management or control functions that require more intensive supervisory focus due to (1) significant changes in inherent risk, control processes, or key personnel; (2) potential concerns regarding the adequacy of controls; or (3) the absence of sufficiently recent examination activities for a primary firmwide risk-management or control function by the Federal Reserve or another relevant primary supervisor or functional regulator.

In these instances, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to develop discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve will participate as actively as appropriate in those activities.

If the primary firmwide risk-management or control function is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant supervisors and regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.1.3 Risk Management of Material Portfolios and Business Lines

Objectives: For each large complex BHC, there are selected portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as mortgage lending or leveraged lending) that are primary drivers of risk or revenue, or that otherwise materially contribute to understanding inherent risk or assessing controls for a broader corporate function (such as consolidated credit-risk management).

During the development of the institutional overview and risk assessment, as well as during other supervisory processes, the Federal Reserve will analyze external factors and internal trends in the BHC's strategic initiatives—as evidenced by budget and internal capital allocations and other factors—to identify significant activities and areas vulnerable to volatility in revenue, earnings, capital, or liquidity that represent material risks of the organization. This determination of material portfolios and business lines considers all associated risk elements, including legal and compliance risks. For example, when evalu-

11. As outlined in SR-08-8/CA-08-11, "Compliance Risk-Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles" (see section 2124.07), while the Federal Reserve does not prescribe a particular organizational structure for primary firmwide risk-management and control functions, establishment of a firmwide function that is dedicated to managing and overseeing compliance risk, and that promotes a strong compliance culture, is particularly important for large banking organizations with complex compliance profiles, due to the unique challenges associated with compliance risk management for these organizations. In addition to the oversight provided by the board and various executive and management committees, a key component of firmwide compliance oversight for these organizations is a corporate compliance function that has day-to-day responsibility for overseeing and supporting the implementation of the organization's firmwide compliance risk-management program, and that plays a key role in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation.

ating whether retail activities such as mortgage or credit card lending are material to a banking organization, the extent of inherent consumer compliance and reputational risks, as well as credit and market risks, should be considered.

Supervisory Activities: Because an understanding of material risks and activities is needed to assess the primary firmwide risk-management and control functions (as discussed in preceding section 1050.1.3.1.2), the Federal Reserve will maintain an understanding of inherent risk and assess the adequacy of risk-management and internal controls for material portfolios and business lines. To form this understanding and assessment, the Federal Reserve will rely primarily on continuous monitoring activities, supplemented as appropriate by examination activities.

To the fullest extent possible, the Federal Reserve will draw its understanding and assessment of these risks and risk-management practices from the information and assessments of a primary supervisor or functional regulator where the BHC's legal and operating structure provides the supervisor or regulator a sufficient view of these areas. In these instances, the Federal Reserve will undertake continuous monitoring and participate in activities led by primary supervisors and functional regulators as necessary to maintain an understanding and assessment of related firmwide risk-management and control functions.

Many activities of large complex BHCs span legal entities that are subject to oversight by multiple supervisors or regulators or that are outside the oversight of other supervisors or regulators. If this is the case, or if the primary supervisor or functional regulator does not conduct or coordinate the necessary continuous monitoring or examination activities in a reasonable period of time, the Federal Reserve will initiate and lead these activities in coordination with other relevant primary supervisors and functional regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.1.4 Risk Management of Nonmaterial Business Lines

Objectives: For nonmaterial business lines identified during the development of the institutional overview and risk assessment, as well as during other supervisory processes, the Federal Reserve's focus will be on identifying and understanding those business lines that are increasing in importance and have the potential to become material.

Supervisory Activities: When a primary supervisor or functional regulator has a sufficient view of nonmaterial business lines, the Federal Reserve will, to the fullest extent possible, use information developed by that supervisor or regulator to monitor areas of increasing importance with the potential to become material. The Federal Reserve also will maintain an ability to access internal MIS for these businesses to facilitate a more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

For nonmaterial business lines that are not subject to oversight by a single primary supervisor or functional regulator, the Federal Reserve will engage in continuous monitoring activities to identify meaningful trends in risks and risk-management practices, initiate discovery reviews (in coordination with relevant primary supervisors or functional regulators as appropriate and in accordance with section 1050.1.1.2 above if relevant) to increase understanding of selected business lines that have the potential to become material, and maintain an understanding of associated MIS to facilitate more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

1050.1.3.1.5 Core Clearing and Settlement Activities (Where Applicable)

Objectives: The Federal Reserve will understand and assess the adequacy of risk-management and internal controls—including credit risk-management practices—related to core clearing and settlement organizations.[12] In light

12. Core clearing and settlement organizations, as defined in the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* (interagency sound practices paper, see SR-03-9), consist of two groups of organizations that provide clearing and settlement services for critical financial markets or act as large-value payment system operators, and that present the potential for systemic risk should they be unable to perform. These organizations are (1) market utilities (government-sponsored services or industry-owned organizations) whose primary purpose is to clear and settle transactions for critical markets (see section 1050.1.3.1.6) or transfer large-value wholesale payments, and (2) private-sector firms that provide clearing and settlement services that are integral to a critical market (i.e., their aggregate market share is significant enough to present the potential for systemic risk in the event of their sudden failure to carry out

of the potential for problems in these areas to transmit an adverse impact across the banking and financial system, and given the Federal Reserve's unique expertise and perspective with respect to these activities, the Federal Reserve focuses special supervisory attention on the risk-management and internal control practices and the public disclosures made by an organization with respect to these activities.

Supervisory Activities: Continuous monitoring and examination activities will be used to maintain an understanding of inherent risk and assess risk-management and internal controls, including related credit risk-management practices. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant change in inherent risk for core clearing and settlement activities stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to design testing activities focused on understanding and assessing areas of change and/or concern, as well as ensure that risk-management and control functions are appropriately designed and achieving their intended objectives. In situations where another primary supervisor or functional regulator leads the discovery review or testing activities, the Federal Reserve will participate as actively as appropriate in those activities.

If the area of change and/or concern is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.

In all instances, the Federal Reserve will conduct testing activities (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating as actively as appropriate in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that these control mechanisms are appropriately designed and achieving their objectives. In addition to assessing the adequacy of risk-management and internal controls, testing activities will focus on assessing the contribution of the organization to the resilience or fragility of the clearance and settlement system as a whole, and on the organization's adherence to the expectations of the interagency sound practices paper. Key expectations include geographic diversity and resiliency of data centers and operations, testing of recovery and resumption arrangements, and identification of downstream implications of failure of a major counterparty or clearing organization.

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.1.6 Significant Presence in Critical Financial Markets (Where Applicable)

Objectives: The Federal Reserve will understand and assess the adequacy of risk management and controls for LCBO business lines with a significant presence in critical financial markets.

"Critical financial markets" are defined in the interagency sound practices paper as the markets for federal funds, foreign exchange, and commercial paper; U.S. government and agency securities; and corporate debt and equity securities. A business line may have a significant presence in a critical financial market even though the business line accounts for a relatively small portion of the organization's total consolidated assets or revenues. These business lines are subject to special supervisory focus by the Federal Reserve in light of their potential to transmit a collective adverse impact across multiple firms and financial markets and the resulting significant reputational and other risks they pose to the organization.

Supervisory Activities: Continuous monitoring and examination activities will be used to understand inherent risk and assess risk-management and internal controls for business lines with a significant presence in a critical financial market. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant

those activities because there are no viable immediate substitutes).

change in inherent risk stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified in these business lines, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to design testing activities focused on understanding and assessing areas of change and/or concern, as well as ensure that risk-management and control functions are appropriately designed and achieving their intended objectives. In situations where another primary supervisor or functional regulator leads the testing activities, the Federal Reserve will participate as actively as appropriate in those activities.

If the area of change and/or concern is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the testing activities and will coordinate these activities with other relevant primary supervisors and functional regulators to the extent possible.

In all instances, the Federal Reserve will conduct testing activities (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating as actively as appropriate in activities led by other relevant supervisors or regulators) on at least a three-year cycle. These activities will focus on the organization's adherence to the expectations set forth in the interagency sound practices paper, including geographic diversity and resiliency of data centers and operations, and testing of recovery and resumption arrangements.

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.1.7 Risk Management of Activities in Key Financial Markets

Objectives: To be designated as an LCBO by the Federal Reserve, a banking organization must meet specified criteria as a significant participant in at least one key financial market.[13] For each key financial market activity where the large complex BHC is a significant participant, the Federal Reserve will maintain an understanding of inherent risk, assess the adequacy of related risk-management and internal controls (including the sufficiency of business continuity planning), and understand the organization's potential impact on the overall functioning of the market.

Supervisory Activities: Continuous monitoring and examination activities will be used to understand inherent risk for key financial market activities and assess related risk-management and internal controls.

To the fullest extent possible, the Federal Reserve will draw its understanding and assessment of these risks and risk-management practices from the information and assessments of a primary supervisor or functional regulator where the BHC's legal and operating structure provides the supervisor or regulator a sufficient view of these areas. In these instances, the Federal Reserve will undertake continuous monitoring and participate in activities led by primary supervisors and functional regulators as necessary to maintain an understanding and assessment of risk-management and control functions for key financial market activities.

For activities that span legal entities subject to oversight by multiple supervisors or regulators, or that are outside the oversight of other supervisors or regulators, the Federal Reserve will develop and conduct—in coordination with other relevant primary supervisors and functional regulators to the extent possible and in accordance with the provisions described above in section 1050.1.1.2 if relevant—testing and discovery review activities as necessary to complement continuous monitoring work.

1050.1.3.1.8 Issues and Developments in Areas of Emerging Interest with Potential Financial Market Consequences

Objectives: The Federal Reserve will use information obtained in the course of supervising LCBOs, as well as information and analysis

13. "Key financial markets" include the critical financial markets defined in section 1050.1.3.1.6 above as well as (1) broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading; (2) retail financial services; and (3) international financial markets. Each LCBO meets at least one of these key market thresholds.

obtained through relationships with other domestic and foreign supervisors and regulators or other sources, to

1. identify potential vulnerabilities across the portfolio of LCBOs and their nonbank peers—such as the operational infrastructure that underpins the credit derivatives market—that have the potential to affect banking organizations generally, financial stability, systemic risk, or domestic or global financial markets;
2. identify areas of supervisory focus—such as counterparty credit risk-management practices—to further the Federal Reserve's understanding of markets, their linkages with banking organizations, and potential implications for financial stability;
3. understand the activities of nonbank counterparties of LCBOs and the implications of such activities on the risks, risk management, and internal controls of banking organizations; and
4. enhance the Federal Reserve's ability to act effectively during periods of financial stress by combining timely and reliable information on conditions in the banking system and capital markets that is obtained through its supervisory activities with information obtained through the Federal Reserve's monetary policy and payments activities.

Supervisory Activities: During each supervisory planning cycle, and more frequently as required, continuous monitoring opportunities will be identified that utilize information gained through LCBO supervision to further the Federal Reserve's understanding of risks and activities that could adversely affect LCBOs or the stability of domestic or global financial markets. Activities will include meetings with chief risk officers, chief financial officers, and other LCBO senior management, as well as collaboration with other domestic and foreign supervisors and regulators and foreign central banks.

These activities also will be used to review areas of specific supervisory interest; answer ad hoc information requests related to areas of emerging interest or concern; help in understanding the contribution of the entity to the resilience or fragility of key markets as a whole; and provide insights into interdependencies across firms, markets, and the real economy. During periods of financial stress, this information will be combined with knowledge obtained from other Federal Reserve functions, such as monetary policy and payments activities, to help mitigate the likelihood or consequences of a financial crisis and to help develop sound policy responses to market developments. Periodic examination activities also may be used to review a specific activity or risk-management practice across a group of peer organizations to obtain a more complete understanding of industry practice.[14]

These activities will be designed and conducted in coordination with other relevant primary supervisors and functional regulators to the fullest extent possible and in accordance with the provisions described above in section 1050.1.1.2, where relevant. Coordination opportunities, however, may be limited in special circumstances, such as when addressing urgent matters with potentially adverse financial market consequences, due to the inherent time constraints when information must be gathered quickly.

1050.1.3.2 Financial Condition

Objectives: The Federal Reserve's evaluation of a large complex BHC's consolidated financial condition focuses on the ability of the organization's resources to support the level of risk associated with its activities. Assessments are developed for each "CAEL" subcomponent—Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).[15]

In developing this evaluation, the Federal Reserve's primary focus is on developing an understanding and assessment of

1. the sufficiency of the BHC's consolidated capital to support the level of risk associated with the organization's activities and provide a sufficient cushion to absorb unanticipated losses;
2. the capability of liquidity levels and funds-management practices to allow reliable access to sufficient funds to meet present and future liquidity needs; and
3. other aspects of financial strength that need to be assessed on a consolidated basis across the organization's various legal entities, or that relate to the financial soundness of the parent company and significant nonbank sub-

14. In order to minimize burden while obtaining information necessary to understand market developments, these activities will focus on those organizations that are most active in the area of interest or concern.

15. See SR-04-18 and section 4070.0.2.3.1 for more information about the CAEL subcomponents.

sidiaries, as discussed in section 1050.1.3.3 below.

In assessing consolidated regulatory capital, the Federal Reserve looks to ensure that the BHC demonstrates the effectiveness of its framework for complying with relevant capital adequacy guidelines and meeting supervisory expectations, and focuses on analyzing key models and processes[16] that influence this assessment. This assessment utilizes results from examinations led by the Federal Reserve or other primary supervisors or functional regulators, as well as information gained from the BHC's internal control functions and from market-based assessments.

Capital planning activities for large complex BHCs should be forward looking and provide for a sufficient range of stress scenarios commensurate with the organization's activities. Many LCBOs require more rigorous and structured internal processes for assessing capital adequacy beyond regulatory capital measures, as these measures often do not adequately capture the full spectrum of risk-taking activities for these organizations.[17] For these organizations, the Federal Reserve focuses on whether internal processes for assessing capital adequacy ensure that all risks are properly identified, reliably quantified (where possible) across the entire organization, and supported by adequate capital.

When assessing the adequacy of a BHC's liquidity levels and funds management practices, areas of focus include[18]

1. the extent to which the treasury function is aligned with risk-management processes, and whether incentives are in place for business lines to compile and provide information on expected liquidity needs and contingency funding plans so that the treasury function is able to develop a firmwide perspective and incorporate business-line information into assessments of actual and contingent liquidity risk;
2. whether funds management practices provide sufficient funding flexibility to respond to unanticipated, evolving, and potentially correlated market conditions for the organization and/or across financial markets; and
3. the sufficiency of liquidity planning tools, such as stress testing, scenario analysis, and contingency planning efforts, including (1) whether liquidity buffers—comprised of unencumbered liquid assets as well as access to stable funding sources—adequately reflect the possibility and duration of severe liquidity shocks; (2) the reasonableness of assumptions about the stability of secured funding in circumstances in which the liquidity of markets for the underlying collateral becomes impaired; and (3) whether these efforts adequately reflect the potential for the organization to be called on in stressed environments to provide contingent liquidity support to off-balance-sheet entities or bring additional assets on the balance sheet (even if not legally or contractually obligated to do so).

Beyond capital adequacy and liquidity, the nature of independent Federal Reserve supervisory work required to evaluate a large complex BHC's consolidated financial condition depends largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. For example, more independent Federal Reserve work typically will be required to assess consolidated asset quality or earnings for large complex BHCs with significant nonbank activities that are not functionally regulated. However, where all material holding company assets are concentrated in a single depository institution subsidiary, a minimal level of incremental Federal Reserve efforts typically will be required to assess consolidated asset quality and earnings.

Supervisory Activities: The Federal Reserve will primarily utilize continuous monitoring activities to assess a large complex BHC's financial strength. Such activities will include periodic meetings with BHC management (such as the chief financial officer); review of regulatory reports, surveillance screens, and internal MIS; and analysis of market indicators, including external debt ratings, subordinated debt spreads, and credit default swap spreads. Testing and discovery activities will be used as necessary to assist in the understanding and assessment of areas of concern.

16. "Key models and processes" are those where evaluation of the model/process will influence the Federal Reserve's assessment of the activity or control area that is supported by the model/process.

17. See SR-99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles" (see section 4060.7).

18. Assessing liquidity levels and funding practices for a consolidated BHC also incorporates elements presented in section 1050.1.3.3.2, "Parent company and nonbank funding and liquidity."

Testing and discovery activities also will be used to understand and assess the sufficiency of the BHC's consolidated capital and liquidity positions to support the level of risk associated with its activities, including (1) regulatory capital calculation methodologies[19] and internal assessments of capital adequacy and (2) funds management and liquidity planning tools and practices. The Federal Reserve will work with other relevant primary supervisors and functional regulators to participate as actively as appropriate in or, if necessary, to coordinate activities designed to analyze key capital and liquidity models or processes of a depository institution or functionally regulated subsidiary that are of such significance that they will influence the Federal Reserve's assessment of these areas. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.3 Impact

1050.1.3.3.1 Risk Management and Financial Condition of Significant Nonbank Subsidiaries

Objectives: Most large complex BHCs engage in activities and manage control functions on a firmwide basis, spanning depository institution and nonbank legal entities. These BHCs often have considerable intra-group exposures and servicing arrangements across affiliates, presenting increased potential risks for depository institution subsidiaries and a higher likelihood of aggregate risk concentrations across the organization's legal entities. Common interactions between a large complex BHC's depository institution subsidiaries and their nonbank affiliates (including the parent company) include assets originating in, or being marketed by, a nonbank affiliate that are booked in the depository institution; a depository institution providing funding for nonbank affiliates; and risk-management or internal control functions being shared between depository and nonbank operations.

Due to these interrelationships, financial, legal, compliance, or reputational troubles in one part of a BHC can spread rapidly to other parts of the organization. Even absent these interactions, the parent or nonbank subsidiaries of an organization may present financial, legal, compliance, or reputational risk to the consolidated entity, and thus directly or indirectly to its depository institution subsidiaries. As the federal banking agency charged with supervising the organization on a consolidated basis, the Federal Reserve is responsible for understanding and assessing the risks that the parent bank holding company and its nonbank subsidiaries may pose to the BHC itself or its depository institution subsidiaries.

The primary objectives of Federal Reserve supervision of the nonbank subsidiaries of a bank holding company are to

1. identify significant nonbank activities and risks—where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution subsidiary—by developing an understanding of the size and nature of primary activities and key trends, and the extent to which business lines, risks, or control functions are shared with or may impact a depository institution affiliate;
2. evaluate the financial condition and the adequacy of risk-management practices of the parent and significant nonbank subsidiaries, including the ability of nonbank subsidiaries to repay advances provided by the parent, using benchmarks and analysis appropriate for those businesses;
3. evaluate the degree to which nonbank entity risks may present a threat to the safety and soundness of subsidiary depository institutions, including through transmission of legal, compliance, or reputational risks;
4. identify and assess any intercompany relationships, dependencies, or exposures—or aggregate firmwide concentrations—with the potential to threaten the condition of a depository institution affiliate; and
5. evaluate the effectiveness of the policies, procedures, and systems that the holding company and its nonbank subsidiaries use to ensure compliance with applicable laws and

19. Assessments of the adequacy of regulatory capital for large complex BHCs that have received Federal Reserve supervisory approval to use internal estimates of risk in their regulatory capital calculations should include, among other things, regular verification that these organizations continue to meet on an ongoing basis all applicable requirements associated with internal estimates. See, for example, the capital adequacy guidelines for market risk at BHCs (Regulation Y: 12 C.F.R. 225, Appendix E) and the new advanced capital adequacy framework for BHCs (Regulation Y: 12 C.F.R. 225, Appendix G).

regulations, including consumer protection laws.[20]

Supervisory Activities: For all significant nonbank subsidiaries and activities of the parent BHC, the Federal Reserve will use continuous monitoring activities and discovery reviews to

1. maintain an understanding of the holding company's business line and legal entity structure, including key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates, utilizing regulatory structure reports, internal MIS, and other information sources;
2. understand and assess the exposure to, and tolerance for, legal, compliance, and reputational risks, as well as the extent to which potential conflicts of interest are identified and avoided or managed;
3. understand the scope of intercompany transactions and aggregate concentrations, and assess the adequacy of risk-management processes, accounting policies, and operating procedures to measure and manage related risks;
4. identify and assess key interrelationships and dependencies between subsidiary depository institutions and nonbank affiliates, such as the extent to which a depository institution subsidiary is reliant on services provided by the parent company or other nonbank affiliates and the reasonableness of associated management fees;
5. identify those nonbank subsidiaries whose activities present material financial, legal, compliance, or reputational risk to the consolidated entity and/or a depository institution subsidiary;
6. identify significant businesses operated across multiple legal entities for accounting, risk management, or other purposes, as well as activities that functionally operate as separate business units for legal or other reasons;
7. identify intercompany transactions subject to Regulation W—utilizing information submitted on quarterly regulatory reporting form FR Y-8 ("The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates"), internal MIS, and other information sources—and determine (in conjunction with the primary supervisor) whether compliance issues are present; and
8. understand and assess the sufficiency, reliability, and timeliness of associated MIS relied upon by the board, senior management, and senior risk managers and committees to monitor key nonbank activities and risks.

20. The Federal Reserve's supervisory objectives and activities related to the effectiveness of consumer compliance policies, procedures, and systems at nonbank subsidiaries of a BHC currently are under review, and additional or modified guidance on this topic may be issued in the future.

Periodic testing may be used to supplement continuous monitoring and discovery reviews to (1) ensure that key risk-management and internal control practices conform to internal policies and/or are designed to ensure compliance with the law and (2) understand and assess operations presenting a moderate or greater likelihood of significant negative impact to a subsidiary depository institution or the consolidated organization. Areas of potential negative impact include financial or operational risks that pose a potential threat to the safety and soundness of a depository institution subsidiary, or to the holding company's ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. Testing will focus on controls for identifying, monitoring, and controlling such risks. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.3.3.2 Parent Company and Nonbank Funding and Liquidity

Objectives: One of the Federal Reserve's primary responsibilities as consolidated supervisor is to help ensure that the parent company and its nonbank subsidiaries do not have an adverse impact on the organization's depository institution subsidiaries. To meet this objective, the Federal Reserve will assess the extent to which funding and liquidity policies and practices of the parent company or nonbank subsidiaries may undermine the BHC's ability to act as a source of strength to the organization's depository institution subsidiaries.

Areas of focus will include an assessment of

1. the ability of the parent company and nonbank subsidiaries to maintain sufficient liquidity, cash flow, and capital strength to service their debt obligations and cover fixed charges;
2. the likelihood that parent company or nonbank funding strategies could undermine pub-

lic confidence in the liquidity or stability of subsidiary depository institutions;

3. policies and practices that are aimed at ensuring the stability of parent company funding and liquidity, as evidenced by the utilization of long-term or permanent financing to support capital investments in subsidiaries and other long-term assets, and the degree of dependence on short-term funding mechanisms such as commercial paper;
4. the extent of "double leverage"[21] and the organization's capital-management policies, including the distribution and transferability of capital across jurisdictions and legal entities;
5. the parent company's ability to provide financial and managerial support to its depository institution subsidiaries during periods of financial stress or adversity, including the sufficiency of related stress testing, scenario analysis, and contingency planning efforts; and
6. intraday liquidity management policies and practices, and compliance with the "Federal Reserve Policy on Payments System Risk,"[22] including expectations for depository institutions with a self-assessed net debit cap (the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account).

The Federal Reserve also will remain apprised of the funding profile and market access of material depository institution subsidiaries, as in most instances these entities represent the consolidated BHC's primary and most active vehicles for external funding and liquidity management. The primary supervisor retains responsibility for assessing liquidity risk-management practices with respect to the depository institution subsidiary.

Supervisory Activities: The Federal Reserve will use continuous monitoring activities—including monitoring market conditions and indicators where available—and discovery reviews to understand and assess parent company and nonbank subsidiary funding and liquidity policies and practices, as well as any potential negative impact these policies and practices might have on a subsidiary depository institution or the consolidated organization. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant change in inherent funding or liquidity risk stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified, the Federal Reserve will design and conduct testing activities focused on understanding and assessing the areas of change and/or concern in order to ensure that funding and liquidity risk-management and control functions are appropriately designed and achieving their intended objectives.

In all instances the Federal Reserve will undertake testing activities on at least a three-year cycle, assessing the individual elements of risk management for parent company and nonbank funding and liquidity: board and senior management oversight; policies, procedures, and limits; risk-monitoring and management information systems; and related internal controls.

For large complex BHCs with a depository institution that has a self-assessed net debit cap, the Federal Reserve will conduct an annual review of the self-assessment file to ensure that the institution has appropriately applied the payment system risk guidelines. The Federal Reserve will either lead this review and coordinate its activities with other relevant primary supervisors or participate as actively as appropriate in the related work of such supervisors. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

1050.1.4 INTERAGENCY COORDINATION

1050.1.4.1 Coordination and Information Sharing Among Domestic Primary Bank Supervisors and Functional Regulators

Objective: Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other relevant domestic primary bank supervisors and functional regulators.[23] To achieve this objective, the Federal Reserve has worked over the years to enhance

21. "Double leverage" refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

22. This policy statement is available on the Board's public website at www.federalreserve.gov/paymentsystems/psr.

23. Section 1050.1.4.2 discusses cross-border cooperation and information sharing among foreign supervisors.

interagency coordination through the development and use of information-sharing protocols and mechanisms. These protocols and mechanisms respect the individual statutory authorities and responsibilities of the respective supervisors and regulators, provide for appropriate information flows and coordination to limit unnecessary duplication or burden, comply with restrictions governing access to information, and ensure that the confidentiality of information is maintained. For example, the Federal Reserve and the U.S. Securities and Exchange Commission entered into a memorandum of understanding (MOU) in July 2008 that, among other things, provides for the parties to share specific types of information concerning entities under the parties' respective supervision as well as information on other areas of mutual regulatory or supervisory interest.

As discussed in section 1050.1.3, in understanding and assessing the activities and risks of the organization as a whole, the Federal Reserve will rely to the fullest extent possible on the examination and other supervisory work conducted by the domestic primary bank supervisors and functional regulators of a BHC's subsidiaries. In addition, the Federal Reserve will seek to coordinate its supervisory activities with relevant supervisors and regulators and will work to align each agency's assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of the consolidated BHC's operations as applicable.

Supervisory Activities. The Federal Reserve will continue to work with the relevant primary supervisors and functional regulators of a large complex BHC's subsidiaries to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the BHC on a consolidated basis. The Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant primary supervisors or functional regulators when appropriate and permitted by applicable laws and regulations.[24]

The Federal Reserve also will continue to use a variety of formal and informal channels to facilitate interagency information sharing and coordination consistent with the principles outlined above, including

- supervisory protocols, agreements, and MOUs with primary supervisors and functional regulators that allow the coordination of supervisory activities and that permit the ongoing exchange of information, including confidential information on a confidential basis;
- bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- periodic and as-needed contacts with primary supervisors and functional regulators to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities;
- the use of information technology platforms, such as the Banking Organization National Desktop (BOND),[25] to provide secure automated access to examination/inspection reports and other supervisory information prepared by the Federal Reserve and other relevant supervisors and regulators; and
- participation in a variety of interagency forums that facilitate the discussion of broad industry issues and supervisory strategies, including the Federal Financial Institutions Examination Council, the President's Working Group on Financial Markets, and the Federal Reserve-sponsored cross-sector meetings of financial supervisors and regulators.

1050.1.4.1.1 Coordination of Examination Activities at a Supervised BHC Subsidiary

As discussed in section 1050.1.3, the Federal Reserve will seek to work cooperatively with the relevant primary supervisor or functional regulator to address information gaps or indications of weakness or risk identified in a supervised BHC subsidiary that are material to the Federal Reserve's understanding or assessment of the consolidated organization's risks, activi-

24. Among the federal laws that may limit the sharing of information among supervisors are the Right to Financial Privacy Act (12 U.S.C. 3401 et seq.) and the Trade Secrets Act (18 U.S.C. 1905). The Federal Reserve has established procedures to authorize the sharing of confidential supervisory information, and Federal Reserve staff must ensure that appropriate approvals are obtained prior to releasing such information. See Subpart C of the Board's Rules Regarding the Availability of Information (12 C.F.R. 261.20 *et seq.*).

25. BOND is a Federal Reserve information technology platform providing secure interagency access to documents, supervisory and financial data, and other information utilized in the consolidated supervision of individual BHCs and FBOs, and in developing comparative analyses of organizations with similar business lines and risk characteristics.

ties, or key corporate governance, risk-management, or control functions. Prior to conducting discovery reviews or testing activities at a depository institution (other than where the Federal Reserve is the primary federal supervisor) or functionally regulated subsidiary of a BHC, the Federal Reserve will

- review available information sources as part of its continuous monitoring activities, including examination reports and the BHC's internal MIS, to determine whether such information addresses the Federal Reserve's information needs or supervisory concerns; and
- if needed, seek to gain a better understanding of the primary supervisor's or functional regulator's basis for its supervisory activities and assessment of the subsidiary. This may include a request to review related examination work.

If, following these activities, the Federal Reserve's information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant primary supervisor or functional regulator in the manner discussed in section 1050.1.3 above. [26]

1050.1.4.2 Cooperation and Information Sharing With Host-Country Foreign Supervisors

Objectives: Many large complex BHCs have considerable international banking and other operations that are licensed and supervised by foreign host-country authorities. As home-country supervisor for domestic BHCs, the Federal Reserve is responsible for the comprehensive, consolidated supervision of these global organizations, while each host country is responsible for supervision of the legal entities (including foreign subsidiaries of U.S. BHCs) in its jurisdiction.

Information sharing among domestic and foreign supervisors, consistent with applicable laws, is essential to ensure that a large complex BHC's global activities are supervised on a consolidated basis. Cross-border information sharing is often facilitated by an MOU that establishes a framework for bilateral relationships and includes provisions for cooperation during the licensing process, in the supervision of ongoing activities, and in the handling of problem institutions. The Federal Reserve has established bilateral and multilateral information-sharing MOUs and other arrangements with numerous host-country foreign supervisors. The Federal Reserve also monitors changes in foreign bank regulatory and supervisory systems and seeks to understand how these systems affect supervised banking organizations. In addition to its longstanding cooperative relationships with home- and host-country foreign supervisors, the Federal Reserve expects to increasingly lead and participate in "colleges of supervisors" and other multilateral groups of supervisors that discuss issues related to specific internationally active banking organizations.

The Federal Reserve also is a member of the Basel Committee on Banking Supervision, which is a forum for supervisors from member countries to discuss important supervisory issues, foster consistent supervision of organizations with similar business and risk profiles, promote the sharing of leading supervisory practices, and formulate guidance to enhance and refine banking supervision globally.

The Federal Reserve's processes for understanding and assessing firmwide legal and compliance risk management, as described earlier, encompass both domestic and international operations. Most areas of supervisory focus for management of legal and compliance risks are applicable to both domestic and international entities, and include proper oversight of licensed operations, compliance with supervisory and regulatory requirements, and the sufficiency of associated MIS.

There are, however, areas of focus for the Federal Reserve that are unique to a holding company's international operations. For example, some host-country legal and regulatory structures and supervisory approaches are fundamentally different from those in the United States. As a result, the banking organization often must devote additional resources to maintain expertise in local regulatory requirements. In some instances, privacy concerns have led to limits on the information a BHC's foreign office may share with its parent company, thereby limiting the parent company's ability to exercise consolidated risk management on a global basis.

Additionally, while considerable progress has been made to strengthen supervisory cross-border cooperation and information sharing, the Federal Reserve and other U.S. supervisors have,

26. As outlined in section 1050.1.3, certain Federal Reserve examination activities are to be conducted on a minimum three-year cycle to verify, through testing, the sufficiency of key control processes. These activities are to be conducted regardless of whether or not there is an information gap or indication of weakness or risk.

at times, faced challenges in accessing information on a bank's or BHC's foreign operations or in carrying out examinations of cross-border or foreign activities. These circumstances are to be taken into account when developing a supervisory strategy for a large complex BHC with cross-border or foreign operations.

Supervisory Activities: Continuous monitoring will be used to understand and assess each large complex BHC's international strategy, trends, operations, and legal entity structure, as well as related governance, risk-management, and internal controls. For a large complex BHC with significant international operations or risks, an assessment of cross-border and foreign operations will be incorporated into the evaluation of key corporate governance functions and primary firmwide risk-management and internal control functions, including legal and regulatory risk management.

Continuous monitoring activities will include review of materials prepared by host-country supervisors, including examination reports and assessments, and ongoing communication with relevant foreign and domestic supervisors regarding trends and assessments of cross-border and foreign operations. These continuous monitoring activities may be supplemented, as appropriate, by examination activities to understand and assess the large complex BHC's international strategy, trends, operations, and legal entity structure, as well as related governance, risk-management, and internal controls.

When assessing the sufficiency of a large complex BHC's management of its international operations, consideration is given to the extent that foreign laws restrict the transmission of information to the BHC's head office. Impediments to sharing information imposed by a host country may constrain the BHC's ability to effectively oversee its international operations and globally manage its risks, and the materiality of such impediments should be a determinant of whether the organization should be conducting operations in that host country.

In addition, any limits placed on the Federal Reserve's ability to access information on host-country operations, or to engage in onsite activities at the organization's operations in the host country, should be considered when assessing whether the organization's activities in that jurisdiction are appropriate.

1050.1.4.3 Indications of Weakness or Risk Related to Subsidiary Depository Institutions

Objectives: For areas beyond those specifically addressed in section 1050.1.3, there may be circumstances where the Federal Reserve has indications of material weakness or risk in a depository institution subsidiary of a BHC that is supervised by another primary supervisor, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of that supervisor. Because a primary objective of consolidated supervision is to protect the BHC's depository institution subsidiaries, the Federal Reserve will follow up with the appropriate primary supervisor in these circumstances to help ensure that, to the extent that a material weakness or risk exists, it is addressed appropriately.

Supervisory Activities: The Federal Reserve will take the following steps if it has indications of material weakness or risk in a depository institution subsidiary (other than where the Federal Reserve is the primary federal supervisor) in an area beyond those specifically addressed in section 1050.1.3, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of the depository institution's primary supervisor.

- The Federal Reserve will first review available information sources, discuss the areas of concern with the primary supervisor, and seek to review the supervisor's related work.
- If concerns remain following these activities, the Federal Reserve will request that the primary supervisor conduct a discovery review or testing activity at the depository institution to address the area of concern.
- In the event the primary supervisor does not undertake activities to address the concern in a reasonable period of time, the Federal Reserve will design and lead an examination of the depository institution to address the matter in consultation with the primary supervisor. A senior Federal Reserve official will communicate this decision in writing to a senior official of the primary supervisor.

1050.1.4.4 Condition or Management of BHC Subsidiary is Less-than-Satisfactory

Objectives: As noted above, a primary responsibility of the Federal Reserve as consolidated BHC supervisor is to ensure that a holding company's activities, policies, and practices do not undermine its ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. In situations where the condition or management of a supervised or functionally regulated BHC subsidiary is determined to be less-than-satisfactory, the Federal Reserve's focus as consolidated supervisor is on complementing the efforts of the primary supervisor or functional regulator. In doing so, the Federal Reserve will seek to ensure that the parent company provides appropriate support to the subsidiary and does not take actions that may further weaken the parent company's depository institution subsidiaries or its ability to act as a source of strength for such subsidiaries.

Beyond the specific activities noted below, these circumstances also may require the Federal Reserve to enhance the activities addressed in section 1050.1.3 for understanding and assessing key corporate governance functions or primary firmwide risk-management and internal controls. In addition, the Federal Reserve will adjust its supervisory activities as necessary when the consolidated BHC is in weakened condition or when there are questions regarding the capabilities of the holding company's management.

Supervisory Activities:

- *Depository institution subsidiary*. In instances when a depository institution subsidiary's condition or management is rated less than satisfactory, or when the depository institution subsidiary otherwise faces financial stress or material risks, the Federal Reserve's primary supervisory objectives as consolidated supervisor are to ensure that the parent company (1) provides appropriate support to the depository institution and (2) does not take action that could harm the depository institution. The Federal Reserve will work closely with the primary supervisor to understand whether the BHC or a nonbank affiliate has contributed to the depository institution's weakened condition, to understand the impact of the depository institution on the BHC's condition, and to determine if the holding company is providing appropriate support to the depository institution. The Federal Reserve will coordinate its activities with those of the primary supervisor to the extent appropriate.
- *Nonbank subsidiary*. When any nonbank subsidiary faces financial stress or material risks, the Federal Reserve will seek to ensure that its condition and activities do not jeopardize the safety and soundness of the BHC or its depository institution subsidiaries, as discussed above in sections 1050.1.3.3.1, "Risk Management and Financial Condition of Significant Nonbank Subsidiaries" and 1050.1.3.3.2, "Parent Company and Nonbank Funding and Liquidity." The Federal Reserve also will take appropriate steps to ensure that any actions taken by the parent company to assist a nonbank subsidiary do not impair the BHC's continuing ability to serve as a source of strength to its depository institution subsidiaries. The Federal Reserve will coordinate its activities with those of any relevant functional regulator to the extent appropriate.

1050.1.4.5 Edge and Agreement Corporations

Objectives: Many large complex BHCs control an Edge or agreement corporation subsidiary. The Federal Reserve serves as the primary supervisor of each Edge and agreement corporation subsidiary in addition to its role as consolidated BHC supervisor.[27] When the Edge or agreement corporation is held by a U.S. bank, the primary supervisor often relies on information provided by the Federal Reserve in developing its own understanding and assessment of the parent bank.

During each calendar year, the Federal Reserve performs an examination of each Edge and agreement corporation, assesses the Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program, and assigns a CAMEO rating. In addition, the Federal Reserve periodically conducts assessments of Edge and agreement corporations to determine whether a consumer compliance examination is warranted, in which case a compliance

27. The Federal Reserve is solely responsible for approving, and supervising the activities of, U.S. Edge and agreement corporations. As discussed in SR-90-21, "Rating System For International Examinations," one of the Federal Reserve's supervisory responsibilities is the assignment of a CAMEO rating (Capital, Asset Quality, Management, Earnings, and Operations and Internal Controls) to each Edge and agreement corporation.

examination is conducted and a consumer compliance rating is assigned.

The Federal Reserve will coordinate the conduct of its activities as Edge and agreement corporation supervisor with its activities as consolidated supervisor. To this end, the extent and scope of Federal Reserve supervisory work related to an Edge or agreement corporation will be tailored to the entity's activities, risk profile, and other attributes. A number of specific elements will be considered when developing a supervisory approach, including

1. structure and attributes, including whether the Edge or agreement corporation is a banking or investment organization;
2. the size, nature, and location of its primary activities, as well as key financial and other trends;
3. the business lines and risks, and associated trends, of the Edge or agreement corporation's primary activities on a standalone basis, as well as their significance to the risk profile of the parent bank (if applicable) and BHC;
4. the extent to which risk-management and internal control functions are unique to the Edge or agreement corporation, or are shared with a parent bank, another affiliate, or the consolidated BHC;
5. any potential Regulation K limitations or other U.S. compliance issues, and the adequacy of processes to ensure ongoing compliance; and
6. the adequacy of processes for ensuring compliance with all applicable laws and regulations imposed by host-country supervisors for the Edge or agreement corporation's international operations.

Supervisory Activities: The Federal Reserve will maintain an understanding and perform an annual examination of each Edge and agreement corporation. While the examination scope will be risk focused to reflect the organization's scale, activities, and risk profile, in all cases the Federal Reserve will assess the adequacy of processes to ensure compliance with BSA/AML requirements and other applicable U.S. laws and regulations and with applicable foreign laws and regulations.

In developing its supervisory strategy, the Federal Reserve will identify those elements that are unique to the Edge or agreement corporation and those that are shared with the parent bank or BHC and will coordinate fulfillment of the Federal Reserve's responsibilities as Edge and agreement corporation supervisor with execution of its consolidated supervision role. This strategy will reflect the extent to which reliance can be placed on (1) the Federal Reserve's understanding and assessments of key corporate governance, risk-management, and control functions, as well as material portfolios and business lines, of the consolidated BHC; (2) assessments developed by the primary supervisor (when applicable) for business lines, risk management, control functions, or financial factors that are common to the Edge or agreement corporation and its parent bank; and (3) findings developed by host-country supervisors for activities under their jurisdiction.

In addition, where the primary supervisor of an Edge or agreement corporation's parent bank relies on the Federal Reserve's understanding and assessment in order to develop its CAMELS rating,[28] the Federal Reserve will work to fulfill that supervisor's information needs.

28. The U.S. banking agencies assign CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings to U.S. banking organizations as part of the ongoing supervision of these organizations. See SR-96-38, "Uniform Financial Institutions Rating System," (see section A.5020.1 of the *Commercial Bank Examination Manual*.) and SR-97-4, "Interagency Guidance on Common Questions About the Application of the Revised CAMELS Rating System."

1050.2.1 ACTIVITIES OF THE FEDERAL RESERVE AND OTHER SUPERVISORS AND REGULATORS, AND FUNCTIONAL REGULATION

The objectives of the Federal Reserve's consolidated supervision program for the portfolio of regional bank holding companies ("regional BHCs," defined as non-LCBO BHCs with $10 billion or more in total consolidated assets, including nontraditional organizations[1]) are the same as those applicable to other portfolios. The manner in which the Federal Reserve achieves these objectives, however, is tailored to the characteristics and risk profiles of regional bank holding companies.[2]

As outlined in the following sections, a range of continuous monitoring activities is utilized, along with discovery reviews and testing activities (examination activities),[3] to develop and maintain an understanding and assessment of each regional BHC. For organizations within this portfolio, continuous monitoring activities typically take the form of meetings with BHC management, analysis of internal management information system (MIS) reports and regulatory reports, review of surveillance screens, and discussions and coordination with other relevant primary supervisors and functional regulators and review of their work. The scale and frequency of monitoring activities will differ by organization. For many regional BHCs that are in sound condition, monitoring activities typically are performed on a periodic or quarterly basis, supplemented by more frequent or intensive activities as necessary, and, in most instances, Federal Reserve staff do not maintain a day-to-day onsite presence at the organization.

1. Nontraditional BHCs, as defined in SR-04-18, "Bank Holding Company Rating System," (see section 4070.0) are bank holding companies where most or all of the organization's significant nondepository subsidiaries are regulated by a functional regulator, and subsidiary depository institution(s) are small in relation to nondepository subsidiaries.

2. See section 1050.0.4, appendix, for definitions of terms commonly used in this section.

3, While by definition "examination" activities are applicable to the supervision of banks and other depository institutions, as well as U.S. banking offices of FBOs, and "inspection" activities are applicable to the supervision of BHCs and nonbank subsidiaries and affiliates, the term "examination" is generally used throughout this section to refer to both examination and inspection activities.

1050.2.1.1 Federal Reserve Activities and Those Activities of Other Supervisors and Regulators

The nature and scope of independent Federal Reserve supervisory work required to develop and maintain an understanding and assessment of a regional BHC depend largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. Many regional BHCs conduct the majority of their business operations through a single bank subsidiary, increasing the likelihood that a single primary supervisor has a complete view of, and ability to address, major aspects of the organization's business activities and related risks, risk management, and controls. In these instances, the Federal Reserve typically will be able to use the information and assessments developed by this primary supervisor to develop its understanding and assessment of significant aspects of the consolidated organization. Similarly, for regional BHCs with limited nonbank activities, the Federal Reserve typically will need to conduct less work to understand and assess the risk-management systems and financial condition of nonbank subsidiaries than the level of monitoring and examination work required for organizations with more-extensive or complex nonbank activities.

By their nature, understanding and assessing some areas—such as the risk management and financial condition of significant nonbank subsidiaries that are not functionally regulated—typically will require more independent Federal Reserve supervisory work. Other areas—such as primary firmwide risk-management and control functions—typically will require a greater degree of coordination with other relevant primary supervisors or functional regulators, who will likely have information or assessments upon which the Federal Reserve can draw.

The following sections provide further detail on how the Federal Reserve will develop, working in coordination with other relevant primary supervisors and functional regulators, an understanding and assessment of a regional BHC. In conducting the activities described throughout this document, the Federal Reserve will, to the fullest extent possible

- rely on the information and assessments of relevant primary supervisors and functional regulators, including the information and assessments reflected in the reports of examination of such supervisors and regulators;
- focus its supervisory activities on the bank holding company, as well as on those of its nonbank subsidiaries that could have a direct or indirect materially adverse effect on the safety and soundness of a depository institution subsidiary of the BHC due to the size, condition, or activities of the nonbank subsidiary, or the nature or size of its transactions with the depository institution; and
- use publicly reported information (including externally audited financial statements) as well as reports that a large complex BHC or a subsidiary prepares for other primary supervisors, functional regulators, or self-regulatory organizations.

1050.2.1.2 Functionally Regulated Subsidiaries

As discussed below, in certain situations, the Federal Reserve may find it necessary to conduct an examination of a functionally regulated nonbank subsidiary in order to fulfill the Federal Reserve's responsibilities as supervisor of the consolidated organization. In any such case, the Federal Reserve will continue to adhere to the procedural and other requirements governing examinations of, or requests for a specialized report from, a functionally regulated subsidiary as discussed in SR-00-13 and sections 1040.0 and 3900.0. Under these provisions, for example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it reasonably determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.[4]

1050.2.2 UNDERSTANDING THE ORGANIZATION

For each regional BHC, the Federal Reserve will develop an understanding of the legal, operating, and corporate governance structure of the organization and its primary strategies, business lines, and risk-management and internal control functions.[5] This understanding will inform the development of a risk-assessment and supervisory plan for the BHC. The extent of information necessary to gain this understanding is tailored to the scope and complexity of the regional BHC's operations, and typically may be obtained from the organization's management, public reports, regulatory reports, surveillance screens, third-party sources (e.g., credit-rating agency and market analyst reports), and other relevant primary supervisors or functional regulators.

Key elements that should be identified and understood include the following:

- *Corporate strategy*. Primary business strategies; institutional risk tolerance; key changes in strategic direction or risk profile; significant new business activities; areas of growth and emerging areas with potential to become primary drivers of risk or revenue; and plans for expansion through mergers or acquisitions.
- *Significant activities*. Key revenue and risk drivers; primary business lines; product mix; budget and internal capital allocations (as applicable); market share for revenue and customers served; key external trends, including competitive pressures; and areas that are vul-

4. The Federal Reserve also may examine a functionally regulated subsidiary of a regional BHC if, after reviewing relevant reports and other information, it has reasonable cause to believe that the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution, or that the subsidiary is not in compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the subsidiary (and the Federal Reserve cannot determine compliance by examining the BHC or its affiliated depository institutions).

Similarly, before requiring a specialized report from a functionally regulated subsidiary, the Federal Reserve first will request that the subsidiary's appropriate functional regulator obtain the report and make it available to the Federal Reserve. In the event that the report is not obtained or made available as requested, the Federal Reserve may, consistent with the Bank Holding Company Act, obtain the report directly from the functionally regulated subsidiary if the report is necessary to allow the Federal Reserve to adequately assess (1) a material risk to the BHC or any of its depository institution subsidiaries, (2) the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a threat to the safety and soundness of a depository institution subsidiary, or (3) compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the BHC or a subsidiary.

5. This understanding is formally documented during development of the institutional overview, which coincides with creation of the annual risk assessment. SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," (see section 2124.01) describes processes for developing an institutional overview, risk assessment, and supervisory plan. Each of these products is kept current to reflect significant changes in an organization's risks or activities.

nerable to volatility in revenue, earnings, capital, or liquidity.

- *Structure*. Business line and legal entity structure; domestic and foreign regulatory responsibilities for legal entities and business lines; key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates; material business lines operated across multiple legal entities for accounting or risk-management purposes; and the activities and risk profile of Edge and agreement corporation subsidiaries.
- *Corporate governance, risk management, and internal controls for primary risks*. Board of directors (board) and executive-level committees; senior management and management committees; key risk-management and internal control functions and associated MIS relied upon by the board, senior management, and senior risk managers and committees; and consistency of public disclosures with how the board and senior management assess and manage risks.

To ensure the quality and consistency of consolidated supervision across the regional BHC portfolio, it also is necessary to understand how these key elements compare with industry trends and with evolving practices of well-managed organizations with similar characteristics.

1050.2.3 ASSESSING THE REGIONAL BHC ON A CONSOLIDATED BASIS

The Federal Reserve uses a systematic approach to develop an assessment of a BHC on a consolidated basis. This assessment is reflected in the RFI (Risk Management, Financial Condition, and Impact) rating assigned to a BHC.[6]

1050.2.3.1 Risk Management

1050.2.3.1.1 Key Corporate Governance Functions

Objectives: One of the primary areas of focus for consolidated supervision of regional BHCs is the adequacy of governance provided by the board and senior management. The culture, expectations, and incentives established by the highest levels of corporate leadership set the tone for the entire organization and are essential determinants of whether a banking organization is capable of maintaining fully effective risk-management and internal control processes.

The board and its committees should have an ongoing understanding of key inherent risks, associated trends, primary control functions, and senior management capabilities. Primary expectations for the board and its committees include

1. selecting competent senior managers, ensuring that they have the proper incentives to operate the organization in a safe and sound manner, and regularly evaluating senior managers' performance;
2. establishing, communicating, and monitoring (for example, by reviewing comprehensive MIS reports produced by senior management) institutional risk tolerances and a corporate culture that emphasizes the importance of compliance with the law and ethical business practices;
3. approving significant strategies and policies;
4. demonstrating leadership, expertise, and effectiveness;
5. ensuring the organization has an effective and independent internal audit function;
6. ensuring the organization has appropriate policies governing the segregation of duties and avoiding conflicts of interest; and
7. for publicly held organizations, ensuring that public disclosures
   - are consistent with how the board and senior management assess and manage the risks of the organization,
   - balance quantitative and qualitative information with clear discussions about risk-management processes, and
   - reflect evolving disclosure practices for peer organizations.

A regional BHC's senior management and its committees should be able to clearly communicate risk tolerances and measures, control risks, hire and retain competent staff, and respond to changes in the organization's risk profile and the external environment. Members of senior management are expected to have qualifications and experience commensurate with the size and complexity of the organization. Primary expectations for senior management include

6. The RFI rating system for BHCs is discussed in SR-04-18 and section 4070.0. RFI ratings are assigned at least annually for BHCs that are complex or that have $1 billion or more in consolidated assets, and are communicated via a comprehensive summary supervisory report that supports the BHC's assigned ratings and encompasses the results of the entire supervisory cycle (as described in SR-99-15, "Risk-Focused Supervision of Large Complex Banking Organizations," and section 2124.04.)

1. establishing effective oversight and an appropriate risk culture;
2. appropriately delegating authority and overseeing the establishment and implementation of effective policies for the proper segregation of duties and for the avoidance or management of conflicts of interest;
3. establishing and implementing an effective risk-management framework capable of identifying and controlling both current and emerging risks, and effective independent control functions that ensure risk taking is consistent with the organization's established risk appetite;
4. establishing and implementing incentives for personnel that are consistent with institutional risk tolerances, compliance with the law, and ethical business practices;
5. promoting a continuous dialogue between and across business areas and risk-management functions to help align the organization's established risk appetite and risk controls;
6. ensuring that the board and its committees are provided with timely, accurate, and comprehensive MIS reports that are adaptive to changing circumstances regarding risks and controls; and
7. ensuring timely resolution of audit, compliance, and regulatory issues.

An effective internal audit function plays an essential role by providing an independent and objective evaluation of all key governance, risk-management, and internal control processes. As the complexity of financial products and supporting technology has grown, in combination with greater reliance on third-party service providers, the importance of internal audit's role in identifying risks and testing internal controls has increased.

In addition, the extent to which supervisors can rely on or utilize the work of internal audit is an essential determinant of the risk-focused supervisory program that is tailored to the activities and risks of individual regional BHCs.

Supervisory Activities: For each regional BHC, the Federal Reserve will understand and assess the adequacy of oversight provided by the board and senior management, as well as the adequacy of internal audit and associated MIS. The Federal Reserve also will understand and assess other key corporate governance functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining consolidated holding company operations, as well as the organization's business resiliency and crisis management capabilities.[7]

- *Board, senior management, and other key corporate governance functions*. Continuous monitoring activities—which draw from all available sources on an as-needed basis, including internal control functions, the work of other relevant primary supervisors and functional regulators, regulatory reports, and related surveillance results—will be used to understand and assess the effectiveness of board and senior management resources and oversight.[8]

  The results of continuous monitoring activities, as documented in supervisory products that reflect the Federal Reserve's overview and risk assessment of the organization, may identify certain corporate governance functions that will require more intensive supervisory focus due to (1) significant changes in corporate strategy, activities, organizational structure, oversight mechanisms, or key personnel; (2) potential concerns regarding the adequacy of a specific governance function; or (3) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another primary supervisor or functional regulator.
- *Internal audit*. Continuous monitoring activities will be used to understand and assess key elements of internal audit governance for the organization on a consolidated basis, including (1) the adequacy (and, where applicable, independence[9]) of the audit committee; (2) the independence, professional competence, and the quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk-assessment process; and (4) the adequacy of audit programs and

7. As discussed further in section 1050.2.4.6, because of the special structure of nontraditional BHCs and the relatively small size of their depository institution subsidiaries, much of the information necessary to develop the assessments of the risk-management (as described in this section 1050.2.3.1) and financial condition elements (as described in section 1050.2.3.2) typically may be obtained or drawn from the work of the relevant functional regulator.

8. As noted in section 1050.2.1 above, the scale and frequency of monitoring activities will differ by organization. For many regional BHCs in sound condition, these activities are typically performed on a periodic or quarterly basis and supplemented as necessary.

9. As outlined in section 2060.05 and SR-02-20, "The Sarbanes-Oxley Act of 2002," section 301 of the Sarbanes-Oxley Act requires that each public company (including banks and bank holding companies that are public companies) have an audit committee composed entirely of independent directors. (See 15 U.S.C. 78j-1.)

workpaper standards. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding the adequacy of key elements of internal audit. In addition to this periodic audit infrastructure review, testing activities for specific control functions or business lines should include an assessment of internal audit's recent work in these areas to the extent possible as a means of validating internal audit's findings.

- *Additional supervisory activities*. If continuous monitoring activities identify a key corporate governance function or element of internal audit requiring more intensive supervisory focus due to significant changes, potential concerns, or the absence of sufficiently recent examination activities, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) in developing discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve may conduct portions of the examination, or otherwise participate as necessary (e.g., in determining the examination objectives and scope), to ensure that the review provides sufficient information on the specific area of concern to form a comprehensive and timely understanding and assessment.

  If the area of concern is not within the oversight of another primary supervisor or functional regulator, or if the supervisor or regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.
- *Additional required audit testing activities*. In all instances, the Federal Reserve will conduct testing activities as part of its audit infrastructure review (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that the internal audit program is appropriately designed and achieving its objectives.[10]

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.2.1.2.

1050.2.3.1.2 Risk-Management and Internal Control Functions for Primary Risks to the Consolidated Organization

Objectives: Underlying the risk-focused approach to consolidated supervision of regional BHCs is the premise that it is each organization's responsibility to develop an appropriate control structure for identifying, measuring, monitoring, and controlling key risks as measured against supervisory standards and expectations, applicable laws and regulations, and evolving practices of well-managed organizations.

The Federal Reserve will understand and assess risk-management and control functions for primary risks to the consolidated organization (primary firmwide risk-management and control functions), and associated MIS, for each regional BHC. This will include risk-management and control functions for primary credit, legal and compliance,[11] liquidity, market, operational, and reputational risks for the consolidated organization. The Federal Reserve also will understand and assess other risk-management and control functions that, based on the specific characteristics and activities of the individual BHC, relate to primary risks to the organization as a whole.

For example, for regional BHCs with particularly dynamic corporate strategies, the Federal Reserve will understand and assess the adequacy of the control mechanisms relevant to such strategies, including strategic planning, merger integration, new business approval, and processes for ensuring that risk management and controls keep pace with areas of growing inherent risk.

In all instances, the adequacy of each primary firmwide risk-management or control mechanism depends on the appropriateness of the following:

10. For nontraditional BHCs, the Federal Reserve will routinely conduct testing activities on at least a three-year cycle in instances where the BHC's relevant functional regulator has not developed—or, because of the organization's legal, operating, and regulatory structure, is not able to develop—a comprehensive understanding and assessment of the internal audit infrastructure.

11. Federal Reserve processes for understanding and assessing legal and compliance risk management encompass consumer compliance risk inherent in the organization's business activities.

1. control infrastructure and governance, including degree of oversight by the board and senior management;
2. development, maintenance, and communication of appropriate policies, procedures, and internal controls;
3. risk identification and measurement systems and processes, and associated MIS, that are adaptive to changing circumstances and capable of providing timely, accurate, and comprehensive information to senior management and the board;
4. monitoring and testing the effectiveness of controls;
5. processes for identifying, reporting, and escalating issues and emerging risks;
6. ability to implement corrective actions in a timely manner;
7. appropriate authority and independence of staff to carry out responsibilities; and
8. integration of risk-management and control objectives within management goals and the organization's compensation structure.

Organizations in the regional BHC portfolio use a variety of control structures to monitor, manage, and control firmwide risks. A number of larger organizations have implemented firmwide risk-management functions to measure and assess the range of their exposures across business lines and legal entities and the way these exposures interrelate. However, many organizations within the portfolio effectively control risks using a decentralized approach that relies on individual control structures for the organization's primary business lines or legal entities. In all instances, the Federal Reserve will assess whether the approach to a key control function used by a particular organization is effective in controlling primary risks to the consolidated organization.[12]

Supervisory Activities: The Federal Reserve will use continuous monitoring activities to understand and assess each primary firmwide risk-management and control function. This process begins with the overarching design and architecture of each primary firmwide risk-management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in section 1050.2.3.1.3 below). Activities will verify the sufficiency of fundamental aspects of internal controls in relation to the holding company's current risk profile and in comparison with supervisory expectations and evolving sound practices, and assess the capability of these primary functions (whether centralized or decentralized) to remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

The results of continuous monitoring activities, as documented in supervisory products that reflect the Federal Reserve's overview and risk assessment of the organization, may identify certain primary firmwide risk-management or control functions that require more intensive supervisory focus due to (1) significant changes in inherent risk, control processes, or key personnel; (2) potential concerns regarding the adequacy of controls; or (3) the absence of sufficiently recent examination activities for a primary firmwide risk-management or control function by the Federal Reserve or another relevant primary supervisor or functional regulator.

In these instances, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to develop discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve may conduct portions of the examination, or otherwise participate as necessary (e.g., in determining the examination objectives and scope), to ensure that the review provides sufficient information on the specific area of concern to form a comprehensive and timely understanding and assessment.

If the primary firmwide risk-management or control function is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the

12. As outlined in SR-08-8/CA-08-11, "Compliance Risk-Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles," (see section 2124.07), while the Federal Reserve does not prescribe a particular organizational structure for primary firmwide risk-management and control functions, establishment of a firmwide function that is dedicated to managing and overseeing compliance risk, and that promotes a strong compliance culture, is particularly important for large banking organizations with complex compliance profiles, due to the unique challenges associated with compliance risk management for these organizations. In addition to the oversight provided by the board and various executive and management committees, a key component of firmwide compliance oversight for these organizations is a corporate compliance function that has day-to-day responsibility for overseeing and supporting the implementation of the organization's firmwide compliance risk-management program and that plays a key role in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation.

examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant supervisors and regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.2.1.2.

1050.2.3.1.3 Risk Management of Material Portfolios and Business Lines

Objectives: For each regional BHC, there are selected portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as residential mortgage or commercial real estate lending) that are primary drivers of risk or revenue, or that otherwise materially contribute to either understanding inherent risk within the consolidated organization or assessing controls for a broader corporate function (such as consolidated credit-risk management).

During the development of supervisory products that reflect the Federal Reserve's overview and risk assessment of the organization, the Federal Reserve will analyze external factors and internal trends in the BHC's strategic initiatives—as evidenced by budget and (where applicable) internal capital allocations and other factors—to identify significant activities and areas vulnerable to volatility in revenue, earnings, capital, or liquidity that represent material risks or activities of the organization. This determination of material portfolios and business lines considers all associated risk elements, including legal and compliance risks. For example, when evaluating whether retail activities such as mortgage or automobile lending are material to a banking organization, the extent of inherent consumer compliance and reputational risks, as well as interest rate and credit risks, should be considered.

Supervisory Activities: Because an understanding of material risks and activities is needed to assess the primary firmwide risk-management and control functions (as discussed in preceding section 1050.2.3.1.2), the Federal Reserve will maintain an understanding of inherent risk and assess the adequacy of risk-management and internal controls for material portfolios and business lines. To form this understanding and assessment, the Federal Reserve will rely primarily on continuous monitoring activities, supplemented, as appropriate, by examination activities.

To the fullest extent possible, the Federal Reserve will draw its understanding and assessment of these risks and risk-management practices from the information and assessment of the primary supervisor or functional regulator where the BHC's legal and operating structure provides the supervisor or regulator a sufficient view of these areas. In these instances, the Federal Reserve will undertake continuous monitoring and participate in activities led by primary supervisors and functional regulators, as necessary, to maintain an understanding and assessment of related firmwide risk-management and control functions.

A regional BHC's activities may span legal entities that are subject to oversight by multiple supervisors or regulators or that are outside the oversight of other supervisors or regulators. If this is the case, or if the primary supervisor or functional regulator does not conduct or coordinate the necessary continuous monitoring or examination activities in a reasonable period of time, the Federal Reserve will initiate and lead these activities in coordination with other relevant primary supervisors and functional regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.2.1.2.

1050.2.3.1.4 Risk Management of Nonmaterial Business Lines

Objectives: For nonmaterial business lines identified during the development of supervisory products that reflect the Federal Reserve's overview and risk assessment of the organization, the Federal Reserve's focus will be on identifying and understanding those business lines that are increasing in importance and have the potential to become material.

Supervisory Activities: When a primary supervisor or functional regulator has a sufficient view of nonmaterial business lines, the Federal Reserve will, to the fullest extent possible, use information developed by that supervisor or regulator to monitor areas of increasing importance with the potential to become material. The Federal Reserve also will maintain an ability to access internal MIS for these businesses to facilitate a more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

For nonmaterial business lines that are not subject to oversight by a single primary supervisor or functional regulator, the Federal Reserve will engage in continuous monitoring activities to identify meaningful trends in risks and risk-management practices, and will maintain an understanding of associated MIS to facilitate more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

1050.2.3.2 Financial Condition

Objectives: The Federal Reserve's evaluation of a regional BHC's consolidated financial condition focuses on the ability of the organization's resources to support the level of risk associated with its activities. Assessments are developed for each "CAEL" subcomponent: Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).[13]

In developing this evaluation, the Federal Reserve's primary focus is on developing an understanding and assessment of

1. the sufficiency of the BHC's consolidated capital to support the level of risk associated with the organization's activities and provide a sufficient cushion to absorb unanticipated losses;
2. the capability of liquidity levels and funds-management practices to allow reliable access to sufficient funds to meet present and future liquidity needs; and
3. other aspects of financial strength that need to be assessed on a consolidated basis across the organization's various legal entities, or that relate to the financial soundness of the parent company and significant nonbank subsidiaries, as discussed in section 1050.2.3.3 below.

In assessing consolidated regulatory capital, the Federal Reserve looks to ensure that the BHC demonstrates the effectiveness of its framework for complying with relevant capital adequacy guidelines and meeting supervisory expectations, and focuses on analyzing key models and processes[14] that influence this assessment. This assessment utilizes results from examinations led by the Federal Reserve or other primary supervisors or functional regulators, as well as information gained from the BHC's internal control functions and from market-based assessments, where available.

When assessing the adequacy of a BHC's liquidity levels and funds-management practices, areas of focus include[15]

1. the extent to which the treasury function is aligned with risk-management processes, and whether incentives are in place for business lines to compile and provide information on expected liquidity needs and contingency funding plans so that the treasury function is able to develop a firmwide perspective and incorporate business line information into assessments of actual and contingent liquidity risk;
2. whether funds-management practices provide sufficient funding flexibility to respond to unanticipated, evolving, and potentially correlated market conditions for the organization and/or across financial markets; and
3. the sufficiency of liquidity planning tools, such as stress testing, scenario analysis, and contingency planning efforts, including (1) whether liquidity buffers—comprised of unencumbered liquid assets as well as access to stable funding sources—adequately reflect the possibility and duration of severe liquidity shocks; (2) the reasonableness of assumptions about the stability of secured funding in circumstances in which the liquidity of markets for the underlying collateral becomes impaired; and (3) whether these efforts adequately reflect the potential for the organization to be called on in stressed environments to provide contingent liquidity support to off-balance-sheet entities or bring additional assets on the balance sheet (even if not legally or contractually obligated to do so).

Beyond capital adequacy and liquidity, the nature of independent Federal Reserve supervisory work required to evaluate a regional BHC's consolidated financial condition depends largely on the extent to which other relevant primary

13. See SR-04-18 and section 4070.0 for more information about the CAEL subcomponents.

14. "Key models and processes" are those where evaluation of the model/process will influence the Federal Reserve's assessment of the activity or control area that is supported by the model/process.

15. Assessing liquidity levels and funding practices for a consolidated BHC also incorporates elements presented in section 1050.2.3.3.2 below on "Parent Company and Nonbank Funding and Liquidity."

supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. For example, more independent Federal Reserve work typically will be required to assess consolidated asset quality or earnings for regional BHCs with significant nonbank activities that are not functionally regulated. However, where all material holding company assets are concentrated in a single depository institution subsidiary, a minimal level of incremental Federal Reserve efforts typically will be required to assess consolidated asset quality and earnings.

Supervisory Activities: The Federal Reserve will primarily utilize continuous monitoring activities to assess a regional BHC's financial strength. Such activities will include periodic meetings with BHC management (such as the chief financial officer); review of regulatory reports, surveillance screens, and internal MIS; and analysis of market indicators (where available), including external debt ratings, subordinated debt spreads, and credit default swap spreads. Testing and discovery activities will be used as necessary to assist in the understanding and assessment of areas of concern.

Testing and discovery activities also will be used to understand and assess the sufficiency of the BHC's consolidated capital and liquidity positions to support the level of risk associated with its activities, including (1) regulatory capital calculation methodologies[16] and, where applicable, internal assessments of capital adequacy[17] and (2) funds-management and liquidity planning tools and practices. The Federal Reserve will work with other relevant primary supervisors and functional regulators to participate in or, if necessary, to coordinate activities designed to analyze key capital and liquidity models or processes of a depository institution or functionally regulated subsidiary that are of such significance that they will influence the Federal Reserve's assessment of these areas. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.2.1.2.

1050.2.3.3 Impact

1050.2.3.3.1 Risk Management and Financial Condition of Significant Nonbank Subsidiaries

Objectives: Many regional BHCs engage in activities and manage control functions on a firmwide basis, spanning depository institution and nonbank legal entities. In some instances, these BHCs have intra-group exposures and servicing arrangements across affiliates, presenting increased potential risks for depository institution subsidiaries and a higher likelihood of aggregate risk concentrations across the organization's legal entities. Common interactions between a regional BHC's depository institution subsidiaries and their nonbank affiliates (including the parent company) include assets originating in, or being marketed by, a nonbank affiliate that are booked in the depository institution; a depository institution providing funding for nonbank affiliates; and risk-management or internal control functions being shared between depository and nonbank operations.

Due to these interrelationships, financial, legal, compliance, or reputational troubles in one part of a BHC can spread rapidly to other parts of the organization. Even absent these interactions, the parent or nonbank subsidiaries of an organization may present financial, legal, compliance, or reputational risk to the consolidated entity, and thus directly or indirectly to its depository institution subsidiaries. As the federal banking agency charged with supervising the organization on a consolidated basis, the Federal Reserve is responsible for understanding and assessing the risks that the parent bank holding company and its nonbank subsidiaries may pose to the BHC itself or its depository institution subsidiaries.

The primary objectives of Federal Reserve supervision of the nonbank subsidiaries of a bank holding company are to

16. Assessments of the adequacy of regulatory capital for BHCs that have received Federal Reserve supervisory approval to use internal estimates of risk in their regulatory capital calculations should include, among other things, regular verification that these organizations continue to meet on an ongoing basis all applicable requirements associated with internal estimates. See, for example, the capital adequacy guidelines for market risk at BHCs (Regulation Y: 12 C.F.R. 225, Appendix E) and the new advanced capital adequacy framework for BHCs (Regulation Y: 12 C.F.R. 225, Appendix G).

17. Capital planning activities for all BHCs should be forward looking and provide for a sufficient range of stress scenarios commensurate with the organization's activities. For those regional BHCs that utilize more-rigorous and structured internal processes for assessing capital adequacy beyond regulatory capital measures, the Federal Reserve focuses on whether such internal processes ensure that all risks are properly identified, reliably quantified (where possible) across the entire organization, and supported by adequate capital. See SR-99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," and section 4060.7.

1. identify significant nonbank activities and risks—where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution subsidiary—by developing an understanding of the size and nature of primary activities and key trends, and the extent to which business lines, risks, or control functions are shared with or may impact a depository institution affiliate;
2. evaluate the financial condition and the adequacy of risk-management practices of the parent and significant nonbank subsidiaries, including the ability of nonbank subsidiaries to repay advances provided by the parent, using benchmarks and analysis appropriate for those businesses;
3. evaluate the degree to which nonbank entity risks may present a threat to the safety and soundness of subsidiary depository institutions, including through transmission of legal, compliance, or reputational risks;
4. identify and assess any intercompany relationships, dependencies, or exposures—or aggregate firmwide concentrations—with the potential to threaten the condition of a depository institution affiliate; and
5. evaluate the effectiveness of the policies, procedures, and systems that the holding company and its nonbank subsidiaries use to ensure compliance with applicable laws and regulations, including consumer protection laws.[18]

Supervisory Activities: For all significant nonbank subsidiaries and activities of the parent BHC, the Federal Reserve will use continuous monitoring activities and discovery reviews to

1. maintain an understanding of the holding company's business line and legal entity structure, including key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates, utilizing regulatory structure reports, internal MIS, and other information sources;
2. understand and assess the exposure to, and tolerance for, legal, compliance, and reputational risks, as well as the extent to which potential conflicts of interest are identified and avoided or managed;
3. understand the scope of intercompany transactions and aggregate concentrations, and assess the adequacy of risk-management processes, accounting policies, and operating procedures to measure and manage related risks;
4. identify and assess key interrelationships and dependencies between subsidiary depository institutions and nonbank affiliates, such as the extent to which a depository institution subsidiary is reliant on services provided by the parent company or other nonbank affiliates and the reasonableness of associated management fees;
5. identify those nonbank subsidiaries whose activities present material financial, legal, compliance, or reputational risk to the consolidated entity and/or a depository institution subsidiary;
6. identify significant businesses operated across multiple legal entities for accounting, risk management, or other purposes, as well as activities that functionally operate as separate business units for legal or other reasons;
7. identify intercompany transactions subject to Regulation W—utilizing information submitted on quarterly regulatory reporting form FR Y-8 ("The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates"), internal MIS, and other information sources—and determine (in conjunction with the primary supervisor) whether compliance issues are present; and
8. understand and assess the sufficiency, reliability, and timeliness of associated MIS relied upon by the board, senior management, and senior risk managers and committees to monitor key activities and risks.

Periodic testing may be used to supplement continuous monitoring and discovery reviews to (1) ensure that key risk-management and internal control practices conform to internal policies and/or are designed to ensure compliance with the law and (2) understand and assess operations presenting a moderate or greater likelihood of significant negative impact to a subsidiary depository institution or the consolidated organization. Areas of potential negative impact include financial or operational risks that pose a potential threat to the safety and soundness of a depository institution subsidiary, or to the holding company's ability to serve as a source of financial and managerial strength to its deposi-

18. The Federal Reserve's supervisory objectives and activities related to the effectiveness of consumer compliance policies, procedures, and systems at nonbank subsidiaries of a BHC currently are under review, and additional or modified guidance on this topic may be issued in the future.

tory institution subsidiaries. Testing will focus on controls for identifying, monitoring, and controlling such risks. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.2.1.2.

1050.2.3.3.2 Parent Company and Nonbank Funding and Liquidity

Objectives: One of the Federal Reserve's primary responsibilities as consolidated supervisor is to help ensure that the parent company and its nonbank subsidiaries do not have an adverse impact on the organization's depository institution subsidiaries. To meet this objective, the Federal Reserve will assess the extent to which funding and liquidity policies and practices of the parent company or nonbank subsidiaries may undermine the BHC's ability to act as a source of strength to the organization's depository institution subsidiaries.

Areas of focus will include an assessment of

1. the ability of the parent company and nonbank subsidiaries to maintain sufficient liquidity, cash flow, and capital strength to service their debt obligations and cover fixed charges;
2. the likelihood that parent company or nonbank funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions;
3. policies and practices that are aimed at ensuring the stability of parent company funding and liquidity, as evidenced by the utilization of long-term or permanent financing to support capital investments in subsidiaries and other long-term assets, and the degree of dependence on short-term funding mechanisms such as commercial paper;
4. the extent of "double leverage"[19] and the organization's capital management policies, including the distribution and transferability of capital across jurisdictions and legal entities; and
5. the parent company's ability to provide financial and managerial support to its depository institution subsidiaries during periods of financial stress or adversity, including the sufficiency of related stress testing, scenario analysis, and contingency planning efforts.

The Federal Reserve also will remain apprised of the funding profile—including intraday liquidity management policies and practices, and compliance with the "Federal Reserve Policy on Payments System Risk"[20]—and market access of material depository institution subsidiaries, as in most instances these entities represent the consolidated BHC's primary and most active vehicles for external funding and liquidity management. The primary supervisor retains responsibility for assessing liquidity risk-management practices with respect to the depository institution subsidiary.

Supervisory Activities: The Federal Reserve will use continuous monitoring activities—including monitoring market conditions and indicators where available—and discovery reviews to understand and assess parent company and nonbank subsidiary funding and liquidity policies and practices, as well as any potential negative impact these policies and practices might have on a subsidiary depository institution or the consolidated organization. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant change in inherent funding or liquidity risk stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified, the Federal Reserve will design and conduct testing activities focused on understanding and assessing the areas of change and/or concern in order to ensure that funding and liquidity risk-management and control functions are appropriately designed and achieving their intended objectives.

For regional BHCs where parent company or nonbank subsidiary third-party debt obligations are deemed to be material in relation to equity or may otherwise have a potentially negative impact on the BHC's ability to serve as a source of strength for its depository institution subsidiaries, the Federal Reserve will undertake testing activities on at least a three-year cycle, assessing the individual elements of risk management for parent company and nonbank funding and

19. "Double leverage" refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

20. This policy statement is available on the Board's public website at www.federalreserve.gov/paymentsystems/psr.

liquidity: board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and related internal controls. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.2.1.2.

1050.2.4 INTERAGENCY COORDINATION

1050.2.4.1 Coordination and Information Sharing Among Domestic Primary Bank Supervisors and Functional Regulators

Objectives: Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other relevant domestic primary bank supervisors and functional regulators.[21] To achieve this objective, the Federal Reserve has worked over the years to enhance interagency coordination through the development and use of information-sharing protocols and mechanisms. These protocols and mechanisms respect the individual statutory authorities and responsibilities of the respective supervisors and regulators, provide for appropriate information flows and coordination to limit unnecessary duplication or burden, comply with restrictions governing access to information, and ensure that the confidentiality of information is maintained.

As discussed in section 1050.2.3, in understanding and assessing the activities and risks of the organization as a whole, the Federal Reserve will rely to the fullest extent possible on the examination and other supervisory work conducted by the domestic primary bank supervisors and functional regulators of a BHC's subsidiaries. In addition, the Federal Reserve will seek to coordinate its supervisory activities with relevant supervisors and regulators, and will work to align each agency's assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of the consolidated BHC's operations as applicable.

Supervisory Activities: The Federal Reserve will continue to work with the relevant primary supervisors and functional regulators of a regional BHC's subsidiaries to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the BHC on a consolidated basis. The Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant primary supervisors or functional regulators when appropriate and permitted by applicable laws and regulations.[22]

The Federal Reserve also will continue to use a variety of formal and informal channels to facilitate interagency information sharing and coordination consistent with the principles outlined above, including

- supervisory protocols, agreements, and memoranda of understanding (MOUs) with primary supervisors and functional regulators that allow the coordination of supervisory activities and that permit the ongoing exchange of information, including confidential information on a confidential basis;
- bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- periodic and as-needed contacts with primary supervisors and functional regulators to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities;
- the use of information technology platforms, such as the Banking Organization National Desktop (BOND),[23] to provide secure automated access to examination/inspection reports and other supervisory information prepared by the Federal Reserve and other relevant supervisors and regulators; and
- participation in a variety of interagency forums that facilitate the discussion of broad industry issues and supervisory strategies, including the Federal Financial Institutions Examination Council, the President's Working Group on Financial Markets, and the Federal Reserve-

21. Section 1050.2.4.2 discusses cooperation and information sharing among foreign supervisors.

22. Among the federal laws that may limit the sharing of information among supervisors are the Right to Financial Privacy Act (12 U.S.C. 3401 *et seq.*) and the Trade Secrets Act (18 U.S.C. 1905). The Federal Reserve has established procedures to authorize the sharing of confidential supervisory information, and Federal Reserve staff must ensure that appropriate approvals are obtained prior to releasing such information. See Subpart C of the Board's Rules Regarding the Availability of Information (12 C.F.R. 261.20 *et seq.*).

23. BOND is a Federal Reserve information technology platform providing secure interagency access to documents, supervisory and financial data, and other information utilized in the consolidated supervision of individual BHCs and FBOs, and in developing comparative analyses of organizations with similar business lines and risk characteristics.

sponsored cross-sector meetings of financial supervisors and regulators.

1050.2.4.1.1 Coordination of Examination Activities at a Supervised BHC Subsidiary

As discussed in section III, the Federal Reserve will seek to work cooperatively with the relevant primary supervisor or functional regulator to address information gaps or indications of weakness or risk identified in a supervised BHC subsidiary that are material to the Federal Reserve's understanding or assessment of the consolidated organization's risks, activities, or key corporate governance, risk-management, or control functions. Prior to conducting discovery reviews or testing activities at a depository institution (other than where the Federal Reserve is the primary federal supervisor) or functionally regulated subsidiary of a BHC, the Federal Reserve will

- review available information sources as part of its continuous monitoring activities, including examination reports and the BHC's internal MIS, to determine whether such information addresses the Federal Reserve's information needs or supervisory concerns; and
- if needed, seek to gain a better understanding of the primary supervisor's or functional regulator's basis for its supervisory activities and assessment of the subsidiary. This may include a request to review related examination work.

If, following these activities, the Federal Reserve's information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant primary supervisor or functional regulator in the manner discussed in section 1050.2.3.[24]

1050.2.4.2 Cooperation and Information Sharing With Host-Country Foreign Supervisors

Objectives: A number of regional BHCs have international banking and other operations that are licensed and supervised by foreign host-country authorities. As home-country supervisor for domestic BHCs, the Federal Reserve is responsible for the comprehensive, consolidated supervision of these organizations, while each host country is responsible for supervision of the legal entities (including foreign subsidiaries of U.S. BHCs) in its jurisdiction.

Information sharing among domestic and foreign supervisors, consistent with applicable laws, is essential to ensure that a regional BHC's global activities are supervised on a consolidated basis. Cross-border information sharing is often facilitated by an MOU that establishes a framework for bilateral relationships and includes provisions for cooperation during the licensing process, in the supervision of ongoing activities, and in the handling of problem institutions. The Federal Reserve has established bilateral and multilateral information-sharing MOUs and other arrangements with numerous host-country foreign supervisors. The Federal Reserve also monitors changes in foreign bank regulatory and supervisory systems and seeks to understand how these systems affect supervised banking organizations. In addition to its longstanding cooperative relationships with home- and host-country foreign supervisors, the Federal Reserve expects to increasingly lead and participate in "colleges of supervisors" and other multilateral groups of supervisors that discuss issues related to specific, internationally active banking organizations.

The Federal Reserve also is a member of the Basel Committee on Banking Supervision, which is a forum for supervisors from member countries to discuss important supervisory issues, foster consistent supervision of organizations with similar business and risk profiles, promote the sharing of leading supervisory practices, and formulate guidance to enhance and refine banking supervision globally.

The Federal Reserve's processes for understanding and assessing firmwide legal and compliance risk management, as described earlier, encompass both domestic and international operations. Most areas of supervisory focus for management of legal and compliance risks are applicable to both domestic and international entities, and include proper oversight of licensed operations, compliance with supervisory and regulatory requirements, and the sufficiency of associated MIS.

There are, however, areas of focus for the Federal Reserve that are unique to a holding company's international operations. For exam-

24. As outlined in section 1050.2.3, certain Federal Reserve examination activities are to be conducted on a minimum three-year cycle to verify, through testing, the sufficiency of key control processes. These activities are to be conducted regardless of whether or not there is an information gap or indication of weakness or risk.

ple, some host-country legal and regulatory structures and supervisory approaches are fundamentally different from those in the United States. As a result, the banking organization often must devote additional resources to maintain expertise in local regulatory requirements. In some instances, privacy concerns have led to limits on the information a BHC's foreign office may share with its parent company, thereby limiting the parent company's ability to exercise consolidated risk management on a global basis.

Additionally, while considerable progress has been made to strengthen supervisory cross-border cooperation and information sharing, the Federal Reserve and other U.S. supervisors have at times faced challenges in accessing information on a bank's or BHC's foreign operations or in carrying out examinations of cross-border or foreign activities. These circumstances are to be taken into account when developing a supervisory strategy for a regional BHC with cross-border or foreign operations.

Supervisory Activities: For regional BHCs with international operations, continuous monitoring will be used to understand and assess each BHC's international strategy, trends, operations, and legal entity structure, as well as related governance, risk-management, and internal controls. For a regional BHC with significant international operations or risks, an assessment of cross-border and foreign operations will be incorporated into the evaluation of key corporate governance functions and primary firmwide risk-management and internal control functions, including legal and regulatory risk management.

Continuous monitoring activities will include review of materials prepared by host-country supervisors, including examination reports and assessments, and ongoing communication with relevant foreign and domestic supervisors regarding trends and assessments of cross-border and foreign operations.

When assessing the sufficiency of a regional BHC's management of its international operations, consideration is given to the extent that foreign laws restrict the transmission of information to the BHC's head office. Impediments to sharing information imposed by a host country may constrain the BHC's ability to effectively oversee its international operations and globally manage its risks, and the materiality of such impediments should be a determinant of whether the organization should be conducting operations in that host country.

In addition, any limits placed on the Federal Reserve's ability to access information on host-country operations, or to engage in onsite activities at the organization's operations in the host country, should be considered when assessing whether the organization's activities in that jurisdiction are appropriate.

1050.2.4.3 Indications of Weakness or Risk Related to Subsidiary Depository Institutions

Objectives: For areas beyond those specifically addressed in section 1050.2.3, there may be circumstances where the Federal Reserve has indications of material weakness or risk in a depository institution subsidiary of a BHC that is supervised by another primary supervisor, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of that supervisor. Because a primary objective of consolidated supervision is to protect the BHC's depository institution subsidiaries, the Federal Reserve will follow up with the appropriate primary supervisor in these circumstances to help ensure that, to the extent that a material weakness or risk exists, it is addressed appropriately.

Supervisory Activities: The Federal Reserve will take the following steps if it has indications of material weakness or risk in a depository institution subsidiary (other than where the Federal Reserve is the primary federal supervisor) in an area beyond those specifically addressed in section 1050.2.3, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of the depository institution's primary supervisor.

- The Federal Reserve will first review available information sources, discuss the areas of concern with the primary supervisor, and seek to review the supervisor's related work.
- If concerns remain following these activities, the Federal Reserve will request that the primary supervisor conduct a discovery review or testing activity at the depository institution to address the area of concern.
- In the event the primary supervisor does not undertake activities to address the concern in a reasonable period of time, the Federal Reserve will design and lead an examination of the depository institution to address the matter in consultation with the primary supervisor. A

senior Federal Reserve official will communicate this decision in writing to a senior official of the primary supervisor.

1050.2.4.4 Condition or Management of BHC Subsidiary is Less than Satisfactory

Objectives: As noted above, a primary responsibility of the Federal Reserve as consolidated BHC supervisor is to ensure that a holding company's activities, policies, and practices do not undermine its ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. In situations where the condition or management of a supervised or functionally regulated BHC subsidiary is determined to be less than satisfactory, the Federal Reserve's focus as consolidated supervisor is on complementing the efforts of the primary supervisor or functional regulator. In doing so, the Federal Reserve will seek to ensure that the parent company provides appropriate support to the subsidiary and does not take actions that may further weaken the parent company's depository institution subsidiaries or its ability to act as a source of strength for such subsidiaries.

Beyond the specific activities noted below, these circumstances also may require the Federal Reserve to enhance the activities addressed in section 1050.2.3 for understanding and assessing key corporate governance functions, or primary firmwide risk-management and internal controls. In addition, the Federal Reserve will adjust its supervisory activities as necessary when the consolidated BHC is in weakened condition or when there are questions regarding the capabilities of the holding company's management.

Supervisory Activities:

- *Depository institution subsidiary*. In instances when a depository institution subsidiary's condition or management is rated less than satisfactory, or when the depository institution subsidiary otherwise faces financial stress or material risks, the Federal Reserve's primary supervisory objectives as consolidated supervisor are to ensure that the parent company (1) provides appropriate support to the depository institution and (2) does not take action that could harm the depository institution. The Federal Reserve will work closely with the primary supervisor to understand whether the BHC or a nonbank affiliate has contributed to the depository institution's weakened condition, to understand the impact of the depository institution on the BHC's condition, and to determine if the holding company is providing appropriate support to the depository institution. The Federal Reserve will coordinate its activities with those of the primary supervisor to the extent appropriate.
- *Nonbank subsidiary*. When any nonbank subsidiary faces financial stress or material risks, the Federal Reserve will seek to ensure that its condition and activities do not jeopardize the safety and soundness of the BHC or its depository institution subsidiaries, as discussed above in sections 1050.2.3.3.1, "Risk Management and Financial Condition of Significant Nonbank Subsidiaries" and 1050.2.3.3.2, "Parent Company and Nonbank Funding and Liquidity." The Federal Reserve also will take appropriate steps to ensure that any actions taken by the parent company to assist a nonbank subsidiary do not impair the BHC's continuing ability to serve as a source of strength to its depository institution subsidiaries. The Federal Reserve will coordinate its activities with those of any relevant functional regulator to the extent appropriate.

1050.2.4.5 Edge and Agreement Corporations

Objectives: Some regional BHCs control an Edge or agreement corporation subsidiary. The Federal Reserve serves as the primary supervisor of each Edge and agreement corporation subsidiary in addition to its role as consolidated BHC supervisor.[25] When the Edge or agreement corporation is held by a U.S. bank, the primary supervisor often relies on information provided by the Federal Reserve in developing its own understanding and assessment of the parent bank.

During each calendar year, the Federal Reserve performs an examination of each Edge and agreement corporation, assesses the Bank Secrecy Act/Anti-Money-Laundering (BSA/AML) compliance program, and assigns a CAMEO rating. In addition, the Federal Reserve periodically conducts assessments of Edge and agreement

25. The Federal Reserve is solely responsible for approving, and supervising the activities of, U.S. Edge and agreement corporations. As discussed in SR-90-21, "Rating System For International Examinations," one of the Federal Reserve's supervisory responsibilities is the assignment of a CAMEO rating (Capital, Asset Quality, Management, Earnings, and Operations and Internal Controls) to each Edge and agreement corporation.

corporations to determine whether a consumer compliance examination is warranted, in which case a compliance examination is conducted and a consumer compliance rating is assigned.

The Federal Reserve will coordinate the conduct of its activities as Edge and agreement corporation supervisor with its activities as consolidated supervisor. To this end, the extent and scope of Federal Reserve supervisory work related to an Edge or agreement corporation will be tailored to the entity's activities, risk profile, and other attributes. A number of specific elements will be considered when developing a supervisory approach, including

1. structure and attributes, including whether the Edge or agreement corporation is a banking or investment organization;
2. the size, nature, and location of its primary activities, as well as key financial and other trends;
3. the business lines and risks, and associated trends, of the Edge or agreement corporation's primary activities on a standalone basis, as well as their significance to the risk profile of the parent bank (if applicable) and BHC;
4. the extent to which risk-management and internal control functions are unique to the Edge or agreement corporation, or are shared with a parent bank, another affiliate, or the consolidated BHC;
5. any potential Regulation K limitations or other U.S. compliance issues, and the adequacy of processes to ensure ongoing compliance; and
6. the adequacy of processes for ensuring compliance with all applicable laws and regulations imposed by host-country supervisors for the Edge or agreement corporation's international operations.

Supervisory Activities: The Federal Reserve will maintain an understanding and perform an annual examination for each Edge and agreement corporation. While the examination scope will be risk focused to reflect the organization's scale, activities, and risk profile, in all cases the Federal Reserve will assess the adequacy of processes to ensure compliance with BSA/AML requirements and other applicable U.S. laws and regulations, and with applicable foreign laws and regulations.

In developing its supervisory strategy, the Federal Reserve will identify those elements that are unique to the Edge or agreement corporation and those that are shared with the parent bank or BHC, and will coordinate fulfillment of the Federal Reserve's responsibilities as Edge and agreement corporation supervisor with execution of its consolidated supervision role. This strategy will reflect the extent to which reliance can be placed on (1) the Federal Reserve's understanding and assessments of key corporate governance, risk-management, and control functions, as well as material portfolios and business lines, of the consolidated BHC; (2) assessments developed by the primary supervisor (when applicable) for business lines, risk management, control functions, or financial factors that are common to the Edge or agreement corporation and its parent bank; and (3) findings developed by host-country supervisors for activities under their jurisdiction.

In addition, where the primary supervisor of an Edge or agreement corporation's parent bank relies on the Federal Reserve's understanding and assessment in order to develop its CAMELS rating,[26] the Federal Reserve will work to fulfill that supervisor's information needs.

1050.2.4.6 Nontraditional Bank Holding Companies

Objectives: A small number of regional BHCs are considered to be nontraditional bank holding companies because most or all of their significant nondepository subsidiaries are regulated by a functional regulator, and subsidiary depository institutions are small in relation to the nondepository entities. As with all BHCs, the level of analysis conducted and resources needed to supervise and assess nontraditional BHCs should be commensurate with the level of risk posed by the organization's depository institution subsidiaries to the federal safety net and the level of risk posed by the parent or its nonbank subsidiaries to the BHC's subsidiary depository institutions.

Due to the unique structure of nontraditional BHCs, it is likely that a single functional regulator will have a complete view of, and ability to address, significant aspects of the organization's

26. The U.S. banking agencies assign CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings to U.S. banking organizations as part of their ongoing supervision of these organizations. See SR-96-38, "Uniform Financial Institutions Rating System," (see A.5020.1 of the *Commercial Bank Examination Manual* and sections 4020.9, 4070.0.4, and 4080.0) Also see SR-97-4, "Interagency Guidance on Common Questions About the Application of the Revised CAMELS Rating System."

firmwide activities, risks, risk management, and controls. Therefore, assessments and information developed by the primary functional regulator typically will be the main tool utilized by the Federal Reserve in developing and assigning the ‘‘R’’ and ‘‘F’’ components of the consolidated RFI rating. More independent Federal Reserve work typically will be required to understand and assess the impact of the nondepository entities on the subsidiary depository institutions in order to assign the ‘‘I’’ rating.

Supervisory Activities: The Federal Reserve will primarily utilize continuous monitoring activities to maintain its assessments of risk management and financial condition for nontraditional BHCs, relying on the assessments and information developed by the primary functional regulator to the fullest extent possible.

In addition to continuous monitoring, discovery reviews and periodic testing will be used to maintain an understanding and assessment of the potential negative impact of nonbank entities on subsidiary depository institutions as discussed above in sections 1050.2.3.3.1 and 1050.2.3.3.2 on, respectively, ‘‘Risk Management and Financial Condition of Significant Nonbank Subsidiaries’’ and ‘‘Parent Company and Nonbank Funding and Liquidity.’’ In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.2.1.2.