The subsections following this introduction address the Board's supervisory authority over, and reporting requirements for foreign banking organizations. Supervisory policy statements issued by the Board or the Federal Financial Institutions Examination Council in conjunction with other federal financial institution regulatory agencies are also discussed. Foreign banks continue to expand their operations in the United States and are significant participants in the U.S. banking system. As of December 31, 1991, 313 foreign banks operated 529 state-licensed branches and agencies (of which 53 had FDIC insurance) and 84 branches and agencies licensed by the Office of the Comptroller of the Currency (of which 9 had FDIC insurance). Foreign banks also directly owned 11 Edge corporations and 13 commercial lending companies. In addition, foreign banks held an interest of at least 25 percent in 90 U.S. commercial banks. Together, these foreign banks controlled approximately 24 percent of U.S. banking assets.

The Federal Reserve has broad authority for the supervision and regulation of foreign banks that engage in banking in the United States through branches, agencies, and commercial lending companies. Foreign banks owning Edge corporations or U.S. banks are more directly subject to Federal Reserve supervision—in the former case as the Edge's chartering authority and in the latter as primary supervisor of bank holding companies. In all cases, the Board is primarily responsible for supervising the U.S. nonbanking operations of foreign banks with a U.S. banking presence.

Before the December 19, 1991 passage of the Federal Deposit Insurance Corporation Improvement Act, the Federal Reserve had residual authority to examine all branches, agencies, and commercial lending subsidiaries of foreign banks in the United States. The International Banking Act of 1978 instructed the Federal Reserve to use, to the extent possible, the examinations reports of other state and federal regulators. The FDICIA amended the International Banking Act and increased the Federal Reserve's authority with respect to these foreign bank operations, including representative offices, in the United States. The Federal Reserve may coordinate the examinations of foreign bank operations with other state and federal regulators. Branches and agencies are now required to be examined at least once during each twelve-month period in an on-site examination.

The FDICIA also authorized the Federal Reserve to terminate the operations of foreign banks in the United States under certain conditions. The legislation requires Federal Reserve approval to establish foreign bank branches, agencies, commercial lending subsidiaries, and representative offices in the United States.

2100.1.1 POLICY STATEMENT ON THE SUPERVISION AND REGULATION OF FOREIGN BANKING ORGANIZATIONS

On February 23, 1979, the Board issued a statement of policy on supervision and regulation of foreign banking organizations that control a U.S. subsidiary bank. The policies set forth in this statement continue to provide the framework within which the Board analyzes foreign bank acquisitions of U.S. banks. The Board has stated in a number of cases it has acted upon since 1984, that it views as ‘‘a negative factor’’ the failure of a foreign bank’s stated capital ratio to meet the Board’s capital adequacy guidelines. In addition to certain mitigating factors such as the existence of ‘‘hidden reserves’’ or a highly liquid funding position, the Board has relied upon assurances and commitments that the capital adequacy of the U.S. bank subsidiary will be maintained at a high level to offset this ‘‘negative factor.’’ Following are major excerpts from the policy statement.

The Board of Governors has a number of supervisory responsibilities over the operations of foreign banking organizations in the United States under the Bank Holding Company Act and under the International Banking Act of 1978. In order to inform the public and the banking industry, the Board issued this statement setting forth its policy toward regulating foreign bank holding companies in the United States.

Bank supervision in the United States has as a principal objective, the promotion of the safety and soundness of banking institutions as going concerns serving depository and credit needs of their communities and the economy as a whole. To this end, a number of standards have been established governing domestic entry into the banking business and ongoing supervision of banking operations of domestic banks and bank holding companies.

In urging legislation to provide for federal regulation of foreign banks in the United States, the Board endorsed the principle of national treatment, or nondiscrimination, as a basis for the rules governing the entry and subsequent operations of foreign banks in this country. The International Banking Act of 1978 generally incorporates that principle in its provisions.

The Board continues to believe that the principle of national treatment should be the guiding rule in administering the Bank Holding Company Act and the International Banking Act of 1978 as they affect foreign banks. Following this rule, the Board believes that in general, foreign banks seeking to establish banks or other banking operations in the United States should meet the same general standards of strength, experience and reputation as required for domestic organizers of banks and bank holding companies. The Board also believes that foreign banks should meet on a continuing basis these standards of safety and soundness if they are to be a source of strength to their U.S. banking operations.

At the same time, the Board is cognizant that foreign banks operate outside the United States in accordance with different banking practices and traditions and in different legal and social environments. The Board also recognizes that its supervisory responsibilities are for the safety and soundness of U.S. banking operations. Its supervisory concerns for the operations and activities of foreign banks outside the United States are, therefore, limited to their possible effects on the ability of those banks to support their operations inside the United States. As embodied in both the Bank Holding Company Act and the International Banking Act of 1978, it is the general policy of the Board not to extend U.S. bank supervisory standards extraterritorially to foreign bank holding companies. The Board will give due regard to these factors in applying the principle of national treatment.

The Board has jurisdiction over foreign entry in the case of foreign organizations seeking to acquire U.S. banks. Whenever a foreign bank applies to become a bank holding company, the Board will seek to assure itself of the foreign bank’s ability to be a source of financial and managerial strength and support to the U.S. subsidiary bank. In reaching this judgment, the Board will analyze the financial condition of the foreign organization, evaluate the record and integrity of management, assess the role and standing of the bank in its home country, and request the views of the bank regulatory authorities in the home country. In connection with its financial analysis, the Board will require sufficient information to permit an assessment of the financial strength and operating performance of the foreign organization. Information will consist of reports prepared in accordance with local practices together with an explanation and reconciliation of major differences between local accounting standards and U.S. generally accepted accounting procedures including full information on earnings, capital, charge-offs, and reserves. The Board will also continue to work with bank supervisory authorities of other major countries to improve overall cooperation in international bank regulation.

Once a foreign bank holding company has been established, Board supervisory procedures will be primarily directed at promoting the safety and soundness of the subsidiary U.S. banks. Examinations carried out by the relevant federal and/or State supervisory authority will continue to be the primary instrument for this purpose. Special attention will be given to transactions and correspondence between the U.S. subsidiary bank and its foreign parent and to monitoring credits by the U.S. bank to parties that are also customers of the parent. In particular, federal bank supervisors will expect the U.S. bank to maintain sufficient information on all borrowers to permit both the U.S. bank and bank examiners to make an independent appraisal of the bank's credits. In addition to the examination process, the Board will require foreign bank holding companies to report semiannually on transactions between the U.S. subsidiary bank and its foreign parent.

The Board requires submission of sufficient financial information to enable it to assess the operations and general condition of the parent institution. In particular, full information on earnings, reserves and capital will be required along with an explanation of major material differences between U.S. and foreign accounting practices. In its use and handling of the information, the Board will take into account the fact that much of the information required may be confidential commercial information that is not generally disclosed and the parent's majority owned subsidiaries.

2100.1.2 INTERAGENCY POLICY STATEMENT ON THE SUPERVISION OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS

A second policy statement was issued on July 20, 1979, through the Federal Financial Institutions Examination Council on the supervision of U.S. branches and agencies of foreign banks. Principal excerpts from this statement are as follows:

The International Banking Act of 1978 gives the three Federal bank regulatory agencies expanded supervisory authority and responsibility with respect to the operations of foreign banks' U.S. branches, agencies, and commercial lending companies.[1] It provides for the establishment of Federal branches and agencies by the Office of the Comptroller of the Currency and permits U.S. branches to apply for insurance coverage by the Federal Deposit Insurance Corporation. It also subjects these U.S. offices to many provisions of the Federal Reserve and Bank Holding Company Acts.

In order to insure adequate supervision of these offices within the present Federal-State regulatory framework, the IBA provides that the Comptroller, the FDIC, and the various State authorities will have primary examining authority over the offices within their jurisdictions. Additionally, the Act gives the Federal Reserve Board residual examining authority over all U.S. banking operations of foreign banks, similar to its existing authority over U.S. subsidiary banks of bank holding companies. This distribution of responsibilities calls for close coordination of the efforts of the relevant authorities. Accordingly, the Comptroller, the FDIC, and the Board, in coordination with the Federal Financial Institutions Examination Council (FFIEC), issued this joint statement to inform the public and the banking industry of their supervisory policy toward these U.S. offices.

The agencies' supervisory interests in the operations of U.S. branches and agencies of foreign banks are directed to the safety and soundness of those operations in serving the needs of borrowers and depositors and other creditors in the United States. For this reason, the regulatory agencies place primary emphasis on assessing the financial well-being of the U.S. offices. They are also concerned with adherence to U.S. law and regulation by these offices.

At the same time, the agencies recognize that, even more than in the case of U.S. bank subsidiaries of foreign banks, the strength of these branches and agencies devolves from their head offices and organizations outside the United States and that ultimate responsibility for branch and agency activities resides in head offices overseas. Consequently, the agencies will seek to assure themselves that the parent institutions are financially sound. To this end, they will collect information on the consolidated operations of the foreign banks and expand their contacts with senior managements of the banks.

1. The term ''commercial lending companies'' is intended to refer to investment companies organized under Article XII of the New York State Banking Law, and any similar corporations that may be organized under the laws of other States.

Additionally, United States authorities are working and will continue to work with bank supervisory authorities of other nations to improve both the coordinated exchange of banking information and the compatibility of international banking regulation.

The International Banking Act of 1978 mandates that the Federal regulatory agencies cooperate closely with State banking authorities in examining U.S. offices of foreign banks. In furtherance of this mandate, a uniform approach to examining these offices has been developed through the FFIEC in order to minimize dual examinations and to facilitate joint Federal-State examinations, when desirable. In exercising their responsibilities, the agencies will ensure that each U.S. office of a foreign bank is examined regularly by either State or Federal authorities.

2100.1.3 BOARD REPORTING REQUIREMENTS FOR FOREIGN PARENT INSTITUTIONS

To gain information on the consolidated bank, the Board has developed reporting requirements for the foreign parent institutions. These information requirements are the same as those for foreign bank holding companies, including disclosure of specific information on earnings, reserves, and capital, and an explanation for material differences between U.S. and foreign accounting practices. In use and handling of this information, the (Board) will take into account the fact that some of the information required may be confidential commercial information that is not generally disclosed.

2110.0.1 INTRODUCTION

2110.0.1.1 Changes Resulting from the Enforcement Provisions and Other Related Sections of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (''FIRREA'') and the Comprehensive Thrift and Bank Fraud Act of 1990 (the ''Bank Fraud Act'')

The provisions of Title IX of FIRREA and several provisions of the Bank Fraud Act granted the Board of Governors, as well as the other federal financial institutions supervisory agencies, numerous new or enhanced enforcement powers over financial institutions and individuals associated with them. The new or enhanced enforcement powers granted, under FIRREA and the Bank Fraud Act, to the Board of Governors and the new responsibilities of banking organizations (and individuals associated with them) that are supervised by the Federal Reserve are as follows:[1]

1. In order to simplify the numerous and lengthy references to ''directors, officers, employees, agents and persons participating in the conduct of the affairs of a financial institution'' contained in the enforcement statutes and to expand the banking agencies' jurisdiction over individuals associated with financial institutions, the term ''institution-affiliated party'' is substituted in the law each time there is a reference to one of the aforementioned individuals. Thus, the Board has enforcement powers, such as cease and desist, removal, prohibition and civil money penalty assessment authority, now over certain financial institutions and institution-affiliated parties including controlling shareholders.

   In addition, the term ''institution-affiliated party'' has been expanded to include independent attorneys, appraisers, and accountants, as well as other independent contractors, who knowingly or recklessly participate in any law or regulation violation, any breach of fiduciary duty or any unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.[2] In this manner, the Board has added responsibilities for monitoring and addressing through enforcement actions, where necessary, the activities of whole new categories of persons who work with or for financial institutions subject to our regulatory jurisdiction.

2. The Bank Fraud Act provides that all of the enforcement powers that the Federal Reserve has against domestic financial institutions and their institution-affiliated parties, such as the authority to initiate cease and desist, civil money penalty assessment and removal and prohibition actions, are applicable to foreign financial institutions and their branches and agencies doing business in the United States and their institution-affiliated parties.

3. The Bank Fraud Act provides for criminal penalties against anyone who corruptly obstructs or attempts to obstruct the examination of a financial institution by the financial institution's supervisory agency.

4. The power to suspend and remove an institution-affiliated party who has been indicted (section 8(g) of the Federal Deposit Insurance Act (the ''FDI Act'')) from a state member bank has been expanded so that it now covers institution-affiliated parties associated with bank holding companies, nonbank subsidiaries of bank holding companies and foreign entities subject to the Board's jurisdiction, such as Edge or agreement Act corporations, and certain branches and agencies.

   The Board's general power to suspend, remove and permanently prohibit an institution-affiliated party from a state member bank or bank holding company (section 8(e) of the FDI Act) was expanded to cover individuals associated with the foreign entities described above, provided that the activities that give rise to the bases for the suspension, removal, or permanent prohibition action took place in the United States.

5. The requirement that the Board initiate a cease and desist action against a state member bank when recurrent violations of the Bank Secrecy Act and internal control deficiencies relating to compliance with that act are uncovered (section 8(s) of the FDI Act) has been

1. To the extent possible, the description of the provisions of Title IX of FIRREA follow the sequence of the sections in Title IX. They are not being listed in any order of importance.

2. The Board is also authorized to issue regulations further defining which individuals should be considered as institution-affiliated parties due to their participation in the conduct of the affairs of an institution. Similarly, the Board can make a determination whether a person is an institution-affiliated party due to his or her participation in the conduct of the affairs of an institution on a case-by-case basis.

expanded to cover the same institutions described in item 4 above.

6. When the Board issues a cease and desist order or a Federal Reserve Bank executes a written agreement, they may not only order the institution to ‘‘cease and desist’’ from its illegal activities or unsafe or unsound practices, but they can, under the law (sections 8(b) and (c) of the FDI Act), also order the entity or individual to take ‘‘affirmative action’’ to correct the conditions resulting from its violations or practices. Under FIRREA, the term ‘‘affirmative action’’ has been clarified to include certain enumerated powers. These now include the power to order (a) restitution or reimbursement in those instances where there was unjust enrichment or a reckless disregard for the law, (b) restrictions on growth, (c) the disposal of a loan or other asset, (d) the rescission of an agreement or a contract, and (e) the employment of a qualified officer or employee at a financial institution, who may be, at the option of the Board, subject to approval by the Federal Reserve.

Under the Board’s cease and desist and temporary cease and desist powers (sections 8(b) and (c) of the FDI Act), the Board can also now issue an order (or execute a written agreement) that places ‘‘limitations on the activities or functions’’ of a financial institution or an institution-affiliated party.

7. The grounds for the issuance of a temporary order to cease and desist (section 8(c) of the FDI Act) were modified to reduce somewhat the burden on the Board. This was done by replacing the term ‘‘substantial financial loss’’ with the term ‘‘significant financial loss’’ and eliminating the modifying word ‘‘seriously’’ from the term ‘‘seriously prejudice the interests of the’’ bank’s depositors. The Board now needs to determine, among other statutory factors needed in order to initiate a temporary cease and desist action, that the institution’s or individual’s unsafe or unsound practice or law or regulation violation is likely to cause ‘‘significant financial loss’’ to the institution or ‘‘prejudice’’ the interests of the bank’s depositors.

The statutory bases for the issuance of a temporary cease and desist order were also expanded to authorize the issuance of such an order if the Board determines that a financial institution’s books and records are so incomplete that the financial condition of the institution or the purpose for a transaction cannot be determined.

8. The Bank Fraud Act authorizes the FDIC to prohibit or limit, by order or regulation, any golden parachute payment or indemnification payment made by an insured depository institution or bank holding company to any institution-affiliated party of an insured depository institution.

The term ‘‘golden parachute’’ is generally defined as any payment or any agreement to make a payment to an institution-affiliated party that is contingent on the termination of the party’s affiliation with the institution or holding company and is received on or after the date which the institution (a) is declared insolvent; (b) is notified by the appropriate federal banking agency that the institution is in a troubled condition; (c) has been assigned a CAMELS composite rating of 4 or 5; or (d) is subject to a termination of insurance proceeding by the FDIC. Several other factors are considered in determining if a payment is a ‘‘golden parachute.’’

The term ‘‘indemnification payment’’ is defined to include any payment or any agreement to make a payment by any insured depository institution or bank holding company for the benefit of any person, who is an institution-affiliated party, to pay or reimburse such person for any liability or legal expense with regard to any administrative proceeding or civil action initiated by a federal banking agency that results in the issuance of a final cease and desist, civil money penalty assessment, or removal or prohibition order.

While the Bank Fraud Act does not specifically authorize the Board to prohibit these payments, the Board refers these matters to the FDIC for action whenever the Board becomes aware of such payments by a bank holding company or a state member bank. Also, the Board may use its general cease and desist authority to prohibit such payments if they are deemed to be an unsafe or unsound practice.

9. The statutory language relating to the removal and suspension of an institution-affiliated party (old sections 8(e)(1) and (2) of the FDI-Act) were merged and simplified. Now, the statutory bases are the same whether the Board removes or suspends an individual from an institution based on conduct at his or her present employer or based on conduct at the individual’s prior place of employment. In addition, the necessity for determining that an individual’s conduct caused ‘‘substantial’’ financial loss or ‘‘seriously’’ prejudiced the bank’s depositors

has been eliminated by the deletion of the terms "substantial" and "seriously".

10. 12 U.S.C. 1818(e)(7) now has a provision that makes one banking agency's suspension, removal or prohibition order universally effective against the individual subject to the order. That is, in the event that the Board removes an individual from a state member bank, that individual cannot work for any other financial institution that is subject to the regulatory jurisdiction of the federal financial institutions supervisory agencies without prior approval of the agency that issued the order in the first place and the regulator of the new employer institution. Violations by any individual of his or her suspension, removal or prohibition order (e.g., the removed individual goes to work for another financial institution without the requisite agency approvals) are now punishable as a felony, with a potential fine of up to $1 million and a prison term of up to five years (section 8(j) of the FDI Act).

A provision of Title IX of FIRREA modified the Board's suspension, removal and prohibition powers. It contemplates the issuance of a suspension, removal or prohibition order against a "corporation, firm, or other business enterprise" in addition to the issuance of such an order against an institution-affiliated party.

11. 12 U.S.C. 1818 (i)(3) corrected the problem relating to jurisdiction for removal and prohibition actions in the event that an individual leaves a financial institution prior to the initiation of the action. With respect to all formal enforcement actions that the Board can take—including cease and desist, removal, prohibition and civil money penalty assessment—the law now provides that the resignation, termination of employment or separation caused by the closing of an institution will not affect the Board's enforcement powers over an individual, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on an individual before the end of a six-year period starting when he or she left the financial institution, regardless of whether or not such date occurs before, on or after August 9, 1989.

The Board basically retains enforcement jurisdiction over any institution-affiliated party that leaves an institution, voluntarily or involuntarily, so long as we initiate our cease and desist, removal, prohibition or civil money penalty assessment action within six years of the individual's departure from the institution.

12. 12 U.S.C. 1818 (i)(2) includes many changes to the Board's civil money penalty assessment authority. The statutory bases for the assessment of fines were expanded and the amounts of the potential penalties were increased.

Civil money penalties can be assessed for (a) any violation of law or regulation,[3] (b) any violation of a final cease and desist, temporary cease and desist, suspension, removal or prohibition order, (c) any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request, and (d) any violation of a written agreement.

The amounts of the potential fines vary. The Board can assess a fine of up to $5,000 per day for any of the violations described in the aforementioned paragraph. A fine of up to $25,000 per day can be assessed for any violation set forth above, if the violator (e.g., the financial institution or the institution-affiliated party) recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or an individual breaches his or her fiduciary duty, where such violation, practice or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss or results in pecuniary gain or other benefit for the violator. A civil money penalty of up to $1 million per day can be assessed for any violation described in the paragraph above, if the violator knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty, and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit.

The modified civil money penalty assessment provisions of Title IX of FIRREA apply with respect to conduct engaged in by any person *after* August 9, 1989. There is an exception however—the increased maximum penalties of $5,000 and $25,000 per day may apply to conduct engaged in *before* August 9, 1989, if the conduct is not already subject to a notice issued by the Board *and* the conduct occurred after the completion of the last report of examination of the institution (which examination took place before August 9, 1989).

13. Violations of the Change in Bank Control Act can now be addressed through the same

3. Note that this provision is very broad. The violation of *any* law or regulation that is applicable to a financial institution or an institution-affiliated party subject to the Board's jurisdiction can expose the institution or the individual to a potential civil money penalty.

type of civil money penalty assessment proceedings that are used for all other penalty actions. That is, the requirement that an institution or individual assessed a fine for a violation of the Change in Bank Control Act be granted a full scale trial in a U.S. District Court has been eliminated.

14. The criminal penalties for violations of the Bank Holding Company Act (the ''BHC Act'') were increased to $100,000 per day for knowingly violating the BHC Act and to $1 million per day in the event that the violations involved an intent to deceive, defraud or profit significantly.

Violations of the BHC Act, which do not rise to the level of criminal offenses, can be addressed through civil money penalty assessments of not more than $25,000 per day.[4]

15. Section 19 of the FDI Act, which prohibits an individual who has been convicted of a felony involving dishonesty or a breach of trust from working for an insured bank without the Federal Deposit Insurance Corporation's approval, was amended to increase the potential fine for a knowing violation of the section to $1 million per day or five years imprisonment. This law now provides that the criminal penalty will apply to both the individual who is employed without the appropriate approval and to the employing institution. Section 19 also applies to a convicted felon's *indirect* involvement with an insured depository institution; therefore, such individuals associated with bank holding companies or their nonbank subsidiaries need to seek FDIC approval of their employment. The Bank Fraud Act has further expanded this prohibition to exclude convicted individuals from serving as an institution-affiliated parties and from owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval.

16. The Bank Protection Act was amended by FIRREA to eliminate the requirement that financial institutions file periodic reports concerning the installation, maintenance and operation of security devices and procedures.

17. Title IX of FIRREA adds new provisions authorizing civil money fines for the submission of false or misleading Call Reports and reports required by the BHC Act and Regulation Y of the Board of Governors. In the event that a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and an institution unintentionally fails to publish any report or submits any false or misleading report or information or is minimally late with the report, it could be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or one percent of the institution's assets can be assessed for each day of the violation.

Civil money penalties for the submission of late, false or misleading reports or information to the Board relate only to conduct engaged in after the effective date of FIRREA (August 9, 1989).

18. 12 U.S.C. 1818(u) requires that the Board publish and make publicly available any final order issued with respect to any administrative enforcement proceeding initiated by the Board, as well as any modification or termination of such an order. Publication of final enforcement orders and written agreements can only be delayed if the Board makes a determination, in writing, that the publication of any final order would seriously threaten the safety or soundness of an insured depository institution. In the event that the Board can make such a determination, the publication of the final order can be delayed for a ''reasonable time''. The Bank Fraud Act requires that administrative hearings on the record, including cease and desist, civil money penalty, and suspension, removal and prohibition actions, are to be open to the public.

19. After August 9, 1989, each insured depository institution that was chartered within two years after that date, all financial institutions that have undergone a change in control within two years after that date, and all financial institutions that are not in compliance with the minimum capital adequacy guidelines or regulations of its federal regulator, and each financial institution that is in an otherwise troubled condition must provide 30-days prior written notice to its appropriate federal regulator before the institution can add an individual to its board of directors or employ a senior executive officer.[5]

4. There is an inconsistency between the Board's authority to assess fines of up to $1 million per day for violations of any law or regulation and this $25,000 limitation on the amount of fines under the BHC Act.

5. The banking agencies have issued regulations defining the terms ''troubled condition'' and ''senior executive officer'' for the purposes of this law.

The Board, and the other federal financial institutions supervisory agencies, have a 30-day period within which to review each individual's competence, experience, character and integrity; and, in the event that they are not acceptable, the Board or the other agencies, where appropriate, can issue a notice of disapproval of an individual.

20. The federal financial institutions supervisory agencies are required to hire a pool of administrative law judges and to develop uniform rules of procedures for all administrative proceedings within 24 months from August 9, 1989.

21. The correction period afforded to an insured depository institution subject to a termination of federal deposit insurance proceeding initiated by the Federal Deposit Insurance Corporation was reduced to 30 days from 120 days. The Federal Deposit Insurance Corporation is also authorized to issue a temporary suspension of deposit insurance order in the event that it determines, after consultation with the Board or the Office of the Comptroller of the Currency, where applicable, that an insured depository institution has no tangible capital under the capital adequacy guidelines or regulations of the banking agencies.

22. Title IX of FIRREA contains a "whistleblower" protection provision. Under this provision, no insured depository institution may discharge or discriminate against an employee because he or she provided information to a banking agency or to the United States Attorney General (e.g., the Department of Justice, a U.S. Attorney's Office or the Federal Bureau of Investigation) about a possible law violation by the institution or one of its officers, directors or employees. In the event that an institution does discharge or discriminate against such an employee, he or she may sue the institution in U.S. District Court, and the individual must also file a copy of his or her lawsuit with the appropriate banking agency.

23. The federal financial institutions supervisory agencies may, with the concurrence of the United States Attorney General, pay a reward for the provision of information that leads to the recovery of a civil money penalty of in excess of $50,000 (or the forfeiture of property in excess of such an amount). The reward may not exceed 25 percent of the fine or forfeiture or $100,000, whichever is less.

As described above, Title IX of FIRREA contains numerous new or enhanced enforcement powers, as well several significant new responsibilities for the Board and the financial institutions that it supervises. While all of these powers and responsibilities are important, the following enforcement action-related provisions of Title IX are highlighted:

1. All new final enforcement orders and written agreements are to be made public.

2. All new directors and senior executive officers (and all promotions to the senior executive officer level) at financial institutions that were chartered within the last two years (if the institutions are state member banks), underwent a change in control within the last two years, have inadequate capital levels, or are otherwise in a troubled condition will have to file a notice form with the Board and await a 30-day review period before they can be appointed to the board of directors or retained as a senior executive officer.

3. The enforcement powers of the Board are applicable to a broader range of individuals who are associated with the financial institutions that the Board supervises—these include shareholders, attorneys, appraisers, and accountants.

4. The Board's removal and prohibition powers have been clarified in order to enable the continuation (or initiation) of such actions against persons who have left the financial institutions where they engaged in wrongdoing or who were associated with failed state member banks or defunct bank holding companies.

5. Cease and desist orders and written agreements can contain provisions requiring the employment of qualified officers and employees, who can be subject to the prior approval of the Federal Reserve, and they can also contain provisions that place limitations on the functions and activities of an institution or an institution-affiliated party.

6. The bases for the assessment of civil money penalties has been greatly expanded to cover, *inter alia*, all violations of law and regulation.

7. The potential civil money penalty assessment against a financial institution or an institution-affiliated party has been increased substantially—up to $1 million a day under some circumstances.

2110.0.1.2 Statutory Tools Available for Formal Supervisory Action

Including changes resulting from the enactment of FIRREA and the Bank Fraud Act, the following statutory tools are available to the Board of Governors in the event formal supervisory action is warranted against a BHC or its nonbank subsidiary or certain individuals associated with either of them. The objective of formal actions is to correct practices that the regulators believe to be unlawful, or unsafe or unsound. The initial consideration and determination of whether formal action is required usually results from the inspection process.

Presented below is information on:

1. Board jurisdiction under the law;
2. Actions or practices that may trigger the statutory remedies;
3. Board staff procedures;
4. The elements of a corrective order;
5. Temporary orders;
6. Written Agreements;
7. Suspensions and removals;
8. Enforcement of orders; and
9. Civil money penalties; and
10. Termination of certain nonbank subsidiary activities or ownership.

2110.0.2 TYPES OF CORRECTIVE ACTIONS

Generally, under 12 U.S.C. 1818(b) the Board may use its cease and desist authority and other enforcement tools against (a) a bank holding company, (b) a nonbank subsidiary of a bank holding company, and (c) any institution-affiliated party, including any director, officer, employee, controlling shareholder (other than a bank holding company), agent, person who has filed or is required to file a change in control notice, consultant, joint venture partner, or other person who participates in the conduct of the affairs of a bank holding company or nonbank subsidiary, and any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice that causes or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the institution. Cease and desist action may be initiated when there is a finding that an offender is engaging, has engaged or may engage in an unsafe or unsound practice in conducting the business of the institution. An action may also be deemed necessary due to a finding that the offender is violating, has violated or may violate a law, rule or regulation, or any condition imposed in writing by the Board in connection with the granting of any application or any written agreement.

2110.0.2.1 Cease and Desist Orders

When Board staff, in conjunction with the appropriate Federal Reserve Bank, determines that a cease and desist action is necessary, the Board may issue a ‘‘notice of charges and of hearing’’ to the offending institution or person. The notice of charges will contain a statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that may include the convening of an administrative hearing (within 30–60 days) to be conducted before an Administrative Law Judge, who makes a recommended decision to the Board. At the conclusion of the hearing process and after consideration of the proceeding by the Board, the Board may issue a final cease and desist order. Institutions and individuals who are subject to cease and desist orders that were issued as a result of contested proceedings can appeal the Board’s issuance of the order to federal courts of appeal.

In order to abbreviate the period of litigation, the offending party or institution is permitted an opportunity to ‘‘consent’’ to the issuance of a cease and desist order without the need for the notice and an administrative hearing. Board staff has the option of first drafting a proposed cease and desist order and presenting the matter to the offenders for their ‘‘consent’’ prior to submission of the case to the Board. In the event the parties voluntarily agree to settle the case by the issuance of a consent cease and desist order, the terms of the settlement will be presented to the Board for its ratification and formal issuance of the order at which time the order will be final and binding. Note that BHC personnel should have legal counsel present at all discussions concerning formal corrective actions.

Once issued by the Board, a cease and desist order may require the persons or entity subject to the order to (a) cease and desist from the practices or violations or (b) take affirmative action to correct the violations or practices. Affirmative actions might include returning the holding company to its ‘‘original condition’’ prior to the practice or violation or having an individual reimburse the company for unauthorized or improper payments received or both. Affirmative actions may also include: restitution, reimbursement, indemnification, or guarantee against loss if the person or entity was unjustly enriched by the violation or practice, or the violation or practice involved a reckless disregard for the law or applicable regulations or prior order; restrictions on growth; disposition of any loan or asset; rescission of agreements or contracts; employment of qualified officers or employees; and any other action the Board determines to be appropriate.

12 U.S.C. 1818(b)(3) makes it clear that the cease and desist authority contained in section 8(b) of the Federal Deposit Insurance Act also applies to BHCs and Edge and Agreement Corporations, as well as all institution-affiliated parties associated with them.

2110.0.2.2 Temporary (Emergency) Cease and Desist Orders

In the event that a violation of law, rule or regulation, or the undertaking of an unsafe or unsound practice meets the test that it is likely to cause the insolvency of a subsidiary bank or company, cause the significant dissipation of a subsidiary bank's or BHC's assets or earnings, or weaken the condition of the subsidiary bank or company, or otherwise seriously prejudice the interests of depositors, the Board may issue a temporary (emergency) cease and desist order to effect immediate correction pursuant to 12 U.S.C. 1818(c). The Board may also issue a temporary order if the Board determines that the institution's books and records are so incomplete that the institution's financial condition or the details or purpose of any transaction cannot be determined through the normal supervisory process. The temporary order may require the same corrections as an order issued either on consent or after the full administrative process. Its advantage is that it is effective immediately upon service on the entity or individual. A hearing must be held within 30–60 days, during which time the temporary order stays in effect. Within 10 days of the service of the temporary order, the subject may appeal to a U.S. District Court for relief from the order.

2110.0.2.3 Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a formal written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 C.F.R. 265.2(f)(26)). All written agreements must be approved by the Board's Staff Director of the Division of Banking Supervision and Regulation and the General Counsel. The provisions of a written agreement may relate to any of the problems found at the institution or involving related individuals.

2110.0.2.4 Removal Authority

In addition to its cease and desist authority, the Board is also authorized by 12 U.S.C. 1818(e) to suspend and remove current or former institution-affiliated parties of bank holding companies and their nonbank subsidiaries for certain violations and activities and to prohibit permanently their future involvement with insured depository institutions, BHC's and nonbank subsidiaries. The Board is authorized to issue a written notice of its intention to remove from office or prohibit from further participation (or under certain conditions to suspend immediately), any institution-affiliated party of a BHC whenever:

1. The institution-affiliated party has directly or indirectly:
   a. Committed any violation of law, regulation, or cease and desist order, condition imposed in writing, or any written agreement; or
   b. Engaged in any unsafe or unsound practice; or
   c. Breached a fiduciary duty; *and*
2. The Board determines:
   a. That the institution has suffered or will suffer financial loss or other damage; or
   b. That interests of depositors have been or could be prejudiced by the violation or practice; or
   c. That the institution-affiliated party has received financial gain or other benefit from the violation or practice; and
3. Such violation or practice:
   a. Involves personal dishonesty; or
   b. Demonstrates a willful or continuing disregard for the safety or soundness of the institution.

In the event that an institution-affiliated party's actions warrant immediate attention, the Board is authorized to temporarily suspend the person pending the outcome of the complete administrative process. Note also that an institution-affiliated party presently associated with a BHC may be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, BHC or ''other business institution.'' ''Other business institution'' is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

12 U.S.C. 1818(g) authorizes the appropriate federal banking agency to suspend from office or prohibit from further participation any

institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under State or Federal law if the continued participation might threaten either the interests of depositors or public confidence in the bank. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the agency.

2110.0.2.5 Termination of Nonbank Activity

The Board is authorized by 12 U.S.C. 1844(e) to order a bank holding company to terminate certain activities of its nonbank subsidiary (other than a nonbank subsidiary of a bank) or to sell its shares of the nonbank subsidiary. When the Board has reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its nonbank subsidiaries constitutes a serious risk to the: (a) financial safety, (b) soundness or (c) stability of the holding company; *and* the activity, ownership or control is (a) inconsistent with sound banking principles, or (b) inconsistent with the purposes of the Bank Holding Company Act, or (c) inconsistent with the Financial Institutions Supervisory Act of 1966, the Board may order the bank holding company to terminate the activity or sell control of the nonbank subsidiary.

2110.0.2.6 Violations of Final Orders and Written Agreements

When any of the various types of formal enforcement orders discussed above has been violated, the Board may apply to a U.S. District Court for enforcement of the action, and the court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending institution or its institution-affiliated parties, as the circumstances warrant. The amount of the civil money penalty is the same as that described below in the civil money penalty section.

Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million or imprisonment for up to five years or both, as well as to a civil money penalty assessment or federal court action.

2110.0.2.7 Civil Money Penalties

The Board may assess civil money penalties against any institution or institution-affiliated party for: (a) any violation of law or regulation, (b) any violation of a final cease and desist, temporary cease and desist, suspension, removal or prohibition order, (c) any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request, and (d) any violation of a written agreement.

The Board can assess a fine of up to $5,000 per day for any of these violations. A fine of up to $25,000 per day can be assessed for any of these violations if the offender recklessly engages in an unsafe or unsound practice in conducting the affairs of the institution, or an individual breaches his or her fiduciary duty, where such violation, practice or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1 million per day can be assessed for any of these violations if the offender knowingly committed the violation, knowingly engaged in the unsafe or unsound practice, or knowingly breached his or her fiduciary duty, and, in so doing, knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit.

The Board may also assess civil money penalties for the submission of any late, false, or misleading reports required by the BHC Act and Regulation Y of the Board of Governors. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors and an institution unintentionally fails to publish any report or submits any false or misleading report or information or is minimally late with the report, it can be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. In the event that the error was not inadvertent, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or one percent of the institution's assets can be assessed for each day of the violation.

Notwithstanding the above, note that violations of the BHC Act (with the exception of late, false, or inaccurate report violations described above) may be addressed by the assessment of civil money penalties of not more than $25,000 per day.

2110.0.2.8 Publication

The Board is required to publish and make publicly available any final order issued with respect to any administrative enforcement proceeding initiated by the Board. These orders include: cease and desist, removal, prohibition, and civil money penalties. The Board is also required to publish and make publicly available any written agreement, effective November 29, 1990 or after, or other written statement that may be enforced by the Board.

2110.0.2.9 Public Hearings

All hearings on the record, including contested cease and desist, removal, and civil money penalty proceedings, are open to the public. Transcripts of all testimony and copies of all documents, which could include examination and inspection reports and supporting documents, (except those filed under seal) are made available to the public. These documents could include examiner's workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

2110.0.2.10 Subpoena Power

12 U.S.C. 1818(n), which is made applicable to BHCs by 12 U.S.C. 1818(b)(3), and 1844(f), gives the Board the authority to issue subpoenas directly or through its delegated representatives and to administer oaths or take depositions in connection with an examination or inspection. An examiner may find it necessary to apply some of these enforcement powers in order to collect certain information from unwilling sources.

2110.0.2.11 Interagency Notification

Any Federal banking regulatory agency that initiates formal enforcement action against a commercial bank must notify the other Federal financial institution regulatory agencies (including the OTS) that such action is being taken and the Board must take similar steps in connection with actions against bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties. This policy pertains to formal administrative actions taken by the Federal banking agencies pursuant to the Financial Institutions Supervisory Act of 1966, as amended and to informal corrective actions such as Memoranda of Understanding. All such notifications must be in writing and must be transmitted by or received by both the regional and head offices of the agencies.

With respect to Federal-State agency coordination, the Federal Reserve provides the appropriate State supervisory authority with notice of its intent to institute a formal corrective action against a bank holding company. Pursuant to 12 U.S.C. 1818(m), the Federal regulatory agencies are required to provide the appropriate State supervisory authority with notice of their intent to institute a formal corrective action against a State chartered bank. This requirement is made applicable to bank holding companies, their nonbank subsidiaries, and all institution-affiliated parties by 12 U.S.C. 1818(b)(3).

2120.0.1 INTRODUCTION

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern with regard to the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act.

While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office. Refer to F.R.R.S. at 3–447.1 and 4–875.

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

The Federal Election Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices. Since 1907, federal law has prohibited national banks from making contributions in connection with political elections. FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976, and it has issued regulations interpreting the statute (11 C.F.R.).

2120.0.3 BANKS AND THE FECA

National banks and other federally chartered corporations are specifically prohibited from making contributions or expenditures in connection with *any* election; other corporations, including banks and bank holding companies, may not make contributions or expenditures in connection with *federal* elections. However, corporations may establish and solicit contributions to ''separate segregated funds'' to be used for political purposes; these are discussed in greater detail below.

State member banks and bank holding companies may make contributions or expenditures that are consistent with state and local law in connection with state or local elections. Because many states have laws that prohibit or limit political contributions or expenditures by banks, familiarization with applicable state and local laws is a necessity. According to the joint policy statement of the three banking agencies, a political contribution must meet not only the requirement of legality but also the standards of safety and soundness. Thus, a contribution or expenditure, among other things, must be recorded properly on the bank's books, may not be excessive relative to the bank's size and condition, and may not involve self-dealing.

Banks may make loans to political candidates provided the loans satisfy the requirements set out below.

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

The words ''contribution'' and ''expenditure'' are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription or gift of money or anything of value which is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does *not* include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide, further, that in order for extensions of credit to a candidate, political committee or other person in connection with a federal election to be treated as a loan and not a contribution, they must be on terms substantially similar to those made to non-political debtors and be similar in risk and amount. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt which are similar to the efforts it would make with a non-political debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee who is providing a candidate or political committee with legal or accounting services which are solely for the purpose of compliance with the provisions of the FECA is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

FECA allows the establishment and administration by corporations of "separate segregated funds" to be utilized for political purposes. While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a "political committee," as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of $200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary; (2) the employee must be informed of the political purposes of the fund at the time of the solicitation; and (3) the employee must be informed of his right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between "executive and administrative" personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation, or a corporation and its subsidiaries, may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount which all political committees of a corporation and its subsidiaries may make to a single candidate is $5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

2120.0.6 INSPECTION OBJECTIVES

1. To determine if the company has made improper or illegal payments in violation of either of these statutes, and regardless of legality, and whether they constitute an unsafe and unsound banking practice.

2. To determine if controls have been established to prevent unproper payments in violation of these statutes.

2120.0.7 INSPECTION PROCEDURES

1. Determine whether the company and its nonbank subsidiaries have a policy prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by either the Foreign Corrupt Practices Act or the Federal Election Campaign Act.

2. Determine how the policy, if any, has been communicated to officers, employees, or agents of the organization.

3. Review any investigation or study performed by, or on behalf of, the board of directors that evaluates policy or operations associated with the advancement of funds in possible violation of the statutes mentioned above. In addition, ascertain whether the organization has been investigated by any other government agency in connection with possible violations of the statutes and, if this is the case, review available materials associated with the investigation.

4. Review and analyze any internal or external audit program employed by the organization to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:

a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Campaign Act and whether audit programs are in place which check for compliance with these laws;

b. Review such programs and the results of any audits; and

c. Determine whether the program directs the auditor to be alert to unusual entries or charges which might indicate that improper or illegal payments have been made to persons or organizations covered by the statutes.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.

6. Both the examiner and assistants should be alert in the course of their usual inspection procedures for any transactions, or the use of organization services or equipment, which might indicate a violation of the statutes. Examination personnel should pay particular attention to:

a. Commercial and other loans (including participations), which may have been made in connection with a political campaign, to assure that any such loans were made in the ordinary course of business in accordance with applicable laws.

b. Income and expense ledger accounts for unusual entries including unusual debit entries (reductions) in income accounts or unusual credit entries (reductions) in expense accounts, significant deviations from the normal amount of recurring entries, and significant entries from an unusual source, such as a journal entry.

Procedure 7, following here, should only be undertaken in cases in which the examiner believes that there is some sufficient evidence indicating that improper or illegal payments have occurred. Such evidence would justify the implementation of these additional procedures.

7. Verification of audit programs and internal controls.

a. Randomly select charged-off loan files and determine whether any charged-off loans were made to (i) foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act, or (ii) persons or organizations covered under the Federal Election Campaign Act.

b. For those significant income and expense accounts on which verification procedures have not been performed: (i) prepare an analysis of the account for the period since the last examination, preferably by month, and note any unusual fluctuations for which explanations should be obtained, and (ii) obtain an explanation for significant fluctuations or any unusual items through discussions with organization personnel and review of supporting documents.

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

Where violations of law or unsafe and unsound banking practices result from improper payments, the Federal Reserve System should exercise its full legal authority, including cease-and-desist proceedings and referral to the appropriate law enforcement agency for further action, to ensure that such practices are terminated. In appropriate circumstances, the fact that such payments have been made may reflect so adversely on an organization's management as to be a relevant factor in connection with the consideration of applications submitted by the organization.

In addition, the Reserve Bank should forward any information on apparent violations of the Federal Election Campaign Act to the Federal

Election Commission. The Federal Election Commission is authorized to enforce FECA. The Commission may be prompted to investigate possible illegal payments by either a sworn statement submitted by an individual alleging a violation of the law, or on its own initiative based on information it has obtained in the course of carrying out its supervisory responsibilities. When the Commission determines that there is probable cause to believe a violation has occurred or is about to occur, it endeavors to enter into a conciliation agreement with the violator. If, however, it finds probable cause to believe that a willful violation has occurred or is about to occur, it may refer the matter directly to the Department of Justice for possible criminal prosecution, without having first attempted conciliation.

If informal means of conciliation fail, the Commission may begin civil proceedings to obtain relief. Should the Commission prevail, a maximum penalty of a fine equal to the greater of $10,000 or 200 percent of the amount of the illegal payment may be imposed. Knowing and willful violations involving over $1,000 may subject the violator to a fine, up to the greater of $25,000 or 300 percent of the illegal payment, and imprisonment for up to one year.

2120.0.9 ADVISORY OPINIONS

Any person, including a bank or a corporation, may request an advisory opinion concerning the application of FECA or of the Commission's regulations to a specific transaction or activity in which that person wishes to engage. The Commission must render such advisory opinion within 60 days from receipt of a complete request. Banks or bank employees wishing to engage in activity which may be regulated by FECA are encouraged to request advisory opinions from the Commission.

Techniques, practices, and tools for credit-risk management are evolving rapidly, as are the challenges that banking organizations face in their business-lending activities. For larger institutions, the number and geographic dispersion of their borrowers make it increasingly difficult for such institutions to manage their loan portfolios simply by remaining closely attuned to the performance of each borrower. As a result, one increasingly important component of the systems for controlling credit risk at larger institutions is the identification of gradations in credit risk among their business loans, and the assignment of internal credit-risk ratings to loans that correspond to these gradations.[1] The use of such an internal rating process is appropriate and necessary for sound risk management at large institutions. See SR-98-25.

Certain elements of internal rating systems are necessary to support sophisticated credit-risk management. Supervisors and examiners, both in their on-site inspections and other contacts with banking organizations, need to emphasize the importance of development and implementation of effective internal credit-rating systems and the critical role such systems should play in the credit-risk-management process at sound large institutions. See SR-98-18 with regard to lending standards for commercial loans.

Internal rating systems are currently being used at large institutions for a range of purposes. At one end of this range, they are primarily used to determine approval requirements and identify problem loans. At the other end, they are an integral element of credit-portfolio monitoring and management, capital allocation, the pricing of credit, profitability analysis, and the detailed analysis to support loan-loss reserving. Internal rating systems being used for these latter purposes should be significantly richer and more robust than systems used for the purposes such as approval requirements and identifying problem loans.

As with all material financial institutional activities, a sound risk-management process should adequately illuminate the risks being taken. It should also cause management to initiate and apply appropriate controls that will allow the institution to balance risks against returns. Furthermore, the process should provide information as to the institution's overall appetite for risk, giving due consideration to the uncertainties faced by lenders and the long-term viability of the institution. Accordingly, large banking organizations should have strong risk-rating systems which should take proper account of gradations in risk. They should also consider (1) the overall composition of portfolios in originating new loans, (2) assessing overall portfolio risks and concentrations, and (3) reporting on risk profiles to directors and management. Moreover, such rating systems should also play an important role in (1) establishing an appropriate level for the allowance for loan and lease losses, (2) conducting internal analyses of loan and relationship profitability, (3) assessing capital adequacy, and possibly (4) administering performance-based compensation.

Examiners should evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of risk management at large institutions. Recognizing that a strong risk-rating system is an important element of sound credit-risk management for such institutions, examiners should specifically evaluate the adequacy of internal risk-rating systems at large institutions as one factor in determining the strength of credit-risk management. In doing so, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the banking organization's activities.

2122.0.1 APPLICATION TO LARGE BANK HOLDING COMPANIES

The guidance provided in this section should be applied to all "large" bank holding companies. For this purpose, examiners should treat an institution as being "large" if its lending activities are sufficient in scope and diversity such that informal processes that rely on keeping track of the condition of individual borrowers are inadequate to manage its loan portfolio. In this context, those institutions with significant involvement in relevant secondary-market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing

1. For information on current practices in risk rating among large banking organizations, see "Credit Risk Rating at Large U.S. Banks," *Federal Reserve Bulletin,* November 1998, pp. 897–921.

the risks associated with these activities.[2] Whether or not they are active in such secondary-market credit activities, however, larger and complex institutions typically would require a more structured and sophisticated set of arrangements for managing credit risk than smaller regional or community institutions. In performing their evaluation, examiners should also consider whether other elements of the risk-management process might compensate for any specific weaknesses attributable to an inadequate rating system.

In addition, examiners should review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution. Examiners should also consider whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve. To some extent, such reviews are already an informal part of the current inspection process. Examiners should also continue the long-standing practice of evaluating trends in categories associated with problem assets.

Examiners should discuss these issues, including plans to enhance existing credit-rating systems, with bank management and directors. Inspection comments on the adequacy of risk-rating systems and the credit quality of the pass portfolio should be incorporated within the inspection report, noting deficiencies where appropriate.

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

A consistent and meaningful internal risk-rating system is a useful means of differentiating the degree of credit risk in loans and other sources of credit exposure. This consistency and meaning is rooted in the design of the risk-grading system itself. Although assigning such risk ratings—as with ratings issued by public rating agencies—necessarily involves subjective judgment and experience, a properly designed rating system will allow this judgment to be applied in a structured, more or less formal manner.

Credit-risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus, explicitly or implicitly, the loss characteristics of that loan or exposure. Increasingly, large institutions link definitions to one or more measurable outcomes such as the probability of a borrower's default or expected loss (which couples the probability of default with some estimate of the amount of loss to be incurred in the event a default occurs). In addition, credit-risk ratings may reflect not only the likelihood or severity of loss but also the variability of loss over time, particularly as this relates to the effect of the business cycle. Linkage to these measurable outcomes gives greater clarity to risk-rating analysis and allows for more consistent evaluation of performance against relevant benchmarks. The degree of linkage varies among institutions, however.

Although the degree of formality may vary, most institutions distinguish the risks associated with the borrowing entity (essentially default risk) from the risks stemming from a particular transaction or structure (more oriented to loss in event of default). In documenting their credit-administration procedures, institutions should clearly identify whether risk ratings reflect the risk of the borrower or the risk of the specific transaction. In this regard, many large institutions currently assign both a borrower and facility rating, requiring explicit analysis of both the loan's obligor and how the structure and terms of the particular loan being evaluated (that is, collateral or guarantees) might strengthen or weaken the quality of the loan.

The rating scale chosen should meaningfully distinguish gradations of risk within the institution's portfolio so that there is clear linkage to loan quality (and/or loss characteristics), rather than just to levels of administrative attention.[3]

2. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in section 2129.05 and in SR-97-21.

3. See the December 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses in section 2010.7. The policy does not apply to bank holding companies directly. As they supervise their respective FDIC-insured financial institution subsidiaries, bank holding companies are advised to apply this supervisory guidance. Internal risk-rating systems and/or supporting documentation should be sufficient to enable examiners to reconcile the totals for the various internal risk ratings under the institution's system to the federal banking agencies' categories for those loans graded below "pass" (that is, loans classified as special mention, substandard, doubtful, or loss).

To do so, the rating system should be designed to address the range of risks typically encountered in the underlying businesses involving the institution's loan portfolio. One reflection of this degree of meaning is that there should be a fairly wide distribution of portfolio outstandings or exposure across grades, unless the portfolio is genuinely homogeneous. Many current rating systems include grades intended solely to capture credits needing heightened administrative attention, such as so-called ''watch'' grades. Prompt and systematic tracking of credits in need of such attention is an essential element of managing credit risk. However, to the extent that loans in need of attention vary in the risk they pose, isolating them in a single grade may detract from that system's ability to indicate risk. One alternative is the use of separate or auxiliary indicators for those loans needing such administrative attention.

Institutions whose risk-rating systems are least effective in distinguishing risk use them primarily to identify loans that are classified for supervisory purposes or that bank management otherwise believes should be given increased attention (that is, ''watch'' loans). Such systems contribute little or nothing to evaluating the bulk of loans in the portfolio—that is, loans for which no specific difficulties are present or foreseen. In some cases these institutions might also establish one or two risk grades for loans having very little perceived risk, such as those collateralized by cash or liquid securities or those to ''blue-chip'' private firms. Although the foregoing gradations are well-defined in terms of the relative credit risk they represent, the consequence for these least effective systems is that the bulk of the loan portfolio falls into one or two remaining broad risk grades—representing ''pass'' loans that are neither extremely low risk nor current or emerging problem credits—even though such grades may encompass many different levels of underlying credit risk.

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

Experience and judgment, as well as more objective elements, are critical both in making the credit decision and in assigning internal risk grades. Institutions should provide clear and explicit criteria for each risk grade in their credit policies, as well as other guidance to promote consistency in assigning and reviewing grades. Criteria should be specified, even when addressing subjective or qualitative considerations, that allow for consistent assignment of risk grades to similarly risky transactions. Such criteria should include guidance both on the factors that should be considered in assigning a grade and how these factors should be weighed in arriving at a final grade.

Such criteria can promote consistency in assessing the financial condition of the borrower and other objective indicators of the risk of the transaction. One vehicle for enhancing the degree of consistency and accuracy is the use of ''guidance'' or ''target'' financial ratios or other objective indicators of the borrower's financial performance as a point of comparison when assigning grades. Banking organizations may also provide explicit linkages between internal grades and credit ratings issued by external parties as a reference point, for example, senior public debt ratings issued by one or more major ratings agencies. The use of default probability models, bankruptcy scoring, or other analytical tools can also be useful as supporting analysis. However, the use of such techniques requires institutions to identify the probability of default that is ''typical'' of each grade. The borrower's primary industry may also be considered, both in terms of establishing the broad characteristics of borrowers in an industry (for example, degree of vulnerability to economic cycles or long-term favorable or unfavorable trends in the industry) and of a borrower's position within the industry.

In addition to quantitative indications and tools, credit policies and ratings definitions should also cite qualitative considerations that should affect ratings. These might include factors such as (1) the strength and experience of the borrower's management, (2) the quality of financial information provided, and (3) the access of the borrower to alternative sources of funding. Addressing qualitative considerations in a structured and consistent manner when assigning a risk rating can be difficult. It requires experience and business judgment. Nonetheless, adequate consideration of these factors is important to assessing the risk of a transaction appropriately. In this regard, institutions may choose to cite significant and specific points of comparison for qualitative factors in describing how such considerations can affect the rating (for example, whether a borrower's financial statements have been audited or merely compiled by its accountants, or whether collateral has been independently valued).

Although the rating process requires the exercise of good business judgment and does not lend itself to formulaic solutions, some formalization of the process can be helpful in promoting accuracy and consistency. For example, the use of a ‘‘risk-ratings analysis form’’ can be important (1) in providing a clear *structure* for identifying and addressing the relevant qualitative and quantitative elements to be considered in determining internal risk grades, and (2) for *documenting* how those grades were set by requiring analysis or discussion of key quantitative and qualitative elements of a transaction.

Risk ratings should be reviewed, if not assigned, by independent credit-risk management or loan-review personnel both at the inception of a transaction and periodically over the life of the loan.[4] Such independent reviewers should reflect a level of experience and business judgment that is comparable to that of the line staff responsible for assigning and reviewing initial risk grades. Among the elements of such independent review should be whether risk-rating changes (and particularly downgrades) have been timely and appropriate. Such independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. If an institution relies on outside consultants, auditors, or other third parties to perform all or part of this review role, such individuals should have a clear understanding of the institution’s ‘‘credit culture’’ and its risk-rating process, in addition to commensurate experience and competence in making credit judgments.

Finally, institutions should track performance of grades over time to gauge migration, consistency, and default/loss characteristics to allow for evaluation of how well risk grades are being assigned. Such tracking also allows for *ex post* analysis of the loss characteristics of loans in each risk grade.

Because ratings are typically applied to different types of loans—for example, to both commercial real estate and commercial loans—it is important that each grade retains the same meaning to the institution (in terms of overall risk) across the exposure types. Such comparability allows management to treat loans in high-risk grades as a potential concentration of credit risk and to manage them accordingly. It also allows management and supervisors to monitor the overall degree of risk, and changes in the risk makeup, of the portfolio. Such consistency further permits risk grades to become a reliable input into portfolio credit-risk models.[5]

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

As noted earlier, robust internal credit-rating systems are an important element in several key areas of the risk-management process. Although nearly all large institutions currently use risk ratings, many of the institutions need to further develop these systems so that they provide accurate and consistent indications of risk and sufficient granularity—finer distinctions among risks, especially for riskier assets. Described below are approaches to risk management and analysis that are based on robust internal risk-rating systems and that are currently being used at some banking organizations. These techniques appear to be emerging as sound practices in the use of risk ratings.

2122.0.4.1 Limits and Approval Requirements

Many large institutions have different approval requirements and thresholds for different internal grades, allowing less scrutiny and greater latitude in decision making for loans with lesser risk.[6] While this appears reasonable, institutions should also consider whether the degree of eased approval requirements (or the degree to which limits are higher) is supported by the degree of reduced risk and uncertainty associated with these lower-risk loans. If not, lesser requirements may provide incentives to rate loans too favorably, particularly in the current benign economic environment, with resulting underassessment of transaction risks.

2122.0.4.2 Reporting to Management on Credit-Risk Profile of the Portfolio

As part of reports that analyze the overall credit risk in the institution’s portfolio, management

4. See section 2010.10 regarding internal loan review.

5. For a discussion of these models and the role played by internal credit-risk ratings, see the May 1998 Federal Reserve System report, ‘‘Credit Risk Models at Major U.S. Banking Institutions: Current State of the Art and Implications for Assessments of Capital Adequacy,’’ prepared by the Federal Reserve System Task Force on Internal Credit-Risk Models.

6. See section 2160.0 for more general guidance involving risk evaluation and control.

and directors should receive information on the profile of actual outstanding balances, exposures, or both by internal risk grade.[7] Such information can thus be one consideration among others, such as concentrations in particular industries or borrower types, in evaluating an institution's appetite for originating various types of new loans. Portfolio analysis may range from simple tallies of aggregates by risk grade to a formal model of portfolio behavior that incorporates diversification and other elements of the interaction among individual loan types. In this more complex analysis, gradations of risk reflect only one among many dimensions of portfolio risk, along with potential industry concentrations, exposure to an unfavorable turn in the business cycle, geographical concentrations, and other factors.

2122.0.4.3 Allowance for Loan and Lease Losses

The makeup of the loan portfolio and the loss characteristics of each grade—including individual pass grades—should be considered, along with other factors, in determining the adequacy of an institution's allowance for loan and lease losses.[8]

2122.0.4.4 Pricing and Profitability

In competitive marketplaces, it is properly the role of bankers rather than supervisors to judge the appropriateness of pricing, particularly with regard to any single transaction or group of transactions. One way that some institutions choose to discipline their overall pricing practices across their portfolio is by incorporating risk-rating-specific loss factors in the determination of the minimum profitability requirements (that is, ''hurdle rates''). Following this practice may render such institutions less likely to price loans well below the level indicated by the long-term risk of the transaction. Given that bank lending, particularly pricing, can be highly competitive, the application of appropriate disciplines to pricing, in conjunction with a clear and meaningful assessment of the risks inherent in each transaction and in the portfolio as a whole, can be important tools in avoiding competitive future excessive practices.

2122.0.4.5 Internal Allocation of Capital

Those institutions that choose to allocate capital may use their internal risk grades as important inputs in identifying appropriate internal capital allocations. Use of appropriately allocated capital in evaluating profitability offers many advantages, including the incentive to consider both risk and return in making lending decisions rather than merely rewarding loan volume and short-term fee revenue. Under appropriate circumstances—that is, where internal capital allocations are sufficiently consistent, rigorous, and well-documented—such allocations may also be considered as a source of input for supervisory evaluations of capital adequacy.[9]

2122.0.5 INSPECTION OBJECTIVES

1. To evaluate whether the internal risk-identification and -monitoring systems are consistent with—
   a. sound practices in the function and design of internal rating systems;
   b. sound practices in assigning and reviewing internal risk ratings; and
   c. the nature, size, and complexity of activities within the banking organization.
2. To determine whether the level and volume of lower-quality pass grades of loans have grown significantly over time and whether any such trends should—
   a. have adverse implications for determining the adequacy of risk management and capital, and
   b. materially alter the institution's asset-quality ratings and valuations, and the examiner's evaluation of the adequacy of the allowance for loan and lease losses.
3. To determine whether improvements are needed in the credit-risk-management process and to discuss them with the board of directors and senior management.
4. To document the extent to which the institution has adopted current and emerging sound

7. See section 2010.2 regarding a bank holding company's supervision of its subsidiaries and loan administration. See also the more general financial analysis sections 4020.2 and 4060.1 with regard to evaluating the asset quality of subsidiary financial institutions and evaluating the asset quality of the holding company on a consolidated basis.

8. See footnote 3. Section 2010.7 emphasizes the bank holding company's responsibility as it supervises its subsidiaries with respect to each entity maintaining an adequate allowance for loan and lease losses.

9. See sections 4060.3 and 4060.4 regarding the evaluation of capital adequacy of bank holding companies.

practices in the use of internal ratings information in internal risk management and analysis.

5. To incorporate the examiner's evaluation of sound credit-risk-rating practices into the assessment of management and capital adequacy.

2122.0.6 INSPECTION PROCEDURES

1. Determine whether the institution is considered ''large'' for purposes of applying this section's guidance and procedures.
2. Evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing the quality and overall strength of risk management. Give particular attention to the following practices:
   a. *Function and design of internal rating systems.*
      - Ascertain whether the rating scale meaningfully distinguishes gradations of risk within the institution's portfolio evidencing clear linkage to loan quality and/or loss characteristics.
        — Determine if the design of the rating system has an adequate number of internal ratings to distinguish among levels of risks in its portfolio, and whether the grades used address the range of risks typically encountered in the underlying businesses of the institution.
        — Determine whether loans or exposures are broadly distributed across the internal grades.
        — Establish if there are ''watch grades'' that are intended to capture loans needing heightened administrative attention, or whether separate or auxiliary indicators are used for such loans.
      - Determine whether credit-risk-rating definitions are linked to one or more measurable outcomes (for example, the probability of a borrower's default or expected loss).
   b. *Sound practices in assigning internal risk ratings.*
      - Determine whether loan policies provide clear and explicit criteria for each risk grade as to the risk factors that are to be considered in assigning a grade with respect to—
        — financial analysis, including whether reference financial ratios or other objective indicators are used to indicate the borrower's financial performance;
        — explicit linkages between the internal grades assigned and credit ratings issued by external parties (for example, senior public debt ratings by major rating agencies);
        — default probability models, bankruptcy scoring, or other analytical tools used;
        — analysis of a borrower's primary industry, considering both the broad characteristics of borrowers within that industry and the borrower's position within that industry; and
        — qualitative factors (for example, the quality of the financial information that is provided, the borrower's access to alternative sources of funding, whether the financial statements were audited or merely compiled, or whether collateral was independently valued).
      - Determine whether loan policies provide clear and explicit guidance as to how these risk factors should be weighed in arriving at a final grade.
      - Determine whether the ratings assignment is well documented, possibly including the use of a risk-rating form to provide formalization and standardization of the quantitative and qualitative criteria elements used in rating borrowers and/or transactions.
      - Establish whether risk ratings are independently reviewed at the inception of a loan and periodically over the life of a loan, and whether risk-rating changes have been timely and appropriate (particularly downgrades).
      - Ascertain whether the performance of rating grades is tracked over time to evaluate migration, consistency, and default/loss characteristics and trends.
   c. *Application of internal risk ratings to internal management and analysis.*
      - Determine whether loan-approval requirements for each grade appear to be supported by the degree of risk and uncertainty associated with the respective loans.
      - Review internal management information system reports and determine

whether such reporting is adequate for the institution.

- Ascertain if the risk-rating-specific loss factors are used to determine risk pricing, minimum profitability requirements, and capital adequacy needs, and document the institution's progress in this regard.

3. Determine whether other risk elements may compensate for any specific weaknesses attributable to an inadequate rating system.
4. Review internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of risk management or capital at the institution.
5. Determine whether a significant shift toward higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, should have negative implications for the institution's asset-quality rating, including the adequacy of the loan-loss reserve.
6. Evaluate trends in risk-rating categories associated with problem assets.
7. Discuss the results of the evaluations with management, including whether there are any plans to enhance existing credit-rating systems.
8. Prepare written comments for the inspection report on the adequacy of risk-rating systems and the credit quality of the pass portfolio, noting any deficiencies.