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Attachment A.1 – Guidance for the Consolidated Supervision of Domestic Bank Holding Companies that are Large Complex Banking Organizations

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Guidance for the Consolidated Supervision of Domestic Bank Holding Companies that are Large Complex Banking Organizations

I. Introduction

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

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

A. Federal Reserve Activities and Those of Other Supervisors and Regulators

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

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

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[1] See SR letter 99-15, "Risk-Focused Supervision of Large Complex Banking Organizations."

[2] See Attachment C for definitions of terms commonly used in this document.

[3] The term "domestic BHC" refers to a BHC incorporated in the United States that is not controlled by a foreign banking organization (FBO). Attachment B.1 addresses – in the context of supervising the combined U.S. operations of FBOs – how the Federal Reserve will develop and maintain an understanding and assessment of a BHC that is, or is controlled by, an FBO that is itself an LCBO.

activities described throughout this document, the Federal Reserve will, to the fullest extent possible:

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

B. Functionally Regulated Subsidiaries

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

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

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

II. Understanding the Organization

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

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

- Corporate strategy. Primary business strategies; institutional risk tolerance; key changes in strategic direction or risk profile; significant new business activities, areas of growth and emerging areas with potential to become primary drivers of risk or revenue; and plans for expansion through mergers or acquisitions.
- Significant activities. Key revenue and risk drivers; primary business lines; product mix; budget and internal capital allocations; market share for revenue and customers served; key external trends, including competitive pressures; and areas that are vulnerable to volatility in revenue, earnings, capital, or liquidity.
- Structure. Business line and legal entity structure; domestic and foreign regulatory responsibilities for legal entities and business lines; key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates; material business lines operated across multiple legal entities for accounting or risk management purposes; and the activities and risk profiles of Edge and agreement corporation subsidiaries.
- Corporate governance, risk management, and internal controls for primary risks. Board of directors (board) and executive-level committees; senior management and management committees; key risk management and internal control functions, and associated management information systems (MIS), relied upon by the board, senior management, and senior risk managers and committees; and consistency of public disclosures with how the board and senior management assess and manage risks.
- Presence in critical or key financial markets.[6] Core clearing and settlement activities; business lines with a significant presence in critical or key national

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

[6] See sections III.A.6 and III.A.7 for definitions of "key financial markets" and "critical financial markets."

or global financial markets; and related risk management and disclosure practices.

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

III. Assessing the Large Complex BHC on a Consolidated Basis

The Federal Reserve uses a systematic approach to develop an assessment of a BHC on a consolidated basis. This assessment is reflected in the RFI (Risk Management, Financial Condition, and Impact) rating assigned to a BHC.[7]

A. Risk Management

1. Key Corporate Governance Functions

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

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

a) Selecting competent senior managers, ensuring that they have the proper incentives to operate the organization in a safe and sound manner, and regularly evaluating senior managers' performance;

b) Establishing, communicating, and monitoring (for example, by reviewing comprehensive MIS reports produced by senior management) institutional risk tolerances and a corporate culture that emphasizes the importance of compliance with the law and ethical business practices;

c) Approving significant strategies and policies;

d) Demonstrating leadership, expertise, and effectiveness;

e) Ensuring the organization has an effective and independent internal audit function;

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

f) Ensuring the organization has appropriate policies governing the segregation of duties and avoiding conflicts of interest; and

g) Ensuring that public disclosures (i) are consistent with how the board and senior management assess and manage the risks of the organization, (ii) balance quantitative and qualitative information with clear discussions about risk management processes, and (iii) reflect evolving disclosure practices for peer organizations.

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

a) Establishing effective oversight and an appropriate risk culture;

b) Appropriately delegating authority and overseeing the establishment and implementation of effective policies for the proper segregation of duties and for the avoidance or management of conflicts of interest;

c) Establishing and implementing an effective risk management framework capable of identifying and controlling both current and emerging risks, and effective independent control functions that ensure risk-taking is consistent with the organization's established risk appetite;

d) Establishing and implementing incentives for personnel that are consistent with institutional risk tolerances, compliance with the law, and ethical business practices;

e) Promoting a continuous dialogue between and across business areas and risk management functions to help align the organization's established risk appetite and risk controls;

f) Ensuring that the board and its committees are provided with timely, accurate, and comprehensive MIS reports that are adaptive to changing circumstances regarding risks and controls; and

g) Ensuring timely resolution of audit, compliance, and regulatory issues.

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

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

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

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

  The results of continuous monitoring activities, as documented in the institutional overview, risk assessment, and other supervisory products, may identify certain corporate governance functions that will require more intensive supervisory focus due to (i) significant changes in corporate strategy, activities, organizational structure, oversight mechanisms, or key personnel; (ii) potential concerns regarding the adequacy of a specific governance function; or (iii) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another primary supervisor or functional regulator.

- Internal audit. Continuous monitoring and examination activities will be used to understand and assess key elements of internal audit governance for the organization on a consolidated basis, including: the adequacy and independence of the audit committee; the independence, professional competence, and quality of the internal audit function; the quality and scope of the audit methodology, audit plan, and risk assessment process; and the adequacy of audit programs and workpaper standards. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there have been significant changes in the internal audit infrastructure, or whether there are potential concerns regarding the adequacy of key elements of internal audit. In addition to this periodic audit infrastructure review, testing activities for specific control functions or business lines should include an assessment of internal audit's recent work in these areas to the extent possible as a means of validating internal audit's findings.

- Additional supervisory activities. If continuous monitoring activities identify a key corporate governance function or element of internal audit requiring more intensive supervisory focus due to significant changes, potential concerns, or the absence of sufficiently recent examination activities, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) in developing discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve will participate as actively as appropriate in those activities.[8]

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

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

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

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

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

The Federal Reserve will understand and assess risk management and control functions for primary risks to the consolidated organization (primary firmwide risk management and control functions), and associated MIS, for each large complex BHC. This will include risk management and control functions for primary credit, legal and compliance,[9] liquidity, market, operational, and reputational risks for the consolidated organization. The Federal Reserve also will understand and assess other risk management and control functions that, based on the specific characteristics and activities of the individual BHC, relate to primary risks to the organization as a whole.

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

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

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

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

a) Control infrastructure and governance, including degree of oversight by the board and senior management;

b) Development, maintenance, and communication of appropriate policies, procedures, and internal controls;

c) Risk identification and measurement systems and processes, and associated MIS, that are adaptive to changing circumstances and capable of providing timely, accurate, and comprehensive information to senior management and the board;

d) Monitoring and testing the effectiveness of controls;

e) Processes for identifying, reporting, and escalating issues and emerging risks;

f) Ability to implement corrective actions in a timely manner;

g) Appropriate authority and independence of staff to carry out responsibilities; and

h) Integration of risk management and control objectives within management goals and the organization's compensation structure.

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

In all instances, the Federal Reserve will focus on individual control structures in place for primary business lines or legal entities as needed to reach an understanding and assessment of the consolidated organization. When applicable, the Federal Reserve also will assess whether a decentralized approach to a key control function is sufficient by evaluating the effectiveness of such an approach in controlling primary risks to the consolidated organization.[10]

[10] As outlined in SR letter 08-8/CA letter 08-11, "Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles," while the Federal Reserve does not

Supervisory activities: The Federal Reserve will use continuous monitoring activities to understand and assess each primary firmwide risk management or control function. This process begins with the overarching design and architecture of each primary firmwide risk management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in section III.A.3 below). Activities will verify the sufficiency of fundamental aspects of internal controls in relation to the holding company's current risk profile and in comparison with supervisory expectations and evolving sound practices, and assess the capability of these primary functions (whether centralized or decentralized) to remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

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

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

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

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prescribe a particular organizational structure for primary firmwide risk management and control functions, establishment of a firmwide function that is dedicated to managing and overseeing compliance risk, and that promotes a strong compliance culture, is particularly important for large banking organizations with complex compliance profiles, due to the unique challenges associated with compliance risk management for these organizations. In addition to the oversight provided by the board and various executive and management committees, a key component of firmwide compliance oversight for these organizations is a corporate compliance function that has day-to-day responsibility for overseeing and supporting the implementation of the organization's firmwide compliance risk management program, and that plays a key role in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation.

3. Risk Management of Material Portfolios and Business Lines

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

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

Supervisory activities: Because an understanding of material risks and activities is needed to assess the primary firmwide risk management and control functions (as discussed in preceding section III.A.2), the Federal Reserve will maintain an understanding of inherent risk and assess the adequacy of risk management and internal controls for material portfolios and business lines. To form this understanding and assessment, the Federal Reserve will rely primarily on continuous monitoring activities, supplemented as appropriate by examination activities.

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

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

4. Risk Management of Nonmaterial Business Lines

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

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

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

5. Core Clearing and Settlement Activities *(Where Applicable)*

Objectives: The Federal Reserve will understand and assess the adequacy of risk management and internal controls – including credit risk management practices – related to core clearing and settlement organizations.[11] In light of the potential for problems in these areas to transmit an adverse impact across the banking and financial system, and given the Federal Reserve's unique expertise and perspective with respect to these activities, the Federal Reserve focuses special supervisory attention on the risk management and internal control practices and the public disclosures made by an organization with respect to these activities.

Supervisory activities: Continuous monitoring and examination activities will be used to maintain an understanding of inherent risk and assess risk management and internal controls, including related credit risk management practices. On at least an annual basis,

[11] Core clearing and settlement organizations, as defined in the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* (interagency sound practices paper, see SR letter 03-9), consist of two groups of organizations that provide clearing and settlement services for critical financial markets or act as large-value payment system operators, and that present the potential for systemic risk should they be unable to perform. These organizations are: (1) market utilities (government-sponsored services or industry-owned organizations) whose primary purpose is to clear and settle transactions for critical markets (see section III.A.6) or transfer large-value wholesale payments, and (2) private-sector firms that provide clearing and settlement services that are integral to a critical market (i.e., their aggregate market share is significant enough to present the potential for systemic risk in the event of their sudden failure to carry out those activities because there are no viable immediate substitutes).

the results of these supervisory activities will be reviewed to determine whether there is (i) a significant change in inherent risk for core clearing and settlement activities stemming from changing strategies or activities; (ii) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk management or internal controls; or (iii) any potential concern regarding the adequacy of related risk management or internal controls.

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

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

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

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

6. Significant Presence in Critical Financial Markets *(Where Applicable)*

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

"Critical financial markets" are defined in the interagency sound practices paper as the markets for federal funds, foreign exchange, and commercial paper; U.S. Government and agency securities; and corporate debt and equity securities. A business line may have a significant presence in a critical financial market even though the business line accounts for a relatively small portion of the organization's total consolidated assets or revenues.

These business lines are subject to special supervisory focus by the Federal Reserve in light of their potential to transmit a collective adverse impact across multiple firms and financial markets and the resulting significant reputational and other risks they pose to the organization.

Supervisory activities: Continuous monitoring and examination activities will be used to understand inherent risk and assess risk management and internal controls for business lines with a significant presence in a critical financial market. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (i) a significant change in inherent risk stemming from changing strategies or activities; (ii) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk management or internal controls; or (iii) any potential concern regarding the adequacy of related risk management or internal controls.

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

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

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

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

7. <u>Risk Management of Activities in Key Financial Markets</u>

Objectives: To be designated as an LCBO by the Federal Reserve, a banking organization must meet specified criteria as a significant participant in at least one key financial market.[12] For each key financial market activity where the large complex BHC

[12] "Key financial markets" include the critical financial markets defined in section III.A.6 above, as well as (i) broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading;

is a significant participant, the Federal Reserve will maintain an understanding of inherent risk, assess the adequacy of related risk management and internal controls (including the sufficiency of business continuity planning), and understand the organization's potential impact on the overall functioning of the market.

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

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

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

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

Objectives: The Federal Reserve will use information obtained in the course of supervising LCBOs, as well as information and analysis obtained through relationships with other domestic and foreign supervisors and regulators or other sources, to:

a) Identify potential vulnerabilities across the portfolio of LCBOs and their nonbank peers – such as the operational infrastructure that underpins the credit derivatives market – that have the potential to affect banking organizations generally, financial stability, systemic risk, or domestic or global financial markets;
b) Identify areas of supervisory focus – such as counterparty credit risk management practices – to further the Federal Reserve's understanding of markets, their linkages with banking organizations, and potential implications for financial stability;
c) Understand the activities of nonbank counterparties of LCBOs and the implications of such activities on the risks, risk management, and internal controls of banking organizations; and

(ii) retail financial services; and (iii) international financial markets. Each LCBO meets at least one of these key market thresholds.

d) Enhance the Federal Reserve's ability to act effectively during periods of financial stress by combining timely and reliable information on conditions in the banking system and capital markets that is obtained through its supervisory activities with information obtained through the Federal Reserve's monetary policy and payments activities.

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

These activities also will be used to review areas of specific supervisory interest; answer ad hoc information requests related to areas of emerging interest or concern; help in understanding the contribution of the entity to the resilience or fragility of key markets as a whole; and provide insights into interdependencies across firms, markets, and the real economy. During periods of financial stress, this information will be combined with knowledge obtained from other Federal Reserve functions, such as monetary policy and payments activities, to help mitigate the likelihood or consequences of a financial crisis and to help develop sound policy responses to market developments. Periodic examination activities also may be used to review a specific activity or risk management practice across a group of peer organizations to obtain a more complete understanding of industry practice.[13]

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

B. Financial Condition

Objectives: The Federal Reserve's evaluation of a large complex BHC's consolidated financial condition focuses on the ability of the organization's resources to support the level of risk associated with its activities. Assessments are developed for each "CAEL" subcomponent -- Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).[14]

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

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

[14] See SR letter 04-18 for more information about the CAEL subcomponents.

a) The sufficiency of the BHC's consolidated capital to support the level of risk associated with the organization's activities and provide a sufficient cushion to absorb unanticipated losses;

b) The capability of liquidity levels and funds management practices to allow reliable access to sufficient funds to meet present and future liquidity needs; and

c) Other aspects of financial strength that need to be assessed on a consolidated basis across the organization's various legal entities, or that relate to the financial soundness of the parent company and significant nonbank subsidiaries, as discussed in section III.C below.

In assessing consolidated regulatory capital, the Federal Reserve looks to ensure that the BHC demonstrates the effectiveness of its framework for complying with relevant capital adequacy guidelines and meeting supervisory expectations, and focuses on analyzing key models and processes[15] that influence this assessment. This assessment utilizes results from examinations led by the Federal Reserve or other primary supervisors or functional regulators, as well as information gained from the BHC's internal control functions and from market-based assessments.

Capital planning activities for large complex BHCs should be forward looking and provide for a sufficient range of stress scenarios commensurate with the organization's activities. Many LCBOs require more rigorous and structured internal processes for assessing capital adequacy beyond regulatory capital measures, as these measures often do not adequately capture the full spectrum of risk-taking activities for these organizations.[16] For these organizations, the Federal Reserve focuses on whether internal processes for assessing capital adequacy ensure that all risks are properly identified, reliably quantified (where possible) across the entire organization, and supported by adequate capital.

When assessing the adequacy of a BHC's liquidity levels and funds management practices, areas of focus include:[17]

a) The extent to which the treasury function is aligned with risk management processes, and whether incentives are in place for business lines to compile and provide information on expected liquidity needs and contingency funding plans so that the treasury function is able to develop a firmwide perspective and incorporate business line information into assessments of actual and contingent liquidity risk;

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

[16] See SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles."

[17] Assessing liquidity levels and funding practices for a consolidated BHC also incorporates elements presented in section III.C.2 below on "Parent company and nonbank funding and liquidity."

b) Whether funds management practices provide sufficient funding flexibility to respond to unanticipated, evolving, and potentially correlated market conditions for the organization and/or across financial markets; and

c) The sufficiency of liquidity planning tools, such as stress testing, scenario analysis, and contingency planning efforts, including (i) whether liquidity buffers – comprised of unencumbered liquid assets as well as access to stable funding sources – adequately reflect the possibility and duration of severe liquidity shocks; (ii) the reasonableness of assumptions about the stability of secured funding in circumstances in which the liquidity of markets for the underlying collateral becomes impaired; and (iii) whether these efforts adequately reflect the potential for the organization to be called on in stressed environments to provide contingent liquidity support to off-balance-sheet entities or bring additional assets on the balance sheet (even if not legally or contractually obligated to do so).

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

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

Testing and discovery activities also will be used to understand and assess the sufficiency of the BHC's consolidated capital and liquidity positions to support the level of risk associated with its activities, including (i) regulatory capital calculation methodologies[18] and internal assessments of capital adequacy, and (ii) funds management and liquidity planning tools and practices. The Federal Reserve will work with other relevant primary supervisors and functional regulators to participate as actively as appropriate in or, if necessary, to coordinate activities designed to analyze key capital and liquidity models or

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

processes of a depository institution or functionally regulated subsidiary that are of such significance that they will influence the Federal Reserve's assessment of these areas. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section I.B.

C. Impact

1. Risk Management and Financial Condition of Significant Nonbank Subsidiaries

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

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

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

a) Identify significant nonbank activities and risks – where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution subsidiary – by developing an understanding of the size and nature of primary activities and key trends, and the extent to which business lines, risks, or control functions are shared with or may impact a depository institution affiliate;

b) Evaluate the financial condition and the adequacy of risk management practices of the parent and significant nonbank subsidiaries, including the ability of nonbank subsidiaries to repay advances provided by the parent, using benchmarks and analysis appropriate for those businesses;

c) Evaluate the degree to which nonbank entity risks may present a threat to the safety and soundness of subsidiary depository institutions, including through transmission of legal, compliance, or reputational risks;

d) Identify and assess any intercompany relationships, dependencies, or exposures – or aggregate firmwide concentrations – with the potential to threaten the condition of a depository institution affiliate; and

e) Evaluate the effectiveness of the policies, procedures, and systems that the holding company and its nonbank subsidiaries use to ensure compliance with applicable laws and regulations, including consumer protection laws.[19]

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

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

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

- Understand and assess the sufficiency, reliability, and timeliness of associated MIS relied upon by the board, senior management, and senior risk managers and committees to monitor key nonbank activities and risks.

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

2. <u>Parent Company and Nonbank Funding and Liquidity</u>

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

Areas of focus will include an assessment of:

a) The ability of the parent company and nonbank subsidiaries to maintain sufficient liquidity, cash flow, and capital strength to service their debt obligations and cover fixed charges;

b) The likelihood that parent company or nonbank funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions;

c) Policies and practices that are aimed at ensuring the stability of parent company funding and liquidity, as evidenced by the utilization of long-term or permanent financing to support capital investments in subsidiaries and other long-term assets, and the degree of dependence on short-term funding mechanisms such as commercial paper;

d) The extent of "double leverage"[20] and the organization's capital management policies, including the distribution and transferability of capital across jurisdictions and legal entities;

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

e) The parent company's ability to provide financial and managerial support to its depository institution subsidiaries during periods of financial stress or adversity, including the sufficiency of related stress testing, scenario analysis, and contingency planning efforts; and

f) Intraday liquidity management policies and practices, and compliance with the "Federal Reserve Policy on Payments System Risk,"[21] including expectations for depository institutions with a self-assessed net debit cap (the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account).

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

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

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

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

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

[21] This policy statement is available on the Board's public website at: http://www.federalreserve.gov/paymentsystems/psr/default.htm.

Federal Reserve will conduct its activities in accordance with the provisions described above in section I.B.

IV. Interagency Coordination

A. Coordination and Information Sharing Among Domestic Primary Bank Supervisors and Functional Regulators

Objective: Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other relevant domestic primary bank supervisors and functional regulators.[22] To achieve this objective, the Federal Reserve has worked over the years to enhance interagency coordination through the development and use of information-sharing protocols and mechanisms. These protocols and mechanisms respect the individual statutory authorities and responsibilities of the respective supervisors and regulators, provide for appropriate information flows and coordination to limit unnecessary duplication or burden, comply with restrictions governing access to information, and ensure that the confidentiality of information is maintained. For example, the Federal Reserve and the U.S. Securities and Exchange Commission entered into a memorandum of understanding (MOU) in July 2008 that, among other things, provides for the parties to share specific types of information concerning entities under the parties' respective supervision, as well as information on other areas of mutual regulatory or supervisory interest.

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

Supervisory activities. The Federal Reserve will continue to work with the relevant primary supervisors and functional regulators of a large complex BHC's subsidiaries to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the BHC on a consolidated basis. The Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant primary supervisors or functional regulators when appropriate and permitted by applicable laws and regulations.[23]

[22] Section IV.B below discusses cross-border cooperation and information sharing among foreign supervisors.

[23] Among the federal laws that may limit the sharing of information among supervisors are the Right to Financial Privacy Act (12 USC 3401 et seq.) and the Trade Secrets Act (18 USC 1905). The Federal Reserve has established procedures to authorize the sharing of confidential supervisory information and Federal Reserve staff must ensure that appropriate approvals are obtained prior to releasing such

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

- Supervisory protocols, agreements, and MOUs with primary supervisors and functional regulators that allow the coordination of supervisory activities and that permit the ongoing exchange of information, including confidential information on a confidential basis;
- Bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- Periodic and as-needed contacts with primary supervisors and functional regulators to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities;
- The use of information technology platforms, such as the Banking Organization National Desktop (BOND),[24] to provide secure automated access to examination/inspection reports and other supervisory information prepared by the Federal Reserve and other relevant supervisors and regulators; and
- Participation in a variety of interagency forums that facilitate the discussion of broad industry issues and supervisory strategies, including the Federal Financial Institutions Examination Council, the President's Working Group on Financial Markets, and the Federal Reserve-sponsored cross-sector meetings of financial supervisors and regulators.

Coordination of Examination Activities at a Supervised BHC Subsidiary

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

- Review available information sources as part of its continuous monitoring activities, including examination reports and the BHC's internal MIS, to determine whether such information addresses the Federal Reserve's information needs or supervisory concerns; and

information. See Subpart C of the Board's Rules Regarding the Availability of Information (12 CFR 261.20 et seq.).

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

- If needed, seek to gain a better understanding of the primary supervisor's or functional regulator's basis for its supervisory activities and assessment of the subsidiary. This may include a request to review related examination work.

If, following these activities, the Federal Reserve's information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant primary supervisor or functional regulator in the manner discussed in section III above.[25]

B. Cooperation and Information Sharing With Host Country Foreign Supervisors

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

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

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

The Federal Reserve's processes for understanding and assessing firmwide legal and compliance risk management, as described earlier, encompass both domestic and international operations. Most areas of supervisory focus for management of legal and compliance risks are applicable to both domestic and international entities, and include

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

proper oversight of licensed operations, compliance with supervisory and regulatory requirements, and the sufficiency of associated MIS.

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

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

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

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

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

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

C. Indications of Weakness or Risk Related to Subsidiary Depository Institutions

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

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

- The Federal Reserve will first review available information sources, discuss the areas of concern with the primary supervisor, and seek to review the supervisor's related work.

- If concerns remain following these activities, the Federal Reserve will request that the primary supervisor conduct a discovery review or testing activity at the depository institution to address the area of concern.

- In the event the primary supervisor does not undertake activities to address the concern in a reasonable period of time, the Federal Reserve will design and lead an examination of the depository institution to address the matter in consultation with the primary supervisor. A senior Federal Reserve official will communicate this decision in writing to a senior official of the primary supervisor.

D. Condition or Management of BHC Subsidiary is Less-than-Satisfactory

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

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

Supervisory activities:

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

E. Edge and Agreement Corporations

Objectives: Many large complex BHCs control an Edge or agreement corporation subsidiary. The Federal Reserve serves as the primary supervisor of each Edge and agreement corporation subsidiary in addition to its role as consolidated BHC supervisor.[26] When the Edge or agreement corporation is held by a U.S. bank, the

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

primary supervisor often relies on information provided by the Federal Reserve in developing its own understanding and assessment of the parent bank.

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

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

a) Structure and attributes, including whether the Edge or agreement corporation is a banking or investment organization;

b) The size, nature, and location of its primary activities, as well as key financial and other trends;

c) The business lines and risks, and associated trends, of the Edge or agreement corporation's primary activities on a stand-alone basis, as well as their significance to the risk profile of the parent bank (if applicable) and BHC;

d) The extent to which risk management and internal control functions are unique to the Edge or agreement corporation, or are shared with a parent bank, another affiliate, or the consolidated BHC;

e) Any potential Regulation K limitations or other U.S. compliance issues, and the adequacy of processes to ensure ongoing compliance; and

f) The adequacy of processes for ensuring compliance with all applicable laws and regulations imposed by host country supervisors for the Edge or agreement corporation's international operations.

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

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

In addition, where the primary supervisor of an Edge or agreement corporation's parent bank relies on the Federal Reserve's understanding and assessment in order to develop its CAMELS rating,[27] the Federal Reserve will work to fulfill that supervisor's information needs.

[27] The U.S. banking agencies assign CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings to U.S. banking organizations as part of the ongoing supervision of these organizations. See SR letter 96-38, "Uniform Financial Institutions Rating System," and SR letter 97-4, "Interagency Guidance on Common Questions About the Application of the Revised CAMELS Rating System."