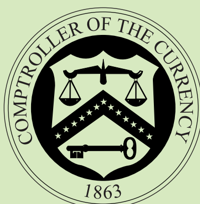

Banking Agencies/Regulators:

- Federal Reserve System
- Office of the Comptroller of the Currency
- Federal Deposit Insurance Corporation
- Office of Thrift Supervision

Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision

Jurisdiction:
United States of America

as of
July 31, 2009

Introduction to the Self-Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision by the U.S. Federal Banking Agencies

The following introduction to the U.S. self-assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs) includes an overview of the U.S. banking supervisory and regulatory structure and framework. The federal banking agencies' respective regulatory and supervisory roles over U.S. banks and holding companies (defined below) and mechanisms governing cooperation and consultation among the agencies and with other functional regulators are briefly described as a complement to the detailed responses to the 25 BCPs. Legal and regulatory preconditions for effective banking supervision are addressed in the *Legal and Regulatory Framework* under each BCP.

For purposes of this self assessment, the following terminology will be used:

- *U.S. federal banking agencies* – includes the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS). Also referred to as the "federal banking agencies" or the "agencies."
- *U.S. federal banking supervisors* – includes the staff of the U.S. federal banking agencies. Also referred to as the "supervisors," which in this context is interchangeable with "regulators" and "examiners."
- *Banks* – includes all FDIC-insured national banks (supervised by the OCC), FDIC-insured state-chartered banks (both Federal Reserve member (supervised by the Federal Reserve) and nonmember (supervised by the FDIC)) and FDIC-insured savings associations (supervised by the OTS), unless the content indicates otherwise.
- *Commercial banks* – includes "banks" as described above, but excludes savings associations.
- *Foreign banking organizations* – foreign banks that conduct commercial banking operations in the United States.
- *Bank holding companies (BHCs) and savings and loan holding companies (SLHCs)* – includes any company that has control over a bank or savings association, respectively**.** For the purposes of this document, they are referred to as "*holding companies*" except in cases where there is a material difference between BHCs and SLHCs (in terms of legal authority, operations, or structure). BHCs are supervised by the Federal Reserve and SLHCs are supervised by the OTS.
- *Financial holding companies* – bank holding companies, whose depository institution subsidiaries meet enhanced capital and managerial standards, that are authorized to engage in expanded financial activities, including securities, insurance, and merchant banking.
- *Consolidated organization* – the consolidated entity including the parent and its bank and nonbank subsidiaries.
- *Banking group or banking organization* – the holding company and its banking subsidiaries.
- *Functionally regulated affiliate* – entities within the consolidated organization that are regulated by the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, or state insurance regulators.

Methodology

The U.S. self-assessment was conducted in accordance with the *Basel Core Principles for Effective Banking Supervision* and *Core Principles Methodology* published by the Basel Committee for Banking Supervision (BCBS) in October 2006. The general guidance for completing the self-assessment against those BCPs were the BCBS publication, *Conducting a Supervisory Self-Assessment – Practical Application,* published in April 2001, and the *Financial Sector Assessment – A Handbook*, published by The World Bank and the IMF.

To complete the self-assessment, legal staff and subject matter experts from each U.S. federal banking agency provided input in response to the principles and their associated criteria. Special emphasis was placed on describing the practical application of the principles within the U.S. legal and regulatory framework. Authors made every attempt to critically review the practical application of all regulatory requirements and activities. While not required, the self-assessment offers U.S. regulators' assessment of compliance in conformance with the BCP methodology.

Background Information

Current Structure and Supervisory Responsibilities

U.S. federal banking agencies addressed in this self-assessment include the Federal Reserve, OCC, FDIC, and OTS. As agreed in advance, the self-assessment does not include an assessment of the state banking agencies, the National Credit Union Administration, or the Federal Housing Finance Authority.

The current framework for the regulation and supervision of financial institutions in the United States has developed over many decades primarily in response to a series of financial crises and other important social, economic, and political events. The structure of the financial system necessitates a high degree of coordination among all relevant supervisors (both federal and, where applicable, state), both in formulating regulatory and supervisory standards and supervising individual banks and holding companies.

Responsibilities of the Federal Banking Agencies

The United States operates under a "dual banking system." A bank may choose to be chartered by the federal government or by a state. Federal bank charters for "national banks" are issued by the OCC. The OTS issues charters for "federal savings associations." OTS and OCC are agencies of the U.S. Treasury. National banks and federal savings associations operate pursuant to a federal grant of powers, subject to uniform national standards pursuant to federal law and regulations, and administered by the OCC or OTS, respectively.

Each of the 50 states has a banking authority that charters banks under its own laws and regulations. These banks are generally referred to as "state banks" or "state savings associations." Each U.S. bank, whether chartered under state or federal law, is subject to regulation, supervision, and examination by a primary federal banking supervisor, irrespective of whether the bank is part of a broader organization:

- for national banks, this is the OCC;
- for state banks that choose to be members of the Federal Reserve System (state member banks), this is the Federal Reserve;
- for state banks that choose not to become members of the Federal Reserve System (nonmember banks) this is the FDIC; and
- for federal or state savings associations, this is the OTS.

Summary of Primary Federal Supervisory Responsibilities – Table 1

Component	Supervisor and Regulator
Bank holding companies (including financial holding companies	Federal Reserve
Nonbank subsidiaries of bank holding companies	Federal Reserve/Functional Regulator
National banks	OCC
State banks Members Nonmembers	 Federal Reserve FDIC
Savings and loan holding companies	OTS
Savings and loan associations	OTS
U.S. offices of FBOs - subs, branches and agencies* State-licensed Federally licensed *There are some grandfathered, insured FBO branches. If they are state-chartered, the primary federal supervisor is the FDIC and if federally chartered, the primary federal supervisor is the OCC.	 Federal Reserve OCC

The FDIC operates the federal deposit insurance program in the United States. Virtually all banks have deposit insurance coverage through the FDIC. All banks are subject to regulation by a U.S. federal banking agency. In addition to its authority to examine state nonmember banks, the FDIC has the

authority to examine for insurance purposes any bank, either directly or in cooperation with state or other federal supervisory authorities. The FDIC has backup enforcement authority over all banks. The FDIC can recommend that another federal banking agency take action against a bank in appropriate circumstances and may take such action directly if the other agency does not take action.
Holding companies are either supervised by the Federal Reserve or the OTS. The Federal Reserve is responsible under the Bank Holding Company Act for regulating and supervising any company that owns or controls a national or state bank. BHCs and their subsidiaries may engage in activities that are closely related to banking. Certain BHCs, whose depository institution subsidiaries meet enhanced capital and managerial standards, may elect to become financial holding companies (FHCs) and engage in a broader array of financial activities, including securities, insurance, and merchant banking. The Federal Reserve is the consolidated supervisor of all BHCs and FHCs on a worldwide consolidated basis. As set forth in the Home Owners' Loan Act, the OTS regulates and supervises SLHCs. SLHCs may engage only in financial activities, although certain SLHCs that control a single savings association acquired before 1999 are not subject to such limits. The OTS is the consolidated supervisor of all SLHCs.

The U.S. federal banking agencies generally have the authority to examine affiliates of banks under their supervision. In addition, the Federal Reserve and the OTS have the authority to examine holding company affiliates. However, the Federal Reserve and the OTS must rely to the fullest extent possible on the bank examinations conducted by the primary federal banking supervisor. For example, for national banks, the Federal Reserve relies on OCC and for securities and insurance subsidiaries the Federal Reserve relies on other functional regulators for supervisory information. The primary federal banking supervisor can only conduct an examination of a functionally regulated subsidiary if the subsidiary is engaging in activities that pose a material risk to the bank or for other prudential reasons and the information cannot be obtained from the functional regulator.

Foreign banking organizations (FBOs) may do business in the United States under a policy of "national treatment" which gives FBOs the same powers and applies the same limitations as are given and applied to domestic banks. National treatment is embedded in the key governing law pertaining to FBOs, the International Banking Act of 1978 (IBA).

No FBO may establish a branch or an agency, or acquire ownership or control of a commercial lending company, without the prior approval of the Federal Reserve. Under the IBA, the Federal Reserve has broad supervisory oversight over the FBO's U.S. banking operations. The Federal Reserve relies on the OCC or state banking agencies to perform examinations and supervision depending on the form of organization and the charter the FBO elects to take in this country.

All banks and branches or agencies of FBOs have a primary federal regulator. An insured, state nonmember bank owned or controlled by an FBO is supervised primarily by the FDIC. A state-chartered member bank owned or controlled by an FBO is supervised primarily by the Federal Reserve. A national bank that is owned or controlled by an FBO is supervised and examined by the OCC. If the FBO acquires a savings association, either state-chartered or federally chartered, the OTS supervises the savings association and supervises the FBO as an SLHC.[1]

If the FBO chooses a federal license for a branch or agency, then it is supervised and examined solely by the OCC. If an FBO elects to open a branch or agency under a state license, then it is typically examined by the state banking authorities and also by the Federal Reserve on a joint or alternate (i.e., rotating) basis.

[1] If the FBO controls both a savings association and at least one other type of bank, the FBO is supervised by the Federal Reserve as a BHC or an FHC.

Information-Sharing and Coordination Among Supervisors

The sharing of information among supervisors is an integral part of the U.S. supervisory process. To promote consistency in the examination and supervision of banks and holding companies, in 1978 Congress created the Federal Financial Institutions Examination Council (FFIEC). The FFIEC is composed of the chairpersons of the FDIC and the National Credit Union Administration, the Comptroller of the Currency, the Director of the OTS, and a governor of the Federal Reserve Board. As the result of legislation in 2006, the Chair of the FFIEC State Liaison Committee serves as a sixth member of the FFIEC. The State Liaison Committee is composed of five representatives of state agencies that supervise financial institutions. The FFIEC's objectives are to prescribe uniform federal principles and standards for the examination of depository institutions, to promote coordination of bank supervision among the U.S. federal banking agencies, and to encourage better coordination of federal and state regulatory activities. Through the FFIEC, state and U.S. federal banking agencies may exchange views on important regulatory issues. Among other things, the FFIEC has developed uniform financial reports for federally supervised banks to file with their appropriate federal regulator.

The U.S. federal banking agencies routinely share supervisory information with each other and with functional regulators, as needed. Banking supervisors have in place a number of formal and informal mechanisms for information sharing. For example, the federal banking agencies routinely share reports of examination, inspection reports, and other agency-to-institution communication. They also provide one another with access to their organizational, structural, financial, and other supervisory information. The federal banking agencies have statutory authority to share relevant supervisory information with each other and with foreign financial sector (banking and functional) supervisors of banks and banking groups of interest to the home or host supervisor. These are supplemented, in many instances, by written information-sharing arrangements or statements of cooperation.

Agency Independence, Accountability, and Transparency

As discussed in the responses to the BCPs, each U.S. federal banking agency operates pursuant to an express statutory grant of authority and has clearly defined objectives and responsibilities. Several circumstances ensure the operational independence and accountability of each agency. These include the circumstances for appointment and removal of agency heads; the self-funding nature of the agencies and independence from the congressional budget process; accountability to, consultations with, and testimony before and other submissions to Congress; multiple provisions for external review of, or public reporting on, agency operations; requirements to make records of the agency available to the public through various specified means, including upon request, under certain circumstances; adherence to requirements for establishing, meeting, and reporting publicly on periodic operational performance targets; availability of judicial review for agency decisions; required annual reporting on regulatory and supervisory actions taken during the year; legal protection for supervisory staff acting within the scope of their employment; and conflicts of interest, financial disclosure, and other similar restrictions applicable to agency personnel, including supervisory staff. These factors minimize the opportunity for government or industry interference which might compromise the agencies' independence or impede the agencies' ability to obtain and deploy the resources needed to carry out their mandate.

Legal Basis for Regulation and Supervision

As discussed in detail for each BCP below, U.S. federal banking agencies issue and regularly update regulations and guidelines implementing their statutory authority and supplement these with policy statements, formal and informal interpretations, and supervisory guidance and manuals. Agency rulemaking is subject to procedural requirements intended to foster public and stakeholder participation in the formulation of relevant standards.

The statutes and regulations provide for the licensing of banks and address permissible bank and nonbank affiliations, acquisitions, and activities. Together, the statutes, regulations, guidelines, policy statements, interpretations, and supervisory guidance and manuals establish a framework of minimum prudential standards that banks must meet. The standards address, among other things, capital adequacy, single borrower and related party exposure limits, asset quality, loan losses and provisioning, risk management (including requirements for addressing specific types of risks), internal controls and audits, accounting standards, liquidity, and AML/CFT/anti-fraud measures.

Holding companies also are subject to prudential requirements under governing statutes, regulations, guidelines, and supervisory guidance, consistent with the principle that holding companies should serve as a source of financial and managerial strength to their subsidiary, insured banks. As described in the self-assessment, holding companies must comply with prudential measures governing capital adequacy, asset quality, risk management, affiliate transactions, and large exposures.

The U.S. federal banking agencies keep apprised of industry, financial markets, and legislative developments, and continually evaluate the need for changes in or additions to existing regulations, guidance, and policies. They also consider whether policies and procedures comport with international standards and collaborate with other supervisors in developing and implementing emerging best practices.

Summary of Recent Events and Implications

During the 24 months preceding the preparation of this self assessment, the United States faced the most severe financial crisis since the Great Depression. As noted in the Obama Administration's June 2009 proposal for financial regulation reform[2], the causes of the recent crisis emerged over decades and involve numerous factors, including

- complacency among financial intermediaries and investors bred from years without economic downturn resulted in investors willing to assume higher levels of risk for marginal, incremental returns;
- rising asset prices, particularly in housing, hid weak credit underwriting standards and masked the growing leverage throughout the system;
- among financial firms, risk-management systems did not keep pace with the complexity of new financial products;

[2] Financial Regulation Reform: A New Foundation, Department of the Treasury, June 2009. See www.**financial**stability.gov/docs/regs/FinalReport_web.pdf - ,

- the lack of transparency and standards in markets for securitized loans helped to weaken underwriting standards;
- market discipline broke down as investors relied excessively on credit rating agencies; and
- compensation practices throughout the financial services industry rewarded short-term profits at the expense of long-term value.

It is clear to the U.S. federal banking agencies, in light of the recent credit and market stress, that supervisory changes are needed in the U.S. and worldwide. The year 2008 was marked by numerous, severe events, any of which could have been the most serious financial problem of a prior year: the first annual decline in nationwide housing prices, record foreclosure levels, substantial losses on subprime loans, the near shutdown of interbank lending markets, the liquidity freeze for asset-backed commercial paper and structured investment vehicles, government takeover of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, Indy Mac and WaMu, the distress sales of Countrywide, Bear Stearns, and Wachovia, and the government's $700 billion plan to unfreeze the credit markets.

In assessing U.S. compliance with the BCPs in light of these market events, the U.S. federal banking agencies considered the adequacy of the BCPs, as well as the adequacy of U.S. implementation of them. In our view, the BCPs remain relevant and appropriate principles even during crisis periods. In addition, we view the U.S. bank supervisors to be, for the most part, compliant with the principles—both before and during the crisis. The United States has a rigorous supervisory regime, involving audit and attestation requirements, leverage ratios and prompt corrective action mandates, comprehensive and frequent disclosure and reporting requirements, sophisticated modeling capabilities, on-site examinations, and a strong focus on risk-management processes. However, the crisis highlights certain shortcomings:

- Many banks' default models relied on historical correlations and, especially for various residential mortgage related exposures, focused on geography and borrower characteristics, but not on the aggregate risk exposure of subprime portfolios, including exposures from highly rated senior collateralized debt obligations and other structured securities.
- Some off-balance-sheet structures were not fully considered due to the legal separateness of these structures from the regulated institutions. In many cases, although the bank did not have any legal obligation to support those transactions, the bank later chose to do so to maintain investor relationships.
- Liquidity contingency plans assumed a ready market existed for highly rated assets. This proved overly optimistic when the markets stalled and concentration existed.
- Because of abundant market liquidity, some banks began following a so-called originate-to-distribute lending model, originating and packaging loans whose risk/return characteristics may not have met the bank's own internal investment hurdles but were sought or accepted by third party investors. In many cases, this led to loans with liberal repayment terms, reduced financial covenants, and higher borrower leverage.
- Weaknesses in executive compensation programs and corporate governance resulted in distorted incentives.

- Weaknesses with respect to regulatory oversight and coordination existed. For example, many of the problems in the subprime mortgage market originated with mortgage brokers and lenders who were not affiliated with federally or state-chartered depository institutions and thus were subject to limited supervision. In other cases, there were not sufficient mechanisms to stabilize or resolve systemically important nonbank firms.

In addressing shortcomings, U.S. federal banking agencies are working with global policymakers (e.g., Basel Committee on Banking Supervision, Financial Stability Board, Senior Supervisors Group, G-20) to identify existing policies needing revision or enhancement. To the extent permissible within the existing U.S. legal and regulatory framework, the U.S. supervisors will make appropriate enhancements and revisions to U.S. policies. As these documents are finalized, the U.S. supervisors will make appropriate changes to the U.S. framework. Policy changes are being considered in a number of areas, including liquidity supervision; treatment of shadow banking (off-balance-sheet vehicles, private equity, hedge funds; remuneration and corporate governance; enhanced regulatory capital standards (i.e., Basel II revisions); and cross-border resolution and supervisory coordination. We also note that the recent adoption by the Financial Accounting Standards Board (FASB) of two new accounting standards, Statement No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140 (FAS 166)* and Statement No. 167, *Amendments to FASB Interpretation No. 46(R) (FAS167)*. These standards become effective for an entity's first fiscal year beginning after November 15, 2009, and will likely have a significant effect on bank securitization activities and transactions as many transactions will lose sales accounting treatment.

Finally, the U.S. supervisors have taken, and continue to plan for, actions to respond to the crisis including the following:

- Performed stress assessments on 19 large banks that resulted in several banks immediately raising additional capital at significant levels and others with plans to do so. Even prior to the stress tests, banks had responded by aggressively raising capital (attracting over $100 billion for large national banks) and improving their liquidity and reserve positions.

- Established the FDIC's Temporary Liquidity Guarantee Program to restore liquidity to the credit markets.

- Joined international efforts to initiate supervisory colleges for large, globally active U.S. banks.

- Directed large banks to improve their ability to aggregate risks across legal entities and product lines to identify potential risk concentrations and correlations, and required improved contingency funding plans.

- Conducted targeted, leveraged lending reviews at the largest syndication banks, focusing on syndicated pipeline management, stress testing, and limit setting. Also, asset quality reviews targeting banks with significant commercial real estate concentrations were conducted.

- Initiated new data gathering, e.g., the OCC and OTS mortgage metrics project that provides data on over 60 percent of residential mortgages serviced in the United States.

BCP Summary of Conclusions

The following table provides an overview of assessment of compliance with the Core Principles:

Core Principle		Compliance Rating*				
		C	LC	MNC	NC	NA
1	***Objectives, independence, powers, transparency and cooperation:*** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.	**X**				
2	***Permissible activities:*** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.	**X**				
3	***Licensing criteria:*** The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.	**X**				

Core Principle		Compliance Rating*				
		C	LC	MNC	NC	NA
4	***Transfer of significant ownership:*** The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.	**X**				
5	***Major acquisitions:*** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.	**X**				
6	***Capital adequacy:*** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.	**X**				
7	***Risk management process:*** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.		**X**			
8	***Credit risk:*** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.	**X**				
9	***Problem assets, provisions and reserves:*** Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.	**X**				

Core Principle		Compliance Rating*				
		C	LC	MNC	NC	NA
10	***Large exposure limits:*** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.		**X**			
11	***Exposures to related parties:*** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.	**x**				
12	***Country and transfer risks:*** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.	**X**				
13	***Market risks:*** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.	**X**				
14	***Liquidity risk:*** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.		**X**			

Core Principle		Compliance Rating*				
		C	LC	MNC	NC	NA
15	***Operational risk:*** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.	**X**				
16	***Interest rate risk in the banking book:*** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.	**X**				
17	***Internal control and audit:*** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.	**X**				
18	***Abuse of financial services:*** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.	**X**				
19	***Supervisory approach:*** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.		**X**			
20	***Supervisory techniques:*** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.	**X**				

Core Principle		Compliance Rating[*]				
		C	LC	MNC	NC	NA
21	***Supervisory reporting:*** Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.	X				
22	***Accounting and disclosure:*** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.	X				
23	***Corrective and remedial powers of supervisors:*** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.	X				
24	***Consolidated supervision:*** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.	X				
25	***Home-host relationships:*** Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.	X				

* C = Compliant, LC = Largely Compliant, MNC = Materially Non-Compliant, NC = Non-Compliant, NA = Not Applicable

Principle 1: Objectives, independence, powers, transparency and cooperation
An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

EC 1	**Principle 1: Objectives, independence, powers, transparency and cooperation**
P1(1)	**Responsibilities and objectives**. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Criterion	Laws are in place for banking, and for the authority (each of the authorities) involved in banking supervision. The responsibilities and objectives of each of the authorities are clearly defined and publicly disclosed.
Legal Framework	Federal law and the laws of each of the states provide for the establishment of banks and address their permissible activities. *See* 12 U.S.C. § 21 (providing for the formation of national banks). Each federal and state banking agency operates pursuant to an express statutory grant of authority and has clearly defined objectives and responsibilities. *See, e.g.,* 12 U.S.C. § 1 et seq. (OCC); 12 U.S.C. § 221 et seq. (Federal Reserve); 12 U.S.C. § 1461 et seq. (OTS); and 12 U.S.C. § 1811 et seq. (FDIC). For the U.S. federal banking agencies, the organizing statutes, implementing regulations, guidelines, and other resources are (and are required to be) made publicly available, including on the website of each agency. *See* 5 U.S.C. § 552(a). The lines of responsibility for banking regulation and supervision are clear, and these are described in detail in the introduction to this assessment. The objective of all banking agencies is to promote safe and sound banking practices in the United States and maintain stability and public confidence in the banking system. The Federal Reserve has the added objectives of containing systemic risk and influencing money and credit conditions in the economy in pursuit of full employment and stable prices. The FDIC also has an additional objective of minimizing the disruptive effects that can occur within the banking system when banks or savings associations fail. The OTS has the additional objective of encouraging savings associations to provide credit for housing safely and soundly.
Practices and Procedures	Each agency issues and regularly updates regulations implementing its authority and supplements these with supervisory guidelines, policy statements, formal and informal interpretations, and supervisory guidance and manuals.

EC 2	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(1)	**Responsibilities and objectives**. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Criterion	The laws and supporting regulations provide a framework of minimum prudential standards that banks must meet.
Legal Framework	Together, the banking statutes, regulations, guidelines, policy statements, interpretations and supervisory guidance and manuals establish a framework of minimum prudential standards that banks must meet. The standards address capital adequacy, loan underwriting, single borrower and related party exposure limits, asset quality, loan losses and provisioning, risk management (including requirements for addressing specific types of risks), internal controls and audits, accounting standards, liquidity, AML/CFT/anti-fraud measures, among others. In addition to statutory and regulatory authorities, the federal banking agencies can issue policies and regulations as deemed necessary to ensure the safety and soundness of the banks under their jurisdiction. *See, e.g.*, 12 U.S.C. § 93a (OCC); and 12 U.S.C. § 1831a (FDIC).
Practices and Procedures	Through their examination programs and based on the agencies' Uniform Financial Institutions Rating System, the agencies evaluate and assign a supervisory rating to each bank that assesses the bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. In addition to the framework of minimum prudential standards that apply to banks, consistent with the long-standing principle, holding companies should serve as a source of financial and managerial strength to their subsidiary banks. Holding companies are expected to use available resources to provide adequate capital funds to subsidiary banks during periods of financial stress or adversity. Holding companies also are expected to maintain financial flexibility and capital-raising capacity to obtain additional resources to assist subsidiary banks. *See* 12 CFR 225.4(a)(1) for BHCs and the OTS *Holding Companies Handbook* for SLHCs. Accordingly, holding companies must comply with prudential measures governing capital adequacy, asset quality, risk management, affiliate transactions, and large exposures.

EC 3	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(1)	**Responsibilities and objectives**. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Criterion	Banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.
Legal Framework	Several factors ensure that banking laws and regulations are regularly reviewed and updated as necessary to remain effective and relevant to changing industry and regulatory practices. A number of statutes require the U.S. federal banking agencies to review their regulations at regular intervals to ensure that they remain relevant and effective and to reduce the burden on regulated entities. *See, e.g.,* 12 U.S.C. §§ 611a, 1817(a)(11), and 3311. These reviews are conducted through a process that allows for widespread public (including industry) participation in developing more efficient and relevant rules. In many instances, regulations are adopted or amended to implement specific legislative initiatives or requirements passed by Con-

EC 3	Principle 1: Objectives, independence, powers, transparency and cooperation
	gress. These statutory provisions may have been adopted by Congress in response to specific crises or market failures, industry concerns or recommendations, or to update the nation's banking laws to address changes in the marketplace. Changes also may be made in response to judicial decisions. In some cases, the U.S. federal banking agencies have the discretion to determine the most effective form (e.g., regulations, guidelines, supervisory guidance, interpretations, etc.) in which to promulgate revised or new requirements. Depending on the urgency or nature of issues to be addressed, change may be made as part of the agencies' regular, periodic review of regulations, or may occur more quickly through the development and issuance of policy statements or guidelines. *See, e.g,*. Interagency "Statement on Subprime Mortgage Lending," 72 *Fed. Reg*. 37569 (July 10, 2007); "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities," 72 *Fed. Reg*. 1372 (Jan. 11, 2007).
Practices and Procedures	As a natural corollary to the continuous process of risk-based supervision, the agencies assess their supervisory policies and procedures on an ongoing basis to ensure that they address market innovations, enhancements, and emerging risks. The agencies keep apprised of industry, financial markets, and legislative developments, and continually evaluate the need for changes in, or additions to, existing regulations, guidance, and policies. They also consider whether policies and procedures comport with international standards and collaborate with other supervisors in developing and implementing emerging best practices.

EC 4	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(1)	**Responsibilities and objectives**. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Criterion	The supervisor confirms that information on the financial strength and performance of the industry under its jurisdiction is publicly available.
Practices and Procedures	The U.S. federal banking agencies regularly publish or make available to the public upon request information on the structure, financial strength, and performance of banks subject to their jurisdiction. The information is derived from periodic and event-generated regulatory reports and is updated regularly. Largely, this information is made available through the agencies' public websites and on the website for the Federal Financial Institutions Examination Council (FFIEC). The FFIEC's website includes data sets and the functionality to allow for peer group performance assessments of banks and banking groups. For publicly traded banks or banking groups, additional financial data is required to be published pursuant to Securities and Exchange Commission (SEC) requirements. *See* following websites for further information: www.ffiec.gov/ www.sec.gov

AC 1	**Principle 1: Objectives, independence, powers, transparency and cooperation**
P1(1)	**Responsibilities and objectives**. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Criterion	In determining supervisory programs and allocating resources, supervisors take into account the risks posed by individual banks and banking groups and the different approaches available to mitigate those risks.
Legal Framework	By statute, 12 U.S.C. § 1820(d), the agencies, are required to conduct a full-scope, on-site exam of each bank at least once during each twelve month period. However, the agencies can lengthen this cycle to eighteen months for banks that meet certain asset size thresholds and supervisory rating criteria. *See* 12 U.S.C. § 1820(d)(4).
Practices and Procedures	The U.S. federal banking agencies utilize a risk-based supervisory approach, and this is extensively detailed in supervisory guidance (*see, e.g,* , Federal Reserve SR letter 97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and Federal Reserve SR letter 97-25, "Risk-Focused Framework for the Supervision of Community Banks") and examination manuals (*see,e.g.*, OCC Comptroller's Handbook on *Bank Supervision Process*, *Large Bank Supervision*, and *Community Bank Supervision*; Federal Reserve's *Commercial Bank Examination Manual (*section 1000.1); FDIC *Risk Management Manual of Examination Practices*; OTS *Examination Handbook* (section 060) and *Holding Companies Handbook* (section 100)). Special examinations are performed for certain bank operations such as trust operations (*see, e.g.*, FDIC's *Trust Examination Manual*.) As part of this approach, they apply supervisory programs that are appropriate to the geographic scope and degree of specialization, sophistication, risk, size, and complexity of the activities and organization of banks. Each program is staffed by supervisory personnel with training and experience applicable to the entities covered. In general, those entities presenting the greatest risk receive the most intense, frequent, and comprehensive scrutiny. All of the supervisory programs consider the best approaches available to mitigate risks. (U.S. federal banking agencies' supervisory practices are discussed in greater detail in the response to subsequent principles.)

EC 1	**Principle 1: Objectives, independence, powers, transparency and cooperation**
P1(2)	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Criterion	The operational independence, accountability and governance structures of each supervisory authority are prescribed by law and publicly disclosed. There is, in practice, no evidence of government or industry interference which compromises the operational independence of each authority, or in each authority's ability to obtain and deploy the resources needed to carry out its mandate. The head(s) of the supervisory authority can be removed from office during his (their) term only for reasons specified in law. The reason(s) for removal should be publicly disclosed.

EC 2	**Principle 1: Objectives, independence, powers, transparency and cooperation**
P1(2)	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent

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	processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Criterion	The supervisor publishes objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives. Please refer to Principle 1(1), EC 1.
Legal Framework	Each of the U.S. federal banking agencies complies with the Government Performance and Results Act of 1993, which requires federal agencies, in consultation with Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. *See* 5 U.S.C. § 306; and 31 U.S.C. § 1115. The performance plans and assessments are incorporated into the agencies' annual reports, which are required to be made public. The agencies also are required, by separate statute, to report annually on regulatory and supervisory actions taken during the year. Together, these requirements provide tangible and transparent measures of agency performance against statutory and stated performance targets.

EC 3	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(2)	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Criterion	The supervisory authority and its staff have credibility based on their professionalism and integrity.
Legal Framework	The U.S. federal banking agencies insist that agency heads and all staff maintain high professional standards and exhibit high integrity. Federal laws and regulations, as well as individual conflict-of-interest rules and codes of conduct of each of the federal banking agencies, help to ensure that these standards are met. For some of the agencies, there are specific statutes governing ethical conduct. For example, the Comptroller of the Currency and the Federal Reserve staff are subject to statutory restrictions on activities and affiliations that might raise conflicts of interests. *See, e.g.,* 12 U.S.C. §§ 27 (unlawful for the Comptroller to hold an interest in a national bank), 242, 244 (respectively prohibiting Federal Reserve members from holding office in or stock of a member bank). Similarly, FDIC employees are prohibited from owning stock in any FDIC regulated entity. In addition, members of the FDIC Board of Directors are prohibited from holding any office, position, or employment in any bank or holding company during their time in office and for two years after they leave office, subject to certain exceptions. Senior examination staff of the agencies generally are subject to a one year post-employment "cooling off" period with respect to entities they supervised. *See, e.g.*, 12 U.S.C. § 1820(k); 12 CFR 4, subpart E; "One-Year Restrictions on Post-Employment Activities of Senior Examiners" (OCC). Violators are subject to civil monetary penalties, can be removed from office, and can be prohibited from participating in the affairs of the bank, the holding company, or any other company for up to five years. Examiners also are prohibited from accepting loans or gratuities from banks that they examine. *See* 18 USC § 213. These standards are reinforced by a number of criminal statutes, including those prohibiting corruption, bribery, theft, and fraud by agency employees. These laws are actively enforced.

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Practices and Procedures	U.S. federal banking agencies have administrative policies to ensure that appropriate codes of conduct are being followed. The agencies' policies outline the requirements for examiners and other supervisory staff concerning investment prohibitions, borrowing prohibitions and recusal requirements based on considerations such as family, debt, or prior employment relationships. *See* Federal Reserve (*Federal Reserve Administrative Manual*, FRAM 5-041 and 5-035), OCC (OCC's Ethics Bulletin Board), FDIC (FDIC Directive 2410.6 Standards of Ethical Conduct for Employees), and OTS (*Examination Handbook*). Each agency has general requirements related to the initial appointment of an examiner, and promotion to commissioned examiner. In general, the guidance specifies standard information required for initial examiner appointments, such as professional qualifications, citizenship, and potential conflicts with banks, holding companies or other affiliates (i.e. the prospective employee's completed conflicts of interest form), and outlines general requirements to be considered for appointment of an assistant examiner to commissioned examiners status, including proficiency tests that must be completed as well as practical supervisory work. The rigorous commissioning process for examiners promotes high standards of performance. References: Federal Reserve (FRAM 5-040), OCC (*Policies and Procedures Manual* (PPM 5400-7)), FDIC (Examiner Training and Development Policy, July 2007), OTS (*Individual Occupational Requirements in the Office of Personnel Management's Qualifications Handbook* for the GS-570 Financial Institution Examining Series).

EC 4	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(2)	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Criterion	The supervisor is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes: • a budget that provides for staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised; • salary scales that allow it to attract and retain qualified staff; • the ability to commission outside experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks; • a training budget and program that provide regular training opportunities for staff; • a budget for computers and other equipment sufficient to equip its staff with the tools needed to review the banking industry and assess individual banks and banking groups; and • a travel budget that allows appropriate on-site work.
Legal Framework	Each of the U.S. federal banking agencies is self-funding and, thus, is not subject to the congressional budget process or congressional appropriations. *See* P1(2), EC1.

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Practices and Procedures	The U.S. federal banking agencies have adequate resources to attract and retain sufficient numbers of qualified staff, with skills commensurate with the size and complexity of the institutions supervised. Each of the agencies undertakes an internal evaluation process to ensure its staff meets its supervisory needs. Examples include annual skills gaps analysis to determine if staffs available are meeting critical supervisory needs. This entails evaluating hiring and retention programs in place to attract and retain staffs that have critical and highly marketable skills. Existing efforts that the agencies have in place are variable-pay and retention programs, benchmarking, and bonus programs. The salary scales, benefits, and work-life programs of the federal banking agencies are not based on the U.S. Federal Government standards (12 U.S.C. § 481 (OCC)) and provide more generous compensation. This provides greater flexibility to attract and retain qualified staff at each respective agency. Each U.S. federal banking agency has a slightly different salary structure, and these salary scales or compensation packages are made available to the public on the following websites: o Board of Governors: http://www.federalreserve.gov/careers/salary.htm o Office of the Comptroller of the Currency: http://www.occ.treas.gov/jobs/salaries.htm o Federal Deposit Insurance Company: http://www.fdic.gov/about/jobs/offer.html o Office of Thrift Supervision: http://www.ots.treas.gov/docs/4/480003.pdf The agencies have the ability to commission outside experts or consultants when and where needed to fulfill any supervisory gaps, particularly during periods of financial stress. Often these are former commissioned examiners who have retired that have familiarity with the agencies' procedures, processes, and objectives. The agencies insist that staff undergo adequate and relevant training and ensure that sufficient resources are available for this purpose. Broadly, the U.S. federal banking agencies have two developmental objectives: to train field examination staff to become commissioned examiners and to accomplish continuing professional development for existing commissioned examiners and other staff. The agencies use a combination of internal, external, and shared training programs to achieve these objectives; examples of shared training programs include collaboration through the FFIEC to provide continuing professional development courses on specialized topics. In addition, the agencies collaborate through the organization of periodic conferences on supervisory policy in the context of current developments within the financial services industry. The agencies approve annual training budgets that provide employees with training opportunities each year. Federal banking agencies participate in training offered by the FFIEC (*see* www.ffiec.gov/exam/courses.htm#programs) and by certain other regulatory agencies. All agencies are involved in developing and implementing basic and advanced training in relation to various emerging issues as well as in specialized areas such as international banking, information technology, anti–money laundering, capital markets, payment systems risk, and consumer compliance. The U.S. federal banking agencies require a staff member seeking an examiner's commission to take proficiency exams or commissioning tests. The agencies' supervisory staff have sophisticated technological equipment and support tools to review the banking industry and assess individual banks and banking groups. The agencies are heavily invested in electronic processes and each have an

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	Information Technology office. The agencies maintain electronic records, obtain bank data and information electronically, and use sophisticated analytical processes. They also dedicate resources for the development of software and other applications that assist supervisory staff in reviewing individual institutions and the overall banking industry. Numerous applications developed by the agencies contain confidential supervisory information not available to the public. However, other web-based applications are available to the public and allow supervisory staff to collect the necessary financial information to conduct effective supervision and oversight. Such applications found on the FFIEC website include: o National Information Center: www.ffiec.gov/nicpubweb/nicweb/nichome.aspx o Central Data Repository Public Data Distribution: https://cdr.ffiec.gov/public All of the U.S. federal banking agencies include travel as part of the cost of supervisory work and approve travel budgets annually. Agency examination staff perform on-site inspections of all banks every 12 or 18 months, regardless of the bank's location.

AC 1	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(2)	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Criterion	The head(s) of the supervisory authority is (are) appointed for a minimum term.
Legal Framework	The heads of the U.S. federal banking agencies are appointed by the President with the advice and consent of the Senate to a set term in office. *See* Principle 1(2), EC 1. The heads of the OCC and the OTS are appointed to a five-year term. During their tenure they also serve as directors of the FDIC. The FDIC's three remaining directors are appointed to six-year terms although one of the appointed members is designated as Chairman for a five-year term. Members of the Federal Reserve Board of Governors are appointed to a full or to an unexpired portion of a 14-year term. On appointment by the President and with the advice and consent of the Senate, one of the members is designated to serve as Federal Reserve Chairman, and another of the members is designed to serve as Vice Chairman, for a four-year term. All of these agency positions are non-partisan, and there is no expectation that agency heads will resign at the conclusion of the term of the President who appointed them.

EC 1	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(3)	**Legal framework.** A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Criterion	The law identifies the authority (or authorities) responsible for granting and withdrawing banking licenses.
Legal	Federal and state laws provide for the creation and establishment of authorities (federal and state banking agencies) with the

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Framework	authority to issue and revoke bank licenses. Each state has its own bank or financial institution supervisor with authority to issue and revoke state bank and savings association licenses. The OCC and OTS have licensing and revocation authority under federal law with respect to national banks and federal savings associations, respectively. *See,* 12 U.S.C. § 27 (OCC), 1464(a) (OTS).

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P1(3)	**Legal framework.** A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Criterion	The law empowers the supervisor to set prudential rules (without changing laws). The supervisor consults publicly and in a timely way on proposed changes, as appropriate.
Legal Framework	The U.S. federal banking agencies have the authority to set, implement, and modify prudential measures without the need for statutory changes. Federal statutes provide clear bases for the imposition of prudential standards. *See, e.g*., 12 U.S.C. §§ 1464(t), 1831o(c) and 3907, 3909 (capital standards); 84, 1464(u) (single borrower lending limits); 371c and 371c-1, 1467a(d), 1468(a),1828a, 1828(j)(1) (affiliate transactions); 375, 375a, 375b, 1468(b), 1828(j)(2) (related party transactions), 1831p-1 (safety-and-soundness standards, including operational and managerial measures, asset quality and underwriting standards, earnings, and stock valuation standards, and compensation standards). Essentially, these provisions and others empower the federal banking agencies to prescribe the scope and substance of prudential measures by rules, regulations, guidelines, or orders. The agencies issue and amend regulations in accordance with the notice and comment requirements of the Administrative Procedure Act, which allows for open and public participation in the process. The prudential standards, as implemented by the agencies, vary in the degree of specificity of requirements for compliance. The rules governing affiliate and related party transactions are prescriptive, *see, e.g*., 12 CFR 215 (related party transactions) and 223 (affiliate transactions). On the other hand, the interagency safety-and-soundness guidelines impose broad minimum requirements without dictating the methods of compliance, *see, e.g*., 12 CFR 208, appendix D-1. This format accommodates a wide range of practice across the industry and allows institutions to design the form and manner of managing their operations. Also, supervisors have the flexibility to assess and timely address emerging issues or conditions of concern. Both approaches are permissible exercises of authority, and in each case, violations can lead to enforcement actions.
Practices and Procedures	The U.S. federal banking agencies have published detailed compliance expectations and best practices, primarily in the form of publicly available supervisory guidance and examination manuals, addressing a number of areas presenting safety-and-soundness concerns. Among other matters, these materials address internal controls, audit, information systems, risk-management programs and assessments of specific risk types, and asset classifications and valuations. The agencies update these materials as needed to keep apace of supervisory and market developments and industry practices, taking into account feedback received through the supervisory process and, where appropriate, through formal public consultation.

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P1(3)	**Legal framework.** A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Criterion	The law or regulations empower the supervisor to obtain information from the banks and banking groups in the form and frequency it deems necessary.
Legal Framework	The U.S. federal banking agencies have broad authority under governing statutes and regulations to obtain financial, structural, and any other information from banks and any of their affiliates (including holding companies) in the form and with such frequency as the agencies deem necessary to determine and enforce banking laws and assess the safety and soundness of banks and holding companies. *See, e.g.,* Books & Records laws and regulations 12 U.S.C. §§ 161(a) and (c), 481, 484, and 12 CFR 5.34(e)(3) (national banks and their affiliates); 12 U.S.C. §§ 1464(v), 1467(h), and 1467a(b)(2) (savings associations and their affiliates, including holding companies); 12 U.S.C. §1817(a) (nonmember banks and insured foreign branches); 12 U.S.C. §324, 483, 1817(a)(2), 1817(a)(3), 1844(c) (state member banks and their affiliates, including holding companies); 1867 (bank service companies); 3105(c)(2) and 3108 (U.S. offices of foreign banks and U.S. operations of any affiliates of the foreign banks). Institutions are subject potentially to significant monetary penalties for failure to make available information or reports, to submit reports on a timely basis, or for submitting or publishing any false or misleading report or information. *See, e.g.,* 12 U.S.C. §§ 164, 1464(v), 1467a(r), and 1817(c)(4); 18 U.S.C. §§ 1001, 1007, 1517, and 1519. Banks and holding companies are required to file consolidated reports of condition with their primary federal supervisor on a quarterly basis (http://www.ffiec.gov/forms031.htm). With limited exceptions, the content of these reports is made publicly available on a timely basis following submission, including through the FFIEC's website. The agencies require the periodic submission of a host of additional information on banks and their affiliates. A list of required reports, along with a description of the report contents and instructions for completion, is available on the Federal Reserve's website.
Practices and Procedures	In addition to standardized collection of data through various financial and structure reports, the U.S. federal banking agencies can collect any information needed to fulfill their supervisory responsibilities. See Principles 21 and 22 for further details on information and data banks and holding companies submit to the agencies. As mentioned in the legal framework, the federal banking agencies have broad authority to review the records of banks.

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P1(4)	**Legal powers.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Criterion	The law and regulations enable the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision. The law and regulations permit the supervisor to apply qualitative judgment in safeguarding the safety and soundness of the banks within its jurisdiction.
Legal Framework	As discussed in detail under Principle 23 and EC 6 of Principle 6, statutes and regulation provide clear and broad authority to supervisors to address compliance with laws and the safety and soundness of institutions under their jurisdiction. In general, these authorities provide supervisors with discretion in determining when supervisory action is warranted and a range of proactive and

EC 1	Principle 1: Objectives, independence, powers, transparency and cooperation
	remedial measures to address matters of concern. The measures include restricting the current activities and operations of the organization, requiring new remedial activities, withholding or conditioning approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, board directors or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, revoking or recommending the revocation of the banking license, and issuing monetary fines against institutions and individuals. In general, remedial measures are imposed according to the gravity of the situation.

EC 2	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(4)	**Legal powers.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Criterion	The supervisor has full access to banks' Board, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations.
Legal Framework	As discussed in detail under Principles 19, 21, and 22, the U.S. federal banking agencies have broad statutory authority to obtain a broad array of information from supervised entities and their affiliates, including financial data and information on their activities, operations, structure, corporate governance, risk management, and any other details necessary to determine and enforce compliance with applicable laws and ensure the safety and soundness of banks. *See, e.g.,* 12 U.S.C. §§ 93a, 161(a) and (c), 324-26, 481, 483, 484, 602, 625, 1464 (d) and (v), 1467(h), and 1467a(b)(2), 1817(a), 1817(a)(2), 1817(a)(3), 1820(b), 1844(c), 1867, 3105(c) and 3108. Banks and their affiliates must provide supervisors with full and complete access to their books, records, and employees; failure to do so can result in the imposition of administrative sanctions. Specifically, bank records related to anti-money-laundering must be made available to a U.S. federal banking agency within 120 hours of a request. *See* 31 U.S.C. § 318(k)(2). These duties extend to the foreign operations of banks and their affiliates; however, note that the laws of foreign host countries may restrict U.S. banks in such countries from sharing certain information with the U.S. banking agencies. Also, the agencies have full and complete access to the workpapers, reports, and other relevant materials of external auditors responsible for conducting an external audit of the banks.

EC 3	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(4)	**Legal powers.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Criterion	When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaged in unsafe or unsound practices, the supervisor has the power to: ● take (and/or require a bank to take) prompt remedial action; and ● impose a range of sanctions (including the revocation of the banking license).

EC 3	Principle 1: Objectives, independence, powers, transparency and cooperation
Legal Framework	As noted under EC 1, above, and discussed at length under Principle 23 (on remedial powers of supervisors), the U.S. federal banking agencies have broad authority to take (or require the bank to take) remedial measures when, in their judgment, a bank or holding company is not complying with laws or regulations or is likely to be engaged or is engaged in an unsafe or unsound practice. This includes the authority to impose a range of sanctions, including, where appropriate, revocation of the banking license.
Practices and Procedures	When a bank or holding company is found to be out of compliance with laws or regulations, or is engaged in unsafe or unsound practices, the U.S. federal banking agencies may require the bank to take prompt remedial action or immediately cease and desist existing practice and may impose a varying degree of sanctions depending on the gravity of the bank's violations. For example, the agencies follow detailed prompt corrective action requirements to address inadequate levels of capital among banks under each agency's respective jurisdiction. The U.S. federal banking agencies may also take formal supervisory actions to address violations of consumer protection laws. (See Principles 6 and 23).

EC 1	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(5)	**Legal protection.** A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Criterion	The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith.
Legal Framework	The federal banking agencies and their staffs are generally protected against lawsuits for actions and/or omissions made while discharging their duties in good faith. Sovereign immunity bars lawsuits without specific statutory authorization to pursue such litigation. Common law qualified immunity protects federal banking agencies' heads and staff from liability for the violation of an individual's federal Constitutional rights in connection with employees' performance of discretionary functions, as long as the employees' conduct does not clearly violate established statutory or Constitutional rights. Lawsuits are permitted against federal banking agencies' employees for acts and/or omissions that cause injuries while acting within the scope of their employment pursuant to the Federal Tort Claims Act, 28 U.S.C. § 2679. In such a case, the United States would substitute itself as the defendant upon the Attorney General's certification that an employee was acting within the scope of his office or employment at the time of the incident giving rise to the tort claim. 28 U.S.C. § 2679(d)(2). Moreover, an exception to the act protects employees from lawsuits involving the execution of a statute or regulation or the exercise or performance or the failure to exercise or perform a discretionary function or duty, whether or not the employee abused the discretion involved. 28 U.S.C. § 2680(a).

EC 2	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(5)	**Legal protection.** A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Criterion	The supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made

EC 2	Principle 1: Objectives, independence, powers, transparency and cooperation
	while discharging their duties in good faith.
Legal Framework	*See* P1 (5) EC 1, above.
Practices and Procedures	In practice, the U.S. federal banking agencies protect their agencies' executives and staffs (during and following employment) against the costs of defending their actions and/or omissions made while discharging their duties in good faith.

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P1(6)	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Criterion	Arrangements, formal or informal, are in place for cooperation and information sharing between all domestic authorities with responsibility for the soundness of the financial system, and there is evidence that these arrangements work in practice, where necessary.
Legal Framework	Unless authorized by law, it is a crime for an employee of the U.S. federal government to divulge, disclose, or make known in any manner trade secrets or other confidential business information collected in the course of employment or official duties. *See* 18 U.S.C. § 1905. However, the U.S. federal banking agencies have broad statutory powers that allow them to share information with other banking supervisors both domestic and foreign. *See, e.g.,* 12 U.S.C §§ 1817(a)(2)(A) and (C) (sharing with FDIC, a state or federal agency with supervisory or regulatory authority over the bank or other entity, or any appropriate person) and 3412(e) (sharing of financial records, reports of examination or other information about a bank, holding company or bank or holding company subsidiary among and between the five FFIEC member agencies, the SEC, Commodity Futures Trading Commission (CFTC), and Federal Trade Commission (FTC). The importance and necessity of maintaining the confidentiality of the information is highlighted in several statutory and regulatory provisions, as is the requirement that the information be used for lawful supervisory purposes. Each of the U.S. regulatory authorities has promulgated rules and policies implementing the civil and criminal statutes relating to the treatment of confidential supervisory and bank information. *See, e.g.,* 12 CFR 4 (OCC); 261.20 et seq. (Federal Reserve); 12 CFR 309.6 (FDIC); and 12 CFR 510.5 (OTS).
Practices and Procedures	U.S banking agencies (state and federal) have in place a number of formal and informal mechanisms for information sharing, which, among other things, are an integral part of supervisory programs providing for the comprehensive consolidated supervision of banks and holding companiess. (Also see Principle 24 for a discussion of consolidated supervision.) By statute, the agencies are required to coordinate on certain matters through the FFIEC. These matters include examinations, communication protocols for emergency situations, and shared access to electronic databases containing examination reports, financial records, and other supervisory information. For example, the FFIEC's Task Force on Supervision and Task Force on Consumer Compliance promote policy coordination, consistent supervisory approaches, and uniform enforcement of laws and regulations. Specific FFIEC-related projects, and other cooperative supervisory efforts among the FFIEC agencies, are described in greater detail in the FFIEC Annual Report

EC 1	Principle 1: Objectives, independence, powers, transparency and cooperation
	(www.ffiec.gov/reports.htm). Domestically, the U.S. federal banking agencies routinely share information with each other. This typically occurs at the time of formation of a banking group, authorization of a new activity, changes in a banking group's structure, as well as during supervisory activities, in crisis situations, and as part of periodic meetings among supervisors. Examination findings are also shared between the agencies, as appropriate. The agencies refer suspected criminal violations to the law enforcement authorities. The U.S. federal banking agencies exchange information with functional regulators, such as the SEC and the CFTC, related to securities companies in a banking group or a financial conglomerate that includes a bank. The U.S. federal banking agencies have formal arrangements with state insurance supervisors to coordinate and plan supervisory activities, both on a routine and an emergency basis, with respect to particular banking groups having significant insurance operations[1]. OTS has information sharing arrangements with state insurance departments in 49 states and the District of Columbia. These agreements generally provide for the sharing of relevant supervisory and enforcement information, as well as the sharing of information related to consumer complaints. The Federal Reserve and OTS make available relevant information to other banking agencies and functional regulators regarding the financial condition, risk-management policies, and operations of a holding company that may have a material impact on an individual regulated subsidiary. The other banking agencies make information about bank subsidiaries of holding companies available to the Federal Reserve or OTS and to each other. Other functional regulators also provide information to the banking agencies concerning regulated entities within U.S. banking groups that may have an adverse effect on the banks within the group. Such sharing is an integral part of the U.S. supervisory process. The arrangements are effective in practice. Additionally, as required by section 305 of the Riegle Community Development and Regulatory Improvement Act, the federal banking agencies submit a joint report annually to the U.S. Congress describing the coordination of examinations and supervision of institutions that are subject to multiple supervisors. The basic principles governing these activities are set forth in the Interagency Policy Statement on Examination Coordination, issued in 1993. This report evidences the high priority the agencies place on working together to identify and reduce regulatory burden and on coordinating supervisory activities, not only with each other and

[1] In 2000, the OCC and the National Association of Insurance Commissioners (NAIC) agreed to a model Memorandum of Understanding that provides for the sharing of insurance-related supervisory and enforcement information and the sharing of consumer complaints. This model agreement implements the functional regulation requirements in GLBA and further increases cooperative efforts, supervisory coordination, and information sharing between the OCC and state insurance departments. As of September 2008, the OCC has executed these insurance information-sharing agreements with the insurance departments of 49 states, the District of Columbia, and Puerto Rico. U.S. federal banking agencies maintain ongoing communication with the states through periodic meetings with the National Association of Insurance Commissioners (NAIC), whose members consist of the state insurance regulators.

EC 1	Principle 1: Objectives, independence, powers, transparency and cooperation
	state bank and thrift supervisors, but also with U.S. securities and insurance regulators and foreign financial institution supervisors. Notwithstanding the coordination that takes place among the federal and state supervisors, recent market events highlighted the role that nonbank lenders and independent mortgage brokers have played in certain segments of the U.S. residential mortgage market. The federal banking agencies worked with state supervisors to encourage states to adopt and apply the agencies' supervisory guidelines on nontraditional and subprime mortgage products to state licensed mortgage brokers. Pursuant to the Housing and Economic Recovery Act of 2008, the agencies also are developing a system to register mortgage loan originators at banks with the Nationwide Mortgage Licensing System and Registry that has been developed by state regulators.

EC 2	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(6)	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Criterion	Arrangements, formal or informal, are in place, where relevant, for cooperation and information sharing with foreign financial sector supervisors of banks and banking groups of material interest to the home or host supervisor, and there is evidence that these arrangements work in practice, where necessary.
Legal Framework	The U.S. federal banking agencies have statutory and regulatory authority to share relevant supervisory information with foreign financial sector (banking and functional) supervisors of banks and banking groups of interest to the home or host supervisor. *See, e.g.*, 12 U.S.C §§ 326, 1817(a)(2)(C), 1818(v), 3109; 12 CFR 4.37(c). Under the International Banking Act provision that specifically authorizes sharing with foreign banking supervisors, the U.S. agencies must determine that disclosure is appropriate and would not prejudice the interest of the United States. 12 U.S.C. § 3109(a).
Practices and Procedures	The U.S. federal banking agencies have concluded multi- and bilateral cooperation arrangements with a number of foreign banking supervisors including those in Argentina, Australia, Brazil, Canada, Chile, China, Dubai, France, Germany, Hong Kong, Mexico, the Netherlands, Panama, Poland, Spain, Switzerland, and the United Kingdom. A number of other arrangements are in process or near completion. Additionally, federal banking agencies have exchanged letters outlining the conditions under which information could be shared on a best efforts, case-by-case basis with supervisors from Bulgaria, El Salvador, Guatemala, Jersey, Latvia, Nicaragua, Qatar, and Slovakia. These arrangements generally cover the elements set forth in the Basel Committee's paper "Essential Elements of a Statement of Cooperation Between Banking Supervisors." They are available to the public on request. The OTS also has an information sharing arrangement with the French insurance supervisor and is negotiating similar arrangements with other foreign insurance supervisors. A formal arrangement is not required, and the federal banking agencies share information on a case-by-case basis with foreign supervisors that have not entered such arrangements. The federal banking agencies routinely share information with banking and financial supervisors from other countries on an informal basis. In the experience of the federal banking agencies, the formal and informal arrangements for information sharing work in practice. See also Principle 25.

EC 3	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(6)	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Criterion	The supervisor may provide confidential information to another domestic or foreign financial sector supervisor. The supervisor is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes and will be treated as confidential by the receiving party. The supervisor receiving confidential information from other supervisors is also required to take reasonable steps to ensure that the confidential information will be used only for supervisory purposes and will be treated as confidential.
Legal Framework	As noted above, the U.S. federal banking agencies are authorized by statute and regulation to share information with domestic and foreign banking and financial supervisors. *See* 12 U.S.C. §§ 326, 1817 (a)(2)(A) and (C), 1818(v), 3109, 3412(e);12 CFR 4.37(c). In general prior to engaging in information sharing, the U.S. federal banking agencies require assurances that the information will be used only for lawful supervisory purposes and will be kept confidential. Under the International Banking Act provision that specifically authorizes sharing with foreign banking supervisors, the U.S. agencies must determine that disclosure is appropriate and would not prejudice the interest of the United States. 12 U.S.C. § 3109(a). In addition, the banking agencies must, obtain, to the extent necessary, the recipient's agreement to keep the information confidential to the "extent possible under applicable law." 12 U.S.C. § 3109(b). Each agency has implemented regulations and policies that restrict disclosure of confidential information. *See e.g.*, 12 CFR 261.20 et seq. In addition, under a recently enacted amendment to the International Banking Act, confidential material provided by a foreign supervisor to a U.S. banking agency will have broad protection from compelled onward disclosure if certain conditions are met. The information must have been obtained from the foreign supervisor through procedures used in connection with the administration and enforcement of U.S. federal banking laws or pursuant to a memorandum of understanding or similar arrangement between a federal banking agency and the foreign supervisor. In addition, the foreign supervisor must in good faith determine and make a written representation to the federal banking agency that public disclosure of the information would violate the laws applicable to the foreign supervisor. If the requirements of the statute are met, the federal banking agencies could not be compelled to disclose such information except to duly authorized committees of the Congress or to comply with an order of a court of the United States in an action commenced by the United States or the federal banking agency. 12 U.S.C. § 3109(c).
Practices and Procedures	Among examples of sharing of confidential supervisory information among domestic financial sector supervisors is a 2007 interagency pilot program to review subprime lending practices conducted at nonbank subsidiaries of supervised bank [and holding companies] institutions. Under this program, the Federal Reserve, the OTS, the FTC, and a number of state banking supervisors have shared information, resources, and supervisory analyses regarding the consumer compliance posture of the subject institutions. Information sharing letters executed with the FTC and state banking supervisors enable the Federal Reserve to exchange supervisory information with representatives of these agencies. The OCC and OTS have entered into information sharing arrangements with a number of state banking supervisors as well as state insurance regulators. The information sharing arrangements discussed in response to EC 2 above generally contain detailed provisions requiring that the information received pursuant to the agreements be used only for lawful supervisory purposes and addressing confidentiality and onward sharing of information.

EC 4	Principle 1: Objectives, independence, powers, transparency and cooperation
P1(6)	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Criterion	The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.
Legal Framework	The U.S federal banking agencies are able to deny demands for confidential information in their possession except in limited situations in which the federal banking agencies can be legally compelled to disclose otherwise confidential information. Such information may be subpoenaed by a court, a grand jury, or a committee of the U.S. Congress. If the agencies receive a subpoena from a litigant, an agency, or Congress for confidential supervisory information and decline to produce the information, the party that obtained the subpoena may go to court to enforce it. When feasible, an agency that is being compelled to provide confidential information received from another supervisor (domestic or foreign) will notify such supervisor and make reasonable efforts to resist disclosure. The federal banking agencies also must notify and provide information to U.S. law enforcement authorities if information comes to their attention that indicates a possible violation of criminal law. Disclosure may also be required under certain statutes that provide for notification and disclosure to other agencies in specific circumstances. As discussed under EC 3, subject to certain conditions, confidential information from foreign supervisors will have broad protection from compelled disclosure. 12 U.S.C. § 3109(c).

Principle 2: Permissible activities
The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

EC 1	Principle 2: Permissible activities
Criterion	The term "bank" is clearly defined in laws or regulations.
Legal Framework/ Practices and Procedures	State and federal laws expressly provide for the establishment, operation, permissible activities and transactions, and supervision of entities referred to as "banks." In general, a "bank" is an institution (a) incorporated or chartered under either state or federal law, (b) authorized to engage in activities as specified under applicable law, typically including accepting demand deposits and engaging in the business of making loans, and (c) subject to supervision by state and/or federal authorities. [1] State and federal laws also provide for the establishment of specialized institutions that engage in some activities also permitted to banks, but that generally are not called "banks". These include "savings associations," which provide "credit for homes and other goods and services." 12 U.S.C. 1464(a). They provide many of the services that banks provide and are supervised similarly.[2]

EC 2	Principle 2: Permissible activities
Criterion	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
Legal Framework/ Practices and Procedures	Federal and state banking laws and regulations provide clear parameters on permissible activities and transactions for banks. The National Bank Act, the Home Owners' Loan Act (HOLA), and implementing regulations specify the permissible activities and transactions of national banks and federal savings associations. For national banks, *see*12 U.S.C. §§ 24 (corporate powers), 92 (acting as insurance broker), and 92a (trust powers); 12 CFR 1 (investment securities activities), 2 (sales of credit life insurance), 5 (initial and expanded activities), 7 (corporate powers), 9 (fiduciary activities), 23 (leasing). For federal savings associations, *see*12 U.S.C. § 1464(b) and 12 CFR 557 (deposit taking and related powers); 12 U.S.C. § 1464(c) and 12 CFR 560 (lending and investments); 12 CFR 559.4(f)(3)(acting as insurance broker); 12 U.S.C. § 1464(n) and 12 CFR 550 (fiduciary activities); 12 CFR 560.37 (leasing).

[1] For the purposes of this principle, the nomenclature for banks and holding companies described in the introduction does not apply.

[2] Because of the similarity in the regulation and supervision of savings associations, the federal banking agencies agreed to include them in the scope of this self-assessment. This self-assessment does not address several more specialized institutions that may engage in some traditional banking activities, including industrial loan companies, trust companies, credit unions, and single purpose banks. Collectively, these specialized institutions comprise only a small percentage of the U.S. banking market.

EC 2	Principle 2: Permissible activities
	The state laws under which state banks and state savings associations are chartered and authorized to operate specify (by statute and regulation) the permissible activities of the state banks and state savings associations. Federal law provides an "overlay" to the states' authority to determine the permissible activities and transactions of state chartered banks and savings associations. *See* 12 U.S.C. §§ 321-339a and 1828; 12 CFR 208, 303 and 362 (banks); 12 U.S.C. §§ 1463(c) and 1831e (savings associations). In general, insured state chartered banks and savings associations may only engage in activities permissible for national banks and federal savings associations respectively, unless the FDIC determines that an activity poses no significant risk to the deposit insurance fund and the banks or savings associations is in compliance with certain capital requirements. *See* 12 U.S.C. §§ 335, 371-378, 1831a (banks); 12 U.S.C. § 1831e (savings associations).

EC 3	Principle 2: Permissible activities
Criterion	The use of the word "bank" and any derivations such as "banking" in a name is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.
Legal Framework/ Practices and Procedures	No entity may operate as a "bank" and engage in banking operations in the United States without a charter from a state or federal banking agency. Federal law makes it a crime for any person or entity to purport to be a bank that accepts deposits if the entity is not licensed as such by an appropriate banking agency. *See* 12 U.S.C. § 378. In addition, states generally prohibit corporations from using the word "bank" in the corporation's name unless the corporation has a bank charter. Federal law also makes it a crime for an entity that engages in banking operations to make unauthorized use of those terms (*e.g.,* "national", "Federal", "United States", "reserve", or "Deposit Insurance") that indicate the entity has a federal banking charter, membership in the Federal Reserve, or federal deposit insurance.

EC 4	Principle 2: Permissible activities
Criterion	The taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks.
Legal Framework/ Practices and Procedures	All persons or entities engaged in demand deposit-taking are required to be subject to some degree of regulation, supervision, or oversight by state or federal authorities. <u>*See*</u> 12 U.S.C. § 378. Persons violating this requirement are subject to criminal penalties, including fines and imprisonment. In practice, most entities engaged in retail deposit-taking are licensed and subject to supervision as banks or savings associations.

EC 5	Principle 2: Permissible activities

EC 5	Principle 2: Permissible activities
Criterion	The supervisory or licensing authority publishes, and keeps current, a list of licensed banks and branches of foreign banks operating within its jurisdiction.
Legal Framework/ Practices and Procedures	Collectively (through the FFIEC) and separately, the U.S. federal banking agencies publish and regularly update information on banks and holding companies (domestic and foreign) subject to their jurisdiction. Data accessible through the FFIEC's National Information Center (NIC) includes detailed financial information (including detailed information on capital ratios) on all banks, savings associations, bank holding companies, and savings and loan holding companies, on consolidated and deconsolidated bases; organizational charts for banks and bank holding companies, detailing all of their direct and indirect bank and nonbank subsidiaries; U.S. offices and bank subsidiaries of foreign banks; foreign branches and direct and indirect foreign bank and nonbank subsidiaries and Edge and agreement holdings of U.S. banks; limited historical structural data; and functionality and data for conducting peer analyses for individual banks and holding companies. The financial information is populated by data obtained from regulatory reports (primarily, the Call Report and Thrift Financial Report) that are filed by banks and holding companies with the appropriate agencies quarterly and/or annually. The organizational structure data generally is updated on an event-generated basis. The website for each federal banking agency includes a link to the NIC website. Additional relevant data is published directly by the individual agencies. See, e.g., Annual Report of National Bank Operating Subsidiaries that do Business Directly with Consumers on OCC's website.[3]

[3] www.occ.gov/consumer/OperatingSubsidiaries.pdf

Principle 3: Licensing criteria
The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

EC 1	Principle 3: Licensing criteria
Criterion	The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisory authority are not the same, the supervisor has the right to have its views considered on each specific application. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed institution.
Legal Framework/ Practices and Procedures	Banks, whether organized under federal or state law, are regulated and supervised by their licensing authority. They also typically are subject to concurrent regulation and supervision by one or more additional banking agencies. Establishing a de novo bank often involves obtaining related authorizations (i.e., for a license, federal deposit insurance, membership in the Federal Reserve) from more than one agency. Under well-established practices and procedures, the licensing and other banking authorities communicate and coordinate actions with respect to supervised entities. *See* Principle 1(6) for further information on information-sharing arrangements. This extends to decisions taken on related applications for licensing, deposit insurance, and Federal Reserve membership. Consultations among the U.S. federal banking agencies are required by law (statute or regulation) in some instances, and statutory provisions authorize the sharing of relevant confidential information among supervisors. Often, the licensing authorities and the FDIC will conduct joint investigations on related licensing and deposit insurance applications.

EC 2	Principle 3: Licensing criteria
Criterion	The licensing authority has the power to set criteria for licensing banks. These may be based on criteria set in laws or regulations.
Legal Framework/ Practices and Procedures	The authority to license banks is conferred by statute, and the criteria to be considered are set forth in statutes and/or regulations. The authority for licensing national banks is conferred on the OCC by statute, *see* 12 U.S.C. § 21 et seq. while the criteria to be considered and procedures to be followed are set forth in regulations issued by the OCC, *see* 12 CFR 5.20. By statute, the OTS is authorized to license federal savings associations and must make certain findings in order to approve a licensing application. *See* 12 U.S.C. § 1464(e). Procedures and additional factors to be considered in licensing are prescribed by OTS regulations. *See* 12 CFR 516 (general application procedures); Id. § 552 (criteria for establishing a de novo federal savings association). In addition, each of the states has the authority to license banks headquartered and operating within its jurisdiction.

EC 2	Principle 3: Licensing criteria
	Typically, the OCC, the OTS, and the states condition licensing approvals on the receipt of deposit insurance coverage by de novo banks. The factors to be considered by the FDIC in authorizing deposit insurance coverage are established by statute, 12 U.S.C. § 1816. The application and authorization procedures are set forth in FDIC regulation, *see* 12 CFR 303, subpart B.

EC 3	Principle 3: Licensing criteria
Criterion	The criteria for issuing licenses are consistent with those applied in ongoing supervision.
Legal Framework/ Practices and Procedures	Although not expressly required by statute, the criteria for issuing licenses are generally consistent with those applied in ongoing supervision. For example, in evaluating an application for approval to establish a national bank, OCC considers whether the proposed bank: (a) has organizers who are familiar with national banking laws and regulations; (b) has competent management that has ability and experience relevant to the type of products and services to be provided, and the scope and size of the projected risks; (c) has capitalization, access to liquidity, and risk-management systems that are sufficient to support the projected volume and type of business; (d) can reasonably be expected to achieve and maintain profitability; and (e) will operate in a safe and sound manner. *See* 12 CFR 5.20(f)(2). The OCC also considers other factors, including the convenience and needs of the community to be served, the risk to the deposit insurance fund, and whether the proposed bank's corporate powers are consistent with the purposes of the FDI Act and the National Bank Act. The U.S. federal banking agencies evaluate these same factors and others, sometimes in much greater detail, in the course of ongoing supervision.

EC 4	Principle 3: Licensing criteria
Criterion	The licensing authority has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate.
Legal Framework/ Practices and Procedures	Authority to establish and operate a bank is a privilege, not a right. Accordingly, each licensing agency has the authority to deny an application if the agency determines that the applicants have not met the established criteria or if the information provided is inadequate. Merely presenting evidence of compliance with each of the qualifying criteria is not sufficient for approval. The licensing agencies must evaluate the evidence and, in this respect, may conduct investigations and exercise independent judgment based on all of the information presented and collected in determining whether the qualifying criteria are adequately met in particular circumstances.

EC 5	Principle 3: Licensing criteria
Criterion	The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.

EC 5	Principle 3: Licensing criteria
Legal Framework/ Practices and Procedures	Developing a complete understanding of the proposed legal, managerial, operational, and ownership structures of a bank, on both a solo and consolidated basis, is an essential component of the licensing process. Each banking agency is responsible for protecting the safety and soundness of banks. In order to fulfill this responsibility agencies must have a clear understanding of proposed internal operating and external ownership (including group) structures and be able to assess (at authorization and during ongoing supervision) the impact that those structures may have on the integrity of an bank. *See* "Joint Agency Statement on Parallel-Owned Banking Organizations" (April 23, 2002) (emphasizing the importance of structural assessments to safety-and-soundness evaluations). If impediments exist or arise, the agencies may take appropriate remedial measures, including denying or terminating a bank's license, deposit insurance coverage, or Federal Reserve membership.

EC 6	Principle 3: Licensing criteria
Criterion	The licensing authority identifies and determines the suitability of major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure and the sources of initial capital.
Legal Framework/ Practices and Procedures	As part of the licensing process, applicants are required to identify prospective shareholders and key policymakers, including ultimate beneficial owners. Each prospective principal shareholder (generally, those owning or controlling 10 percent or more of a class of a bank's shares) and key policymakers who are not considered "known to banking" of a bank or holding company subject to federal supervision must complete fingerprint cards and an "Interagency Biographical and Financial Report," detailing information on their current and past work experiences and financial holdings. The appropriate agency conducts a background check and/or field investigation for information on criminal convictions, financial capacity, and expertise in the financial industry. *See,e.g.,* OCC PPM 5400-9, "Bank Supervision: De Novo and Converted Banks."[1] Assessments regarding principal shareholders primarily consider whether they have the ability to provide financial support to the proposed bank. A necessary part of this evaluation is identifying the sources of initial capital and ensuring transparency of ownership structures.

EC 7	Principle 3: Licensing criteria
Criterion	A minimum initial capital amount is stipulated for all banks.
Legal Framework/ Practices and	In general, a de novo bank must have a minimum amount of initial capital. For federal savings associations, this amount is at least $2 million, net of pre-opening expenses charged to capital after the institution commences business. *See* 12 CFR 543.3(b). Although the OCC does not stipulate a minimum dollar amount, *see* 12 CFR 5.20(h)(4) (requiring sufficient net initial capital to

[1] http://occnet.occ/examinerlibrary/ppm/ppm-5400-9.pdf

EC 7	Principle 3: Licensing criteria
Procedures	support the "projected volume and type of business"), national banks are de facto subject to a $2 million net minimum by virtue of the FDIC's imposition of that requirement for all banks receiving deposit insurance coverage. *See* FDIC's "Statement of Policy on Applications for Deposit Insurance". The FDIC also expects the initial capital injection to be sufficient to provide for a tier 1 leverage capital ratio of no less than 8 percent throughout the first three years of operation, based on a realistic business plan. Banks must retain a minimum stated amount of paid in capital funds as a condition of continuing deposit insurance coverage. Prior to issuing a license and allowing a bank to commence operations, the licensing agency will ensure that the bank has the appropriate capitalization as proposed in the application and that this is available and ready to be deployed. Typically, the licensing agency will do this by verifying that the capital funds are fully available and on deposit with the institution's correspondent bank.

EC 8	Principle 3: Licensing criteria
Criterion	The licensing authority, at authorization, evaluates proposed directors and senior management as to expertise and integrity (fit and proper test), and any potential for conflicts of interest. The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.
Legal Framework/ Practices and Procedures	The licensing agencies carefully evaluate proposed directors and senior management with respect to expertise, integrity, and any potential for conflicts of interest. The agencies generally consider each individual's (a) financial institution and other business experience; (b) duties and responsibilities with respect to the proposed bank and, if applicable, holding companies and affiliates; (c) personal and professional financial responsibility; (d) reputation for honesty and integrity; and (e) familiarity with the economy, financial needs, and general character of the community in which the bank will operate. Applicants must demonstrate that each prospective director has sufficient competence, experience, and ability to direct the policies of the bank in a safe and sound manner. Officers must show their ability to perform their proposed duties successfully. In conducting their evaluations, the licensing agencies rely on diverse sources of information, including (a) statements in the application regarding qualifications and expertise and all positions and offices currently held or to be held with the bank and the bank's holding company and affiliates, if applicable; (b) organizational charts, business plans, and proposed policies and procedures in an effort to understand the role and expectations of directors and officers; (c) completed "Interagency Biographical and Financial Reports," including details on educational and professional experience and financial resources and dealings; and (d) completed fingerprint cards and background checks by law enforcement to determine if the individual has any criminal convictions and to verify financial condition and professional positions. Reviews by supervisory staff include evaluations of the bank's strategic objectives and corporate values to determine the extent to which the board of directors is actually involved in the corporate planning and budgeting processes. This review also shows how directors and officers respond to changes in the operating environment and adapt to changing dynamics. Assessments of directors and officers also are required when a bank is not in compliance with minimum capital requirements or otherwise is in troubled condition.

EC 9	Principle 3: Licensing criteria
Criterion	The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.
Legal Framework/ Practices and Procedures	As part of the licensing process, applicants are required to submit and the licensing agencies evaluate information on applicants' proposed strategic and operating plans. *See* 12 CFR 5.20(h) and 543.3(c). Applicants must show that the proposed strategic plan is viable and that the proposed management team has the ability to implement the plan successfully. The plan generally must (a) establish the bank's ability to achieve a reasonable market share; (b) show that the bank has reasonable earnings prospects and the ability to attract and maintain adequate capital; (c) demonstrate that the bank will be responsive to community needs; and (d) be supported by adequate policies, procedures, and management expertise so that the bank can be operated in a safe and sound manner. Typically, applicants must provide a documented analysis of the market environment and realistic financial projections based on reasonable assumptions related to interest rates, growth, expenses, and potential losses. To evaluate corporate governance structures, the agencies must understand the board's involvement in setting and enforcing clear lines of responsibility and accountability by reviewing organizational charts, business plans, and proposed policies and procedures. They specifically determine how a bank's board of directors will approve, oversee, and communicate the bank's strategic objectives and otherwise exercise its fiduciary responsibilities. Board members are expected to exercise the duties of loyalty and care, and this requires directors and officers to act as prudent and diligent business persons in conducting the affairs of the bank. Directors are responsible for (a) selecting, monitoring, and evaluating competent management; (b) establishing business strategies and policies; (c) monitoring and assessing the progress of business operations; (d) establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and (e) making business decisions based on fully informed and meaningful deliberation. Also in evaluating the effectiveness of corporate governance systems, the agencies consider the relationship between the proposed bank (its affiliates and holding company, if applicable) and any related parties, including directors, officers, organizers, agents, and principal shareholders. This extends to evaluating (a) potential conflicts of interest; (b) the terms and conditions of any transactions, contracts, or business relationships, and (c) the terms of compensation (including stock-based) plans. With respect to risk-management systems and policies, applicants are expected to develop appropriate written investment, loan, funds management, and liquidity policies. They also must establish an acceptable internal control structure and audit program, including policies and procedures necessary to prevent the bank from being used for criminal purposes (including money laundering

EC 9	Principle 3: Licensing criteria
	and terrorist financing) and for exercising appropriate oversight over outsourced functions. The operational structure and risk-management framework are expected to be consistent with the complexity, risk, and scope of proposed operations. [2] Plans that involve high risk lending, a special purpose market, or significant funding from sources other than core deposits, or that otherwise diverge from conventional bank-related financial services, require specific documentation as to the suitability of the proposed activities for a bank. Similarly, additional documentation is required where markets to be entered are intensely competitive or economic conditions are marginal.

EC 10	Principle 3: Licensing criteria
Criterion	The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.
Legal Framework/ Practices and Procedures	An evaluation of the inherent risks of the applicant's business model and reasonableness of the financial projections is paramount to the licensing process since a proposed de novo bank has no financial history on which to base a financial analysis. Also critical is an assessment of the adequacy of financial strength, including capital levels, to support the proposed strategic plan. The licensing agencies require estimates to be fully documented, supported, and based on established growth patterns in the applicant's specific market area. They also evaluate concentrations of funding sources for safety and soundness concerns and determine whether contingency funding plans are adequate for the bank's complexity and risk profile. With respect to asset growth projections, the agencies generally review the nature and risk profile of the asset mix, identify high-risk asset concentrations, and consider whether risk-management systems and policies sufficiently measure, identify, and control risks. Depending on the risk profile of the assets contemplated, the licensing authority may require stress tests to show that the bank can maintain required minimum capital ratios and adequate profitability under adverse market conditions. In addition, with respect to financial projections the applicant must demonstrate that the proposed bank can achieve stabilized operations and be operated profitably. The applicant must demonstrate, through realistic and supportable estimates that the earnings of the applicant will be sufficient to generate an adequate profit within a reasonable period of time (typically, three years). As previously noted, the licensing agencies assess the suitability of principal shareholders (generally defined as those owning or controlling 10 percent or more of a class of a bank's shares). This includes consideration of whether these shareholders have the ability to provide financial support to the proposed bank.

[2] Pre-opening examinations of national banks evaluate readiness to begin operations. These examinations include a review of policies, procedures, organizational structures, and corporate governance. *See* OCC PPM 5400-9, "Bank Supervision: De Novo and Converted Banks." *See* http://occnet.occ/examinerlibrary/ppm/ppm-5400-9.pdf.

EC 11	Principle 3: Licensing criteria
Criterion	In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.
Legal Framework/ Practices and Procedures	Foreign banks establishing a branch, agency, or a subsidiary bank in the U.S. must obtain approval both from the licensing authority (the OCC in the case of federal branches and national banks or the state banking authority in the case of state branches or state banks) and from the Federal Reserve. The licensing authority may, and the Federal Reserve generally must, determine that the foreign bank, and any parent foreign bank, is subject to comprehensive and consolidated supervision by its home country supervisor. The Federal Reserve and the licensing authority also assess the extent, if at all, to which home country supervisors oversee or monitor any operations between a foreign bank and any foreign nonbank parent. The adequacy of home country supervision is evaluated at authorization and as part of ongoing supervision. The Federal Reserve and the licensing authority routinely contact the home country supervisor during the application process and, in making a decision on an application, take into account whether the home country supervisor has approved (or expressed no objection) to the proposal. *See* 12 CFR § 28.12(b)(6) (OCC). A foreign entity that is not a BHC must obtain OTS approval before establishing or acquiring a subsidiary savings association in the United States. If the foreign entity is a foreign bank, the OTS must determine that the foreign bank and any foreign bank parent are subject to comprehensive and consolidated supervision by the home country supervisor. To make this determination, the OTS follows procedures similar to those of the Federal Reserve.

EC 12	Principle 3: Licensing criteria
Criterion	If the licensing, or supervisory, authority determines that the license was based on false information, the license can be revoked.
Legal Framework/ Practices and Procedures	Providing false or misleading information can provide a basis for civil, administrative, and criminal liability, and the penalties can include license revocation. *See*12 U.S.C. § 93(a); *see also* 12 U.S.C. § 327 (forfeiture of Federal Reserve membership). In filing an application to establish a de novo bank, the organizers must certify that the information contained in the application has been examined carefully and that it is true, correct, and complete as of the date submitted. They also acknowledge that any misrepresentations or omissions of material facts with respect to the application may be grounds for denial or revocation of the license. Similar representations are made on applications for federal deposit insurance coverage and for membership in the Federal Reserve.

EC 13	Principle 3: Licensing criteria
Criterion	The Board, collectively, must have a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.

EC 13	Principle 3: Licensing criteria
Legal Framework/ Practices and Procedures	In general, the licensing agencies require applicants to show that the members of a bank's board of directors have the ability to establish and operate the bank in a safe and sound manner, considering the economic and competitive environment of the market to be served. *See* 12 CFR 5.20(g)(1) and 12 CFR 543.3(d)(2). At a minimum, this standard presumes that the board of directors, collectively, has a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.

AC 1	Principle 3: Licensing criteria
Criterion	The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.
Legal Framework/ Practices and Procedures	As noted, assessments regarding principal shareholders primarily consider whether they have the ability to provide financial support to the proposed bank. In addition, a holding company that controls a bank is expected to serve as source of financial and managerial strength to its subsidiary banks. The holding company is expected to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity. The holding company also is expected to maintain financial flexibility and capital-raising capacity to obtain additional resources to assist subsidiary banks. *See* 12 CFR 225.4(a)(1).

AC 2	Principle 3: Licensing criteria
Criterion	The licensing or supervisory authority has policies and processes in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.
Legal Framework/ Practices and Procedures	The U.S. federal banking agencies monitor the progress of de novo banks in meeting business plans and strategic plans for a period of time after licensing (generally, two or three years) during annual on-site reviews. These reviews also include consideration of whether the banks have complied with any other conditions imposed as part of licensing[3]. After this period, changes in a bank's activities, if permissible under state and federal law, are subject to review during periodic safety-and-soundness examinations. In addition, de novo banks are required to give the licensing and insurance agencies prior notice of any change to the bank's business plan during the first three years of operation.

[3] In addition to annual, full scope examinations, an on-site examination of national banks is conducted within 180 days of opening to assess the bank's performance in relation to its business plan and the effectiveness of its internal controls and to test its compliance with policies. *See* OCC PPM 5400-9, "Bank Supervision: De Novo and Converted Banks (http://occnet.occ/examinerlibrary/ppm/ppm-5400-9.pdf). A national bank must receive no objection from the OCC before engaging in any significant deviation from its business plan.

Principle 4: Transfer of significant ownership
The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. (Reference documents: Basel Committee *Parallel-owned banking structures*, January 2003[1]; and *Shell banks and booking offices*, January 2003.)[2]

EC 1	Principle 4: Transfer of significant ownership
Criterion	Laws or regulations contain clear definitions of "significant" ownership and "controlling interest".
Legal Framework/ Practices and Procedures	Four federal statutes (and their implementing regulations) define significant ownership and controlling interest. They address proposed changes in ownership, control, or structure of banks. In each instance, the circumstances triggering the need for authorization are clear. The U.S. federal banking agencies have statutory authority under the Change in Bank Control Act (CIBC Act), 12 U.S.C. § 1817(j), to review and reject proposals involving significant changes in ownership or control of banks. In general, prior authorization by the appropriate federal banking agency is required for any person to acquire "control" of a bank. "Control" for this purpose is defined as "the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25 per centum or more of any class of voting securities of an insured depository institution." Id. §1817(j)(8)(B). Under limited circumstances a rebuttable presumption of control arises when a person, as a result of a proposed transaction, would own, control, or hold with the power to vote 10 percent or more of any class of voting securities. A "person" for purposes of the CIBC Act includes an individual, a group of individuals acting in concert, or certain entities (e.g. corporations, partnerships, trusts) that own shares of banks but that do not qualify as bank holding companies. The agency processing the notice is required by statute to consult with the appropriate state banking agency when the proposal involves a state chartered bank. The agencies have authority to reject proposed acquisitions based upon criteria enumerated in the CIBC Act. In general, prior authorization of the Federal Reserve is required under the Bank Holding Company Act (BHC Act), 12 U.S.C. § 1842(a), for a company that is subject to the BHC Act to directly or indirectly acquire control of a bank or BHC. "Control" for this purpose generally includes direct or indirect ownership, control, or the power to vote 25 percent or more of any class of voting securities of a bank or BHC. A rebuttable presumption of control is presented when the company, as a result of the proposed transaction, would own, control, or hold with the power to vote between 10 percent and 24.99 percent of a bank's voting shares. In addition, a presumption of control may exist at the 5 percent share level under certain circumstances. "Control" is further defined to include (a) control over the election of a majority of directors (or persons exercising similar functions); or (b) the power to exercise directly or indirectly a controlling influence over the management or policies of the bank or BHC. *See* 12 CFR 225.2(e)(1). For existing BHCs, Federal Reserve authorization is required before the BHC can acquire, directly or indirectly, 5 percent or more of any

[1] www.bis.org/publ/bcbs94.pdf
[2] www.bis.org/publ/bcbs95.pdf

EC 1	Principle 4: Transfer of significant ownership
	class of voting shares of another bank. *See* 12 U.S.C. § 1842(a)(3). The Federal Reserve generally is required to consult with the state banking agency and/or the OCC (as appropriate) in processing the request for authorization. *See* 12 U.S.C. § 1842(b)(1). By statute, the Federal Reserve cannot approve a BHC application under certain enumerated circumstances. *See* 12 U.S.C. § 1842(c) and 12 CFR 225.13. Prior authorization of the OTS is required under the Home Owners' Loan Act (HOLA), 12 U.S.C. § 1467a(e), for a company directly or indirectly to acquire control of a savings association or savings and loan holding company (SLHC). The definition of "control" under the HOLA is similar to the BHC Act definition of control. Approval criteria for SLHC applications are similar to the approval criteria for BHC Act applications, and by statute OTS cannot approve a SLHC application under certain circumstances. *See* 12 U.S.C. § 1467a(e)(2). In addition, subject to statutorily enumerated exceptions, OTS approval is required before an SLHC can acquire, directly or indirectly, more than 5 percent of a class of voting securities of another savings association or SLHC. *See* 12 U.S.C. § 1467a(e)(1)(A)(iii). Changes of control or ownership of a bank resulting from a merger transaction fall under the Bank Merger Act (BMA), 12 U.S.C. § 1828(c). The BMA requires prior approval of the appropriate U.S. federal banking agency before any bank can merge with an insured or an uninsured bank. The agency must consider the views of the U.S. Department of Justice regarding the competitive aspects of any proposed bank merger involving unaffiliated insured depository institutions. An agency may deny a merger application based upon the factors enumerated in the BMA; denial is required where the agency determines the merger would result in a monopoly. Mergers of BHCs must be approved under the BHC Act, and mergers of SLHCs must be approved under the HOLA.

EC 2	Principle 4: Transfer of significant ownership
Criterion	There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
Legal Framework/ Practices and Procedures	The implementing regulations for the CIBC Act, the BHC Act, and the HOLA set forth procedures that must be followed to effect a change in ownership (including beneficial ownership), the exercise of voting rights over a particular threshold, or control of a bank, or holding company. Submission of a prior notice under the CIBC Act is required, but the Act exempts various categories of transactions from this requirement or requires 90-days after-the-fact notice for other categories of transactions. Similarly, the Federal Reserve's and OTS's regulations provide for the filing of either an application or prior notice with respect to a company's acquisition of a bank, identify a limited set of transactions not requiring agency approval, and allow for a waiver of filing requirements under certain circumstances. *See* 12 CFR 225, subpart B, and 12 CFR 574. Prior approval requirements applicable to bank merger transactions are set forth in the BMA.

EC 3	Principle 4: Transfer of significant ownership
Criterion	The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.
Legal Framework/ Practices and Procedures	The federal banking agencies have the power to reject a proposal for a change in ownership. In general, the factors considered with respect to proposed changes in significant ownership (including beneficial ownership) or control of banks are comparable to those used in approving new banks. Common criteria include (a) the financial condition and integrity of the ownership group; (b) the competence, experience, and integrity of management; (c) the future prospects of the bank; (d) business plans for the bank, and (e) the impact of the proposal on the safety and soundness of the bank and (f) the convenience and needs of the community (ies) to be served. These same factors are considered under the BMA, the BHC Act, and the HOLA. In addition, under the CIBC Act, the BMA, the BHC Act, and the HOLA, the agencies also evaluate the competitive effects of the proposal. A request for authorization under any of these statutes may be denied on any of the grounds considered, or an agency may impose conditions on authorization limiting an acquirer's exercise of voting rights.

EC 4	Principle 4: Transfer of significant ownership
Criterion	The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership.
Legal Framework/ Practices and Procedures	The agencies obtain from banks and holding companies through annual reporting and/or on-site examinations, the names of all significant shareholders, including those that may exert a controlling influence and the identities of beneficial owners. The Federal Reserve, for example, requires the annual submission of the identities of those shareholders who own or control 5 percent or more of a class of voting shares of a bank or BHC. OTS on-site examinations will review stock ownership and report the identities of shareholders owning more than 5 percent of the outstanding stock. Controlling shareholders are monitored as part of off-site surveillance.

EC 5	Principle 4: Transfer of significant ownership
Criterion	The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.
Legal Framework/ Practices and	The agencies can and, as appropriate, do require after-the-fact requests for authorization for changes in control made without necessary notice to, or approval of, the agencies. In evaluating such requests, the agencies consider whether the failure to request authorization in the first instance was a knowing violation of the law. (Such a violation could result in the imposition of civil monetary penalties against participants and sanctions against any "institution-affiliated party" up to and including debarment.) The

EC 5	Principle 4: Transfer of significant ownership
Procedures	agencies also consider whether appropriate policies and procedures have been put in place to ensure that further violations do not occur. The agencies have the authority to deny or condition an after-the-fact request for authorization.

AC 1	Principle 4: Transfer of significant ownership
Criterion	Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder.
Legal Framework/ Practices and Procedures	The agencies expect controlling shareholders, or the bank(s) with which they are affiliated, to provide the agencies with timely notice of any material information that would impact the shareholders' continued suitability. Federal statutes provide for sanctions if an institution submits false or misleading report or information to an agency. *See, e.g.*, 12 U.S.C. § 164(a)(1)(B). A failure to disclose material information regarding a controlling shareholder when providing information to an agency could trigger these provisions. Also, federal banking agency supervisors meet with and, in that connection, generally assess the competence and integrity of officers and directors during on-site reviews. At times, these meetings and evaluations include principal shareholders. Nevertheless, these evaluations do not impact the affirmative disclosure obligation, noted above. Further, section 19 of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. § 1829, prohibits a person who has been convicted of any criminal offense involving dishonesty or a breach of trust, or money laundering, or has agreed to enter into a pre-trial diversion or similar program in connection with a prosecution for such offense, from becoming, or continuing as, an institution-affiliated party with respect to a bank or holding company; from owning or controlling, directly or indirectly, any bank; or otherwise participating, directly or indirectly, in the conduct of the affairs of any bank. Section 19(b) of the FDIA, 12 U.S.C. §1829(b), states that whoever knowingly violates the statute shall be fined not more than $1,000,000 for each day the prohibition is violated or imprisoned for not more than five years or both.

Principle 5: Major acquisitions
The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

EC 1	Principle 5: Major acquisitions
Criterion	Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval.
Legal Framework/ Practices and Procedures	Federal and state laws limit and define the types of acquisitions or investments banks may make. For banks the permissible activities and investments are set forth in the statutes discussed under Principle 2 and the agencies' implementing regulations. The agencies have established regulatory criteria for prior review of major acquisitions or investments of banks and other investors (e.g., Edge and agreement corporations). Not every investment or acquisition must be reviewed in advance by the regulatory authorities; procedural criteria have been designed to allow the banking supervisors to review acquisitions or investments that could have a significant effect on a bank's condition (e.g., mergers and acquisitions of subsidiaries). Under the Federal Reserve's Regulation K (12 CFR 211), foreign investments by member banks may be made under general consent, prior notice, or application procedures. Similarly, the FDIC's International Banking regulations (12 CFR 347), authorize state nonmember banks to make foreign investments under general consent or with prior approval after the filing of an application. The regulations set forth criteria for determining the appropriate procedure in 12 CFR 347.117, 347.118, and 347.119. Under 12 CFR 28.3, national banks acquiring an interest in an Edge or Agreement corporation, foreign bank or other foreign organization must provide notice to the OCC. With respect to federal savings associations, the OTS's Lending and Investment Regulation, 12 CFR 560, and Subordinate Organization Regulation part 559, apply to both domestic and foreign activities and investments. The Bank Holding Company Act and the Savings and Loan Holding Company Act (section 10 of the HOLA) set forth the permissible activities of BHCs and SLHCs, respectively. *See* 12 U.S.C. §§ 1843(c) and 1843(k) and 12 U.S.C. § 1467a(c). The OTS's SLHC regulation applies to both domestic and foreign activities and investments. *See* 12 CFR 584.

EC 2	Principle 5: Major acquisitions
Criterion	Laws or regulations provide criteria by which to judge individual proposals.
Legal Framework/ Practices and Procedures	Major acquisitions and business combinations are subject to approval by federal authorities. Implementing regulations specify the criteria by which individual proposals are to be judged. In some instances, these criteria also are specified by statute. Factors considered in reviewing such proposals include competitive concerns, financial and managerial resources, convenience and needs concerns, and future prospects of the affected bank (*see* 12 CFR 5.33(e)). Where acquisitions by a holding company of a bank

EC 2	Principle 5: Major acquisitions
	require agency approval, applicable statutes and regulations provide review criteria[1]. The federal banking agencies' regulations set forth preconditions for foreign activities and investments. The federal banking agencies expect that investments and foreign activities, whether conducted directly or indirectly, will be confined to activities of a banking or financial nature and those necessary to carry on such activities[2]. At all times, investors must act in accordance with high standards of banking or financial prudence, with due regard for diversification of risks, suitable liquidity, and adequacy of capital. To be eligible to make foreign investments, the investor and its parent(s) must be in compliance with applicable minimum capital adequacy standards. In order to make investments under general consent authority, the investor and any insured parent bank must have received at least a composite rating of "satisfactory" at the most recent examination.

EC 3	Principle 5: Major acquisitions
Criterion	Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of foreign branches or subsidiaries) in countries with secrecy laws or other regulations prohibiting information flows deemed necessary for adequate consolidated supervision.
Legal Framework/ Practices and Procedures	In all instances in which a notice or application is required for a proposed acquisition or investment, the agencies assess whether the acquisition or investment would expose a bank to undue risk or would hinder effective supervision. When evaluating proposals by organizations to establish foreign operations (including an office or subsidiary), the federal banking agencies require the applicants to show, and the federal banking agencies must determine, that the laws or regulations of the foreign jurisdiction would not prohibit the federal banking agencies from obtaining information needed to determine and enforce compliance with U.S. banking laws. The federal banking agencies have the authority to deny a request for authorization if they determine that they would not be able to obtain adequate information for the exercise of consolidated supervision. *See* Principles 24 and 25 for further information and 12 CFR 211.13(a)(3).

EC 4	Principle 5: Major acquisitions
Criterion	The supervisor determines that the bank has, from the outset, adequate financial and organizational resources to handle the acquisition/investment.
Legal	For those proposals requiring authorization, the federal banking agencies consider whether the bank or holding company has the

[1] In considering some types of applications, federal banking agencies are required to assess bank's record of helping to meet the credit needs of the local communities in which the bank is chartered, consistent with the safe and sound operation of the bank, and to take this record into account in the agency's evaluation of a business combination.
[2] A small number of "grandfathered" SLHCs are not subject to this limitation.

EC 4	Principle 5: Major acquisitions
Framework/ Practices and Procedures	financial and organizational resources to support the acquisition or investment. This includes, but is not limited to, an assessment of the amount and source of initial funding, the capital condition and examination ratings of the investor (and, if different, bank and holding company), the policies and procedures that would be implemented at the target (including to ensure compliance with AML/CFT requirements), and the measures that the investor/bank or holding company would use to oversee the operations of the target. For examples, see OCC's Licensing Manual: *Business Combinations Booklet*[3]; *Investment in Subsidiaries and Equities*, and sections 230 and 510 of the OTS *Applications Processing Handbook*.[4]

EC 5	Principle 5: Major acquisitions
Criterion	Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.
Legal Framework/ Practices and Procedures	Implementing regulations define the circumstances under which acquisitions or investments may be made under general consent (i.e., without prior approval of, or notice to, a federal banking agency). In general, the general consent procedures are tied to the capital levels and quality of management of the investor and its parents, if any, or otherwise are restricted by amount of the proposed investment. The Federal Reserve requires after-the-fact notification for a bank or holding company's acquisition of interests in a nonbanking company (i.e., a company that is not a BHC, bank organized under U.S. law, or foreign banking organization) that engages in activities closely related to banking. A specific reporting form (Y-10) is used for this purpose. For national banks, the OCC regulations define cases where after-the-fact notification is available for acquisition of subsidiaries. These instances involve activities which have been previously determined to be permissible activities and banks which meet standards of being well-capitalized and well-managed. Other cases require prior approval. The acquisition by a national bank of another bank by merger always requires prior approval. For examples, see OCC's Licensing Manual: *Business Combinations*. SLHCs file periodic reports with OTS and are required to disclose material investments.

EC 6	Principle 5: Major acquisitions
Criterion	The supervisor is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks.
Legal Framework/	The federal banking agencies are aware of the risks that nonbanking activities can pose to a bank and holding company. Significant nonbanking activities must be approved in advance by the federal banking agencies and the federal banking

[3] http://www.occ.gov/corpbook/group2/public/pdf/bizcombo.pdf
[4] http://www.occ.gov/corpbook/group2/public/pdf/opsubs.pdf

EC 6	Principle 5: Major acquisitions
Practices and Procedures	agencies have the authority to supervise and examine all of the bank's affiliates and subsidiaries, as well as, contract providers. See, for example, OCC's Licensing Manual*: Investment in Subsidiaries and Equities*[5]; *Federal Branches and Agencies*[6]. The Federal Reserve is responsible for approving the establishment of BHCs and their nonbank subsidiaries and examines the activities of BHCs on a consolidated basis. The OTS examines savings associations, and, on a consolidated basis, examines SLHCs and their subsidiaries. There are statutory provisions designed to protect against a bank suffering losses in transactions with affiliates *See* Principle 11 for further information. During examinations, federal supervisors review transactions between the bank and its affiliates to determine compliance with such provisions. If there are transactions that pose safety and soundness concerns for the bank, federal supervisors, as appropriate, can take actions, formal and informal, to ensure that corrective action is taken and that the bank is protected.

AC 1	Principle 5: Major acquisitions
Criterion	When a bank wishes to acquire a significant holding in a financial institution in another country, the supervisor should take into consideration the quality of supervision in that country and its own ability to exercise supervision on a consolidated basis.
Legal Framework/ Practices and Procedures	In practice, when a bank seeks to acquire a direct or indirect significant holding in a foreign financial institution, the federal banking agencies consider the quality of host country supervision and its own ability to exercise supervision on a consolidated basis. As part of this evaluation, the federal banking agencies consider whether they will be able to obtain information (directly from the supervisor and from the bank or holding company) needed to determine and enforce compliance with U.S. banking laws and exercise consolidated supervision. Particularly for those jurisdictions in which U.S. banks and holding companies do not have existing or significant operations, the federal banking agencies confirm that the bank or holding company is aware of host country laws and any restrictions that may be imposed on its operations. In all instances, the federal banking agencies inquire into the need for host country authorization, the policies and procedures to be applied at the foreign financial institution, and the measures the bank or holding company will put in place to oversee and monitor the operations of the foreign financial institution.

[5] http://www.occ.gov/corpbook/group2/public/pdf/opsubs.pdf
[6] http://occnet.occ/examinerlibrary/manual/fba.pdf

Principle 6: Capital adequacy
Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

EC 1	Principle 6: Capital adequacy
Criterion	Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. Laws, regulations or the supervisor define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.
Legal Framework	Federal statutes (1) authorize the federal banking agencies to establish minimum capital requirements for banks, and (2) require the federal banking agencies to impose two types of capital adequacy standards on banks. *See* 12 USC § 1831*o*(c), 12 USC § 3907. The Federal banking agencies also have the authority to establish minimum capital requirements for certain affiliates of banks, including BHCs. *See* 12 USC § 3907, 3909(b). Under those authorities, the federal banking agencies have adopted capital adequacy rules for banks and BHCs, which include both risk-based capital and leverage capital requirements. *See* 12 CFR 3.6, 12 CFR Part 3, appendixes A, B, and C (national banks); 12 CFR 325.3, 12 CFR Part 325, appendices A, C, and D (state nonmember banks); 12 CFR Part 208, appendixes A, B, E, and F (state member banks); 12 CFR Part 225, appendixes A, B, D, E, and G (bank holding companies); 12 CFR Part 567 (savings associations). The leverage capital requirement supplements the risk-based capital requirement and establishes a minimum ratio of a bank's or BHC's tier 1 capital to total balance-sheet assets. The leverage ratio limits the extent to which a bank or BHC is able to fund itself with debt. The federal banking agencies have implemented bifurcated risk-based capital frameworks for banks and BHCs. One risk-based capital framework (advanced approaches final rule), is mandatory for "core banking organizations" and available on a voluntary basis to other banks and BHCs. This rule is consistent with the advanced approaches of the Basel II Capital Accord developed by the Basel Committee on Banking Supervision. Core banking organizations include banks and BHCs that have $250 billion or more of total consolidated assets or $10 billion or more of on-balance-sheet foreign exposure. All other U.S. banks and BHCs[1] are subject to the general risk-based capital framework that is consistent with the Basel I Capital Accord (general risk-based capital rule). The risk-based capital rule for trading book activities is based on the market risk amendment to Basel I, adopted by the federal banking agencies in 1996 (market risk rule).[2] The federal banking agencies have also issued a proposed rule that would implement the Basel II standardized approach (standardized approach rule) with certain modifications to address U.S. markets, most notably residential mortgages. The proposal would permit banks and BHCs (other than core banking organizations subject to the advanced approaches

[1] As discussed in AC 4, the risk-based capital requirement differs for BHCs with consolidated assets of $500 million or less.

[2] The OTS did not join the other federal banking agencies in adopting the market risk rule in 1996 as it was not applicable to the trading activities levels of savings associations at that time. The OTS plans to join the other federal banking agencies in any future market risk amendment proposals due to increased trading book activities.

EC 1	Principle 6: Capital adequacy
	final rule) to choose to remain under the general risk-based capital rule or opt into the standardized approach rule as described in the proposal. However, a bank or BHC that chooses to opt in to the standardized approach rule must adopt all aspects of the proposed rule, including the operational risk capital charge and public disclosure requirements. Additionally, if one bank that is a subsidiary of a BHC decides to apply the proposed standardized approach rule, then all related banks and the parent BHC would be required to comply with the rule unless the primary federal banking supervisor of a related bank or BHC approves a request of that bank or BHC to remain under the general risk-based capital rule. *See* 73 *Fed. Reg.* 43982 (July 29, 2008). The U.S. risk-based capital rules define the components of tier 1, tier 2, and tier 3 capital and focus on those elements of capital that are available to absorb losses. Allowable capital for banks and BHCs conforms to the Basel Capital Accord standards. The methodology for calculating tier 1 and tier 2 capital is detailed in the practices and procedures section of EC1.
Practices and Procedures	Banks and BHCs are subject to tier 1 and total risk-based capital ratio requirements on a consolidated basis.[3] The minimum capital requirements for individual banks and BHCs are 4 percent tier 1 risk-based capital, 8 percent total risk-based capital, and 4 percent tier 1 leverage capital (3 percent tier 1 leverage capital is the minimum requirement for banks and BHCs rated composite 1 under their respective rating systems and for BHCs that have implemented the market risk rule). Most banks and BHCs operate with capital levels well above these minimum requirements. For the purposes of calculating the risk-based capital ratios, a bank's or BHC's total capital consists of two components: tier 1 capital (core capital elements) and tier 2 capital (supplementary capital elements). To qualify as tier 1 or tier 2 capital, the capital instruments must be unsecured, and may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. *See* section 3020 of the Federal Reserve's *Commercial Bank Examination Manual* (CBEM), the Comptroller's *Corporate Manual on Capital and Dividends* (November 2007), the FDIC's Risk Management Manual of Examination Policies (Section 2.1 – Capital) and Section 0100 of the OTS Examination Handbook for a full definition and description of tier 1 and tier 2 capital. *See also* 12 CFR Part 3, appendix A (OCC); 12 CFR Part 208, appendix A (Federal Reserve); and 12 CFR Part 225, appendix A (Federal Reserve); 12 CFR 567.5 (OTS) and 12 CFR Part 325, appendix A (FDIC). In addition to the components of tier 1 and tier 2 capital described above, tier 3 capital is used to protect against market risks. Tier 3 capital is unsecured subordinated debt that has several other characteristics that are described in the market risk rule (*see* 12 CFR Part 3 appendix B; 12 CFR Part 208, appendix E; and 12 CFR Part 225, appendix E). Federal banking supervisors review the quality and regulatory capital eligibility of more complex capital instruments. Capital elements for both banks and BHCs are reviewed on a case-by-case basis to determine their ability to absorb potential losses. In addition, the Federal Reserve issued a rule in 2005 (see 12 CFR part 225), amended in March 2009 (*see* http://www.federalreserve.gov/newsevents/press/bcreg/20090317a.htm), that tightened

[3] The OTS maintains standardized capital requirements for all savings associations. The OTS does not apply a single standardized requirement to all SLHCs, however. SLHCs are too diverse to develop a single, meaningful capital ratio requirement, since many of these companies are engaged in significant lines of business other than banking. The OTS takes a case-by-case approach that considers the overall risk profile of the entire conglomerate to ensure solvency and to assess the adequacy of capital on a consolidated basis. Generally, the OTS considers three capital measures in determining SLHC capital sufficiency: GAAP equity; tangible capital; and a measure similar to tier 1 core capital ratio for SLHCs that are primarily engaged in financial activities.

EC 1	Principle 6: Capital adequacy
	the limits on the extent to which trust preferred securities can be included in BHC regulatory capital. The OTS similarly limits trust preferred securities in SLHC capital. For the OCC, see Interpretive Letter 894 (March 10, 2000).[4] For more information regarding the qualifying components of tier 1 and tier 2 capital, review the risk-based capital rules for national banks (12 CFR Part 3, appendices A, B, and C); and the "Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure" (Capital Adequacy Guidelines; 12 CFR Part 208, appendices A and F), "Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure" (Capital Adequacy Guidelines; 12 CFR Part 225, appendices A and G), or consult section 3020, "Assessment of Capital Adequacy," in the CBEM . For the OTS, see 12 CFR 567.5 and *Examination Handbook* section 120, appendix A. For the FDIC, see 12 CFR Part 325, appendix A. In addition, all banks are required to report data quarterly on the calculation of their risk-based capital ratios on schedule RC-R of the Consolidated Reports of Condition and Income (Call Report; Forms FFIEC 031 and FFIEC 041, and TFR Schedule CCR). BHCs are required to report data quarterly on the calculation of their risk-based capital ratios on schedule HC-R of the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). These materials apply to all of the criteria in Principle 6.

EC 2	Principle 6: Capital adequacy
Criterion	At least for internationally active banks, the definition of capital, the method of calculation and the ratio required are not lower than those established in the applicable Basel requirement.
Legal Framework	As indicated, all banks and most BHCs, [5] regardless of size, are subject to risk-based capital rules consistent with one of the two Basel Capital Accords. Large, internationally active banks are subject to the advanced approaches final rule and will be required to calculate their risk-based capital ratios under that rule (72 *Fed. Reg*. 69288 (Dec. 7, 2007)). The U.S. risk-based capital requirements provide for definitions of capital, methods of calculation, and required ratios no lower than those imposed under the applicable Basel Capital Accord.
Practices and Procedures	The definition of capital, the method of calculation, and the minimum ratios required for U.S. banks and BHCs (as discussed in EC 1 above) are based on the Basel I and Basel II Capital Accords (including the market risk amendment for commercial banks). At this time, the general risk-based capital rule applies to U.S. banks and BHCs on a consolidated basis (with the exception of capital requirements for market risk, which, as discussed below, only apply to certain large, complex, commercial banks and BHCs). For a description of the general risk-based capital requirements, *see* 12 CFR Part 3, appendix A (national banks); 12 CFR Part 208, appendix A (state member banks); 12 CFR Part 225, appendix A (BHCs); 12 CFR Part 325, appendix A (state nonmember banks); and 12 CFR Part 567 (savings associations). Federal banking supervisors expect certain large, complex banks and BHCs to create internal processes to account for market risks

[4] www.occ.gov/interp/oct00/int894.pdf

[5] *See* AC 4 regarding BHCs with consolidated assets of $500 million or less.

EC 2	Principle 6: Capital adequacy
	(consistent with the 1996 market risk amendment). The market risk rule applies to any commercial bank or BHC with trading activity (on a worldwide consolidated basis) equal to 10 percent or more of its total assets, or $1 billion or more. On a case-by-case basis, the federal banking agencies may require a bank or BHC that does not meet the applicability criteria to comply with the market risk rule if deemed necessary for safety-and-soundness reasons (*see* AC 5), or may exclude a bank or BHC that meets the applicability criteria if its recent or current exposure is not reflective of the level of its ongoing trading activity. A bank or BHC that does not meet the applicability criteria may, subject to supervisory approval, comply voluntarily with the market risk rule. In addition to the general risk-based capital rule currently applied to U.S. commercial banks and BHCs, the federal banking agencies have adopted the advanced approaches final rule and are currently in the process of implementing this rule. The advanced approaches final rule applies all three pillars of the advanced Basel II approaches on a mandatory basis to banks with consolidated assets of at least $250 billion or consolidated on-balance-sheet foreign exposures of $10 billion or more. Banks and BHCs subject to the advanced approaches final rule also remain subject to the market risk rule, where applicable. Any other bank or BHC may opt in to the advanced approaches final rule, provided it meets all minimum qualifying criteria. While the advanced approaches final rule went into effect on April 1, 2008, mandatory banks were expected to submit a bank- or BHC-specific implementation plan within six months, and generally must begin a parallel run of the advanced approaches final rule and the general risk-based capital rule no later than April 1, 2010. 72 *Fed. Reg*. 69288 (Dec. 7, 2007). As more fully described in EC 6, U.S. banks also are subject to the federal banking agencies' prompt-corrective-action (PCA) requirements that establish a capital-based supervisory scheme that requires federal banking supervisors to place increasingly stringent restrictions on banks as their regulatory capital levels decline. Because of these restrictions, most U.S. banks seek to maintain capital levels at or above the "well capitalized" thresholds, which exceed the capital thresholds specified by the Basel Capital Accords. Specifically, to be "well capitalized," a bank must have a total risk-based capital ratio of 10 percent or greater; a tier 1 risk-based capital ratio of 6 percent or greater; and a leverage ratio of 5 percent or greater.

EC 3	Principle 6: Capital adequacy
Criterion	The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures.
Legal Framework	The risk-based capital rules require banks and BHCs to hold capital commensurate with the level and nature of all risks to which they are exposed. The federal banking agencies have broad statutory authority to establish minimum capital levels for a bank or BHC as an agency, at its discretion, deems necessary or appropriate in light of the particular circumstances. 12 USC §§ 3907(a)(2), 3909. Under the risk-based capital rules, the federal banking agencies have authority to impose specific capital charges on one or more exposures if the applicable capital charge under the rules is not appropriate for the exposures. *See* 12 CFR 3.10 (OCC); 12 CFR Parts 208 and 225, appendix A, § IV, 12 CFR Part 208, appendix F, section 1(c), 12 CFR Part 225, appendix G, section 1(c) (Federal Reserve); 12 CFR 567.11 (OTS).

EC 3	Principle 6: Capital adequacy
Practices and Procedures	Under the federal banking agencies' Uniform Financial Institutions Rating System (known as CAMELS)[6], federal banking supervisors assess a bank's capital adequacy during every full-scope examination. This assessment is reflected in the Capital component of the CAMELS rating and is an important component of the overall CAMELS composite rating, which also factors into the PCA requirements for banks that are not adequately capitalized (*see* EC 6). In assessing capital adequacy, the federal banking agencies take into account, among other things, the level and severity of problem and classified assets; exposure to economic declines in capital as a result of interest rate, liquidity, funding, and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit; certain risks arising from nontraditional activities; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities. *See*, *e.g,*. OCC's *Bank Supervision*, *Community Bank Supervision* and *Large Bank Supervision* booklets of the Comptroller's Handbook series[7]; Federal Reserve CBEM and 12 CFR Part 208, appendix A; FDIC's Risk Management Manual of Examination Policies (section 2.1 – Capital)[8]; and OTS *Examination Handbook* section 120 and 12 CFR 567.3. As such, an assessment of a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratios. The federal banking agencies may require banks and BHCs to increase overall capital to be able to support the risks to which they are exposed. The RFI/C(D) rating system measures the overall performance and condition of BHCs. The "F" component of the RFI/C(D) represents the financial condition of the BHC, which is supported by four subcomponents, one of which is an assessment of the adequacy of the BHC's capital which takes into account the same factors described above for banks. *See* section 4070 of the BHCSM for a full description of the "F" component under the RFI/C(D) ratings methodology. Similarly, the OTS CORE rating system measures the overall performance and condition of SLHCs. *See* OTS CEO Memorandum 266, Changes to the Holding Company Rating System and Examination Components, attachment (72 *Fed. Reg*. 72442 (Dec. 20, 2007)) for a full description of the SLHC rating system.

EC 4	Principle 6: Capital adequacy
Criterion	The required capital ratio reflects the risk profile of individual banks. Both on-balance sheet and off-balance sheet risks are included.
Legal Framework	Consistent with the Basel Capital Accords, U.S. risk-based capital rules for banks and BHCs reflect the risk profile of individual banks and BHCs and capture both on-balance-sheet and off-balance-sheet risks. For a comprehensive list of assets and their risk-weight classes, as well as procedures for calculating the risks associated with off-balance-sheet items, see 12 CFR Part 3, appendices

[6] For rating definitions, see appendix A of OCC's *Bank Supervision Handbook*: www.occ.gov/handbook/banksup.pdf

[7] www.occ.gov/handbook/banksup.pdf; www.occ.gov/handbook/cbsh2003intro.pdf; www.occ.gov/handbook/cbsh2003appendixes.pdf; http://www.occ.gov/handbook/lbs.pdf

[8] www.fdic.gov/regulations/safety/manual.

EC 4	Principle 6: Capital adequacy
	A and B; 12 CFR Part 208, appendix A (state member banks); appendix A of 12 CFR part 325 (FDIC); and 12 CFR Part 225, appendix A (BHCs).
Practices and Procedures	The general risk-based capital rule described in EC 2 addresses the on-balance-sheet and off-balance-sheet risks of banks and BHCs by weighting assets and off-balance-sheet exposures according to their broad inherent risk levels. The advanced approaches final rule produces risk-based capital requirements for on- and off-balance-sheet items that are more risk-sensitive than those produced under the federal banking agencies' general risk-based capital rule. The advanced approaches final rule provides a detailed discussion regarding the calculation of capital requirements for particular exposures.

EC 5	Principle 6: Capital adequacy
Criterion	Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, laws and regulations in a particular jurisdiction may set higher capital adequacy standards than the applicable Basel requirement.
Legal Framework	The U.S. risk-based capital rules, like the Basel Capital Accords they implement, do not explicitly address all material risks that banks and BHCs may face, particularly in the most sophisticated and competitive financial markets. The general risk-based capital rule has built in "buffers" against these additional risks. Both the general risk-based capital rule and the advanced approaches final rule acknowledge that risk profiles are dynamic and, accordingly, the federal banking agencies expect banks and BHCs to have forward-looking capital plans. They also express the supervisory expectation that banks and BHCs will operate at all times at capital levels commensurate with the risks to which they are exposed, including those not explicitly addressed by the capital guidelines. A federal banking supervisor can impose higher capital levels if, in the supervisor's judgment, existing levels are not commensurate with the risks faced. 12 CFR 3.10 (OCC); *see also* the discussion in EC 3. In addition to the risk-based capital requirements, the federal banking agencies also review a bank's or BHC's tier 1 leverage ratio (tier 1 capital divided by average total consolidated assets) when assessing its capital adequacy. The principal objective of this measure (which is used as a supplement to the risk-based capital measure) is to place a constraint on the maximum degree to which a bank or BHC can leverage its equity capital base. Federal banking supervisors generally expect and require banks and BHCs to operate at capital levels well above the required minimums (12 CFR Part 3, appendix A (OCC); 12 CFR Parts 208 and 225, appendix A (Federal Reserve) 12 CFR part 325, appendix A (FDIC)). Finally, as described above, while the minimum regulatory capital ratios are set forth in EC 1 above, the United States has established PCA requirements, including the tier 1 leverage ratio, which generally result in higher *de facto* capital adequacy requirements because there are disincentives for banks to fall below the "well capitalized" category. In addition, as a result of the Gramm-Leach-Bliley Act, Pub. L. 106-102, BHCs that have elected to be financial holding companies (FHCs) have the incentive to ensure their bank subsidiaries or affiliates remain well-capitalized so they can retain their FHC status in order to establish and retain

EC 5	Principle 6: Capital adequacy
	certain non-banking financial subsidiaries and merchant banking investments. PCA requirements are discussed in more detail below in EC 6.
Practices and Procedures	*See* Legal Framework.

EC 6	Principle 6: Capital adequacy
Criterion	Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.
Legal Framework	The federal banking agencies have clear statutory authority to take a number of remedial measures in the event a bank falls out of compliance with applicable capital adequacy requirements. Under the PCA statute, 12 USC § 1831*o*, the primary federal banking agency for a bank may take a range of mandatory and discretionary actions if that institution's capital falls below the required minimum level for any relevant capital measure. The severity of the supervisory action depends on the severity of the capital shortfall. Well-capitalized banks are not subject to any specific regulatory restrictions. However, a bank may not make any capital distributions or pay management fees if either would leave the bank undercapitalized. If a bank does not meet the definition of "well capitalized" it can be classified into one of four capital categories: adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. *See* 12 CFR 6.4 (OCC); 12 CFR 208.43 (Federal Reserve); 12 CFR 565.4 12 CFR 325.103 (FDIC); 12 CFR 565.4 (OTS). An adequately capitalized bank may not pay a rate of interest on deposits that is more than 75 basis points over the average rate for that type of deposit in the market in which the deposit is offered. An adequately capitalized bank must also apply for and receive a waiver from the FDIC before it can accept, renew, or rollover brokered deposits. *See* 12 USC § 1831f (a). In addition, for adequately capitalized banks, federal banking supervisors may take discretionary actions enumerated for undercapitalized banks. *See* 12 USC § 1831*o*(g). If a bank is "undercapitalized," it must, by a certain deadline, submit a capital restoration plan for the primary federal banking supervisor's approval. A holding company that controls the bank must guarantee that the bank will comply with the plan in an amount up to 5 percent of the bank's total assets at the time the institution became undercapitalized. 12 USC § 1831*o*(e)(2)(E). Until such time as the primary federal banking supervisor approves the plan, the bank's asset growth and new lines of business generally are restricted. The federal banking supervisor may also take other discretionary actions (e.g., require recapitalization; direct improvements in management; and restrict transactions with affiliates, interest rates offered, asset growth, and activities). *See* 12 USC § 1831*o*(e). If a bank is "significantly undercapitalized," or is undercapitalized but fails to submit or implement an acceptable capital restoration plan, some of the discretionary actions discussed above become mandatory. In addition, the federal banking supervisor may require the bank to dismiss officers or directors, divest itself of a risky subsidiary, or be divested by a BHC under certain circumstances. Also, the federal banking supervisor must approve certain compensation before it can be paid to senior executive officers of the

EC 6	Principle 6: Capital adequacy
	bank. *See* 12 USC § 1831*o*(f). If a bank is "critically undercapitalized," the FDIC generally will restrict the activities of the bank and, at a minimum, the bank must receive the FDIC's approval to engage in certain material transactions. The primary federal banking agency may be required to appoint a receiver or conservator. 12 USC § 1831*o*(h). A comprehensive list of provisions for adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized banks is available in section 4133.1 of the CBEM and OCC Banking Circular 268[9]. The federal banking agencies have the same PCA requirements as required under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and section 38 of the Federal Deposit Insurance Act (12 USC 1831*o*). *See* 12 CFR Part 6 (OCC); 12 CFR 208.43 (Federal Reserve); and 12 CFR 565.4, 565.5 (OTS) In addition to being subject to PCA requirements, a bank that fails to meet required capital minimums may become subject to a capital directive under 12 USC § 3907(b)(2). Directives are enforceable in the same manner and to the same extent as an effective and outstanding cease and desist order that has become final under 12 USC § 1818(k). Violation of a directive may result in an assessment of civil money penalties in accordance with 12 USC § 3909(d). A directive can be issued in addition to or in lieu of any other action permitted under law. Other possible remedial measures include an enforcement action, assessment of civil monetary penalties, and/or denial, conditioning, or revocation of corporate applications. A failure to achieve or maintain minimum capital levels also can be the basis for termination of FDIC insurance. *See* 12 USC § 1818(a)(8), 12 CFR 325.412. While not subject to PCA requirements, BHCs that do not meet the minimum risk-based requirement, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve for achieving adequate levels of capital within a reasonable period of time (see 12 CFR 225, Appendix A). In addition, the Federal Reserve's authority to issue capital directives for failing to maintain sufficient capital also extends to BHCs. 12 USC §§ 3907(b)(2), 3909.
Practices and Procedures	The PCA requirements provide the federal banking supervisors a framework to take necessary measures should a bank become less-than-well capitalized. As noted above, the risk-based and leverage requirements to be "well capitalized" are above the federal banking agencies' regulatory minimums and those established by the Basel Capital Accords. A bank's total risk-based capital, tier 1 risk-based capital, AND leverage ratios must be at or above the regulatory minimum requirements (e.g., 12 CFR Part 3) to be considered adequately capitalized. Should any ratio fall below the minimum requirement, the bank would no longer be considered adequately capitalized. In practice, banks typically have a strong preference to remain well capitalized, as falling below this threshold results in certain restrictions on activities (e.g., inability to accept or roll over brokered deposits). The minimum ratio requirements for each level of capitalization under the PCA requirements may be found in 12 CFR 6.4 (OCC); 12 CFR 208.43 (Federal Reserve); and 12 CFR 565.5 (OTS).

[9] www.occ.gov/ftp/bc/bc-268.doc

EC 6	Principle 6: Capital adequacy
	Examples of prompt corrective actions, capital directives, and other formal enforcement actions that include capital measures are available for review on each agency's website. An example includes the OCC's 2009 determination that a bank needs to achieve and maintain higher capital minimums (e.g. 9 percent leverage and 12 percent tier 1 risk-based capital) and must submit a specific plan for the maintenance of adequate capital.

EC 7	Principle 6: Capital adequacy
Criterion	Where the supervisor permits banks to use internal assessments of risk as inputs to the calculation of regulatory capital, such assessments must adhere to rigorous qualifying standards and be subject to the approval of the supervisor. If banks do not continue to meet these qualifying standards on an ongoing basis, the supervisor may revoke its approval of the internal assessments.
Legal Framework	Under the advanced Basel II-based capital framework, subject banks and BHCs will be required to use internally generated assessments of credit and operational risk as the basis for their regulatory capital requirements. Banks and BHCs subject to the Basel II advanced approaches must meet rigorous qualifying standards – on an initial and ongoing basis – for reliance on internal assessments of risk as inputs to capital calculations. *See* 12 CFR Part 3, appendix C, part III (OCC); 12 CFR Part 208, appendix F, part III and 12 CFR Part 225, appendix G, part III (FRB); 12 CFR part 325, appendix D, part III (FDIC); 12 CFR Part 567, appendix C (OTS). The U.S. Basel II advanced capital rule specifically requires banks and BHCs to meet qualifying standards on an ongoing basis. *See*12 CFR 3, appendix C, section 23 (OCC); 12 CFR 208, appendix F, part III, § 23; 12 CFR 225, appendix G, part III, § 23; 12 CFR 325, appendix D, section 23 (FDIC); 12 CFR 567 appendix C part 23 (OTS). Should the bank or BHC fail to meet these standards on an ongoing basis, the supervisor will require the bank or BHC to improve all deficient models and risk management practices. A bank and holding company is required to notify its primary federal banking supervisor when it makes any change to an advanced system that would result in a material change to the risk-weighted amount of an exposure type, or when the bank or holding company makes any significant change to its modeling assumptions. The federal banking supervisor will notify the bank or holding company in writing of any failure to comply. The bank or holding company must develop and submit a plan for returning to compliance. Use of the advanced approaches framework is subject to rigorous qualifying criteria that must be met on an initial and ongoing basis. If the federal banking supervisor determines that a bank or BHC's risk-based capital requirements are not commensurate with credit, market, operational, or other risks, the supervisor may require the bank or BHC to calculate its risk-based requirements under the advanced approaches final rule with any modifications established by the supervisor or under the general risk-based capital rule. In addition, a bank or BHC applying the market risk rule (discussed above in EC 2) must have its internal model and risk-management procedures evaluated by its primary federal banking supervisor to ensure compliance with the market risk rule's qualifying standards. These rigorous standards are discussed in section 3020 of the CBEM. National banks are expected to comply

EC 7	Principle 6: Capital adequacy
	with OCC Bulletin 2000-16, Model Validation Standards.[10] While the general risk-based capital rule does not, by and large, allow use of bank or BHC internal estimates, there is an exception allowing a bank or BHC to use an internal risk-rating approach for certain exposures to asset-backed commercial paper programs. Even so, there are strict requirements for use of such estimates. *See* 12 CFR Part 3, appendix A, section 4(g)(1) (OCC); and 12 CFR Parts 208 and 225, appendix A, § III.B.3. (Federal Reserve); and 12 CFR 567.6(a)(3) (OTS).
Practices and Procedures	See Legal Framework.

AC 1	Principle 6: Capital adequacy
Criterion	For non-internationally active banks, the definition of capital, the method of calculation and the capital required are broadly consistent with the principles of applicable Basel requirements relevant to internationally active banks.
Legal Framework	All banks and BHCs are subject to one of the two risk-based capital frameworks adopted by the federal banking agencies. As discussed above, these respectively implement (and are broadly consistent with) Basel I and the advanced approaches of Basel II in all material respects. The definition of capital in both the general risk-based capital rule and the advanced approaches final rule are broadly consistent with Basel II requirements. As noted above, as a general matter, large, internationally active banks and BHCs are obligated to use the advanced approaches framework, while other banks and BHCs have the option to use the advanced approaches framework rule or the general risk-based capital framework. The market risk rule is mandatory for commercial banks and BHCs that have significant trading activities as described in EC 2. (See 12 CFR Part 3, Appendix A, § 2 (national banks); 12 CFR Part 208, Appendix A, § II (state member banks); 12 CFR Part 225, Appendix A, § II (bank holding companies); 12 CFR Part 325, Appendix A, § I (state nonmember banks); and 12 CFR 567.5 (savings associations).
Practices and Procedures	See Legal Framework.

AC 2	Principle 6: Capital adequacy
Criterion	For non-internationally active banks and their holding companies, capital adequacy ratios are calculated and applied in a manner generally consistent with the applicable Basel requirement, as set forth in the footnote to the Principle.
Legal	For banks and their holding companies, capital is assessed on a fully consolidated basis. Bank and BHC capital ratios are calculated

[10] www.occ.gov/ftp/bulletin/2000-16.doc

AC 2	Principle 6: Capital adequacy
Framework	and applied in a manner consistent with Basel Capital Accord requirements and are consolidated for the bank and BHC. *See* EC 2. By using consolidated group accounts, measuring group capital excludes intra-group holdings, multiple gearing, and excessive leveraging.
Practices and Procedures	See Legal Framework.

AC 3	Principle 6: Capital adequacy
Criterion	The supervisor has the power to require banks to adopt a forward-looking approach to capital management and set capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect.
Legal Framework	The federal banking agencies have the power to require corrective action if, in their judgment, a bank's current or prospective capital plan is inadequate and causes it to be in an unsafe or unsound condition. *See,* for example, 12 CFR 3.10 and the provisions for capital plans under PCA, 12 CFR 6.5.
Practices and Procedures	The federal banking agencies expect banks and holding companies to assess their current capital adequacy and future capital needs in a systematic and comprehensive manner in light of their risk profiles and business plans. This requires a forward-looking approach to capital management in which capital levels are set in anticipation of possible changes in events or changes in market conditions that could have an adverse effect. Federal banking supervisors evaluate the adequacy of bank and BHC strategic and capital plans. Federal banking supervisors evaluate internal capital management processes to assess whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the bank or holding company's capital needs (independent of the bank or BHC's risk-based regulatory capital requirements). Banks and holding companies must consider and incorporate internal processes to address risk factors that affect the capital condition, such as overall credit risk exposure; interest-rate exposure; liquidity, funding, and market risks; earnings; investment or loan portfolio concentrations; the effectiveness of loan and investment policies; the quality of assets; and management's ability to monitor and control financial and operational risks. *See* 72 *Fed. Reg*. 1372 (January 11, 2007) (Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities) (OCC); SR letter 99-18, *Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles*; OCC's *Community Bank Supervision* and *Large Bank Supervision* booklets of the Comptroller's Handbook series; FDIC's Risk Manual Management Manual of Examination Policies (Section 2.1 – Capital) and the OTS's *Examination Handbook* and *Holding Companies Handbook.*[11] In addition, the federal banking agencies have developed supervisory guidance that addresses concentrations in high-risk exposure areas such as subprime lending and commercial real estate. *See*, for example, Federal Reserve's SR letter 07-12 and SR letter 07-01; 71 *Fed. Reg*. 74580 (December 12, 2006), and the OCC, Federal Reserve, and

[11] www.occ.gov/handbook/cbsh2003intro.pdf; www.occ.gov/handbook/cbsh2003appendixes.pdf; www.occ.gov/handbook/lbs.pdf

AC 3	Principle 6: Capital adequacy
	FDIC's Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices and OCC Bulletins 2007-26 and 2006-46[12]. In their implementation of the Basel II framework, the federal banking agencies have continued their longstanding emphasis, through Pillar 2, on the need for banks and holding companies to conduct an internal assessment of capital adequacy over and above minimum regulatory capital requirements. Beyond the requirement in the advanced approaches final rule, the federal banking agencies have issued guidance for Pillar 2 containing standards for bank and BHC internal capital adequacy assessment process. *See* 73 *Fed. Reg*. 44620 (July 31, 2008).

AC 4	Principle 6: Capital adequacy
Criterion	The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks.
Legal Framework	If a federal banking supervisor believes a bank or BHC is operating in an unsafe or unsound manner, after taking into account affiliate capital adequacy, the supervisor can require it to hold more capital.
Practices and Procedures	The capital adequacy of BHCs is assessed on a top-tier, fully consolidated basis. Capital ratios also are assessed on a consolidated basis at the subsidiary bank level. The federal banking agencies expect the distribution of capital among entities within a banking group to reflect the risks presented by those entities. In addition, each functionally regulated subsidiary is subject to its functional regulator's capital requirements, and those requirements take into account sector-specific risks. (For example, insurance liability risk is incorporated into the insurance risk-based capital regime.) Other subsidiaries also are expected to maintain appropriate levels of capital that are, if applicable, consistent with the expectations of federal banking supervisors with oversight responsibilities. For BHCs in which there is a significant nonbank presence, capital adequacy is analyzed with particular emphasis on the threat that current or potential issues present to any affiliated bank. • While differing slightly, capital guidelines apply to both banks and BHCs on a consolidated basis and are consistent with Basel Capital Accord requirements. The risk-based capital rules apply to any BHC with consolidated assets of $500 million or more. The risk-based capital rules also apply on a consolidated basis to any BHC with consolidated assets of less than $500 million if the BHC meets additional criteria outlined in section 4060.3 of the *Bank Holding Company Supervision Manual*. BHCs with consolidated assets of less than $500 million are generally exempt from the calculation and analysis of risk-based capital ratios on a consolidated holding company basis, subject to certain terms and restrictions. In addition, the Federal Reserve may apply the risk-based capital rules at its discretion to any BHC, regardless of asset size, if such action is warranted for supervisory purposes.

[12] www.occ.gov/ftp/bulletin/2007-26.html; www.occ.gov/fr/fedregister/72fr37569.pdf; www.occ.gov/ftp/bulletin/2006-46.html; www.occ.gov/fr/fedregister/71fr74580.pdf

AC 4	Principle 6: Capital adequacy
	• SLHC capital is closely reviewed on a case-by-case basis through the CORE holding company examination components and ongoing monitoring by OTS supervision staff. The adequacy of a SLHC's capital is determined in relation to its unique organizational structure and risk profile. SLHCs are not subject to an explicit uniform minimum regulatory capital requirement. The OTS approach to evaluating capital of SLHCs is outlined in section 300 of the *Holding Companies Handbook.*

AC 5	Principle 6: Capital adequacy
Criterion	The supervisor may require an individual bank or banking group to maintain capital above the minimum to ensure that individual banks or banking groups are operating with the appropriate level of capital.
Legal Framework	The federal banking agencies have the statutory authority to establish and enforce minimum capital levels for individual banks, BHCs, and SLHCs as determined, at the federal banking agencies' discretion, to be necessary or appropriate for those banks, BHCs, or SLHCs in light of their particular circumstances. 12 USC §§ 3907(a)(2), 3909. These levels generally exceed minimum regulatory capital requirements. In addition, as described above, the federal banking agencies' PCA requirements present strong incentives for banks to maintain capital levels in excess of regulatory minimums and sets forth supervisory actions that the federal banking agencies will take as a bank's capital level falls below those minimums.
Practices and Procedures	Banks and holding companies that are exposed to high or unusual levels of risk are expected to maintain sufficient capital above the minimum ratios. For example, banks and BHCs that are undertaking significant expansion are expected to maintain strong capital levels substantially above the minimum ratios. In all cases, banks and BHCs should hold capital commensurate with the level and nature of the risks to which they are exposed. Banks and BHCs that do not meet the minimum risk-based standard, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the appropriate federal banking agency for achieving adequate levels of capital within a reasonable period of time. *See* 12 CFR 3.10 and 12 CFR 6.5 (OCC); the Federal Reserve's Regulation H (12 CFR Part 208) and Regulation Y (12 CFR Part 225), as well as the CBEM and the BHCSM for more information; 12 CFR 567.3 and 567.4; *Examination Handbook* sections 120 and 080 (OTS);); 12 CFR 325.104 (FDIC) and *Holding Company Handbook* section 300 (OTS). Examples where the primary federal banking supervisor has required banks and holding companies to increase their capital ratios above the regulatory minimums can be found on the federal banking agencies' websites.

Principle 7: Risk Management Process

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

(Reference document: *Enhancing corporate governance for banking organisations,* February 2006)

Overview

Taking and managing risks are fundamental to the business of banking. Accordingly, the agencies place significant supervisory emphasis on the adequacy of an institution's management of risk, including its system of internal controls. The agencies expect holding companies and banks to have in place comprehensive risk management policies and processes for identifying, evaluating, monitoring and controlling or mitigating all material risks. For banks, this expectation ultimately derives from the statutory responsibility of the agencies for the safety and soundness of institutions under their jurisdiction. See, e.g., 12 U.S.C. § 1831p-1; 12 U.S.C. § 1818(b). Authority also derives from the agencies' ability to impose minimum capital levels on individual banks and BHCs as necessary and appropriate under the circumstances. See 12 U.S.C. §§ 3907[1], 3909. These requirements are addressed in implementing safety and soundness guidelines, see 12 CFR Parts 30 (OCC), 208 (Federal Reserve), 364 (FDIC), and 570 (OTS), and capital adequacy guidelines, see 12 CFR Parts 3 (OCC), 208 and 225 (Federal Reserve), 325 (FDIC), and 567 (OTS).

Since rules and regulations cannot reasonably prescribe the specific practices each individual institution should utilize in managing its risk, agencies have issued prudential policy and guidance documents that expand upon the requirements set forth in U.S. laws and regulations, and articulate expectations for sound practices. The agencies rely extensively on these policy and guidance documents in conducting their supervisory activities. Expectations regarding risk management programs (active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls) are detailed in supervisory guidance and examination manuals issued by the agencies and discussed in further detail below. These resources emphasize that individual programs should be appropriate to the size and activities of consolidated organizations and individual institutions and that risk management activities should be sufficiently independent of the business lines. Institutions are expected to conduct regular evaluations of their risk management systems to ensure that the systems are adjusted, as appropriate, in light of new products, changing risk profiles and external market developments.

As outlined in the introduction, the Federal Reserve is responsible for the supervision of BHCs and the OTS is responsible for the supervision of SLHCs. Guidance for rating the risk management processes of domestic BHCs is provided in SR Letter 04-18, *Bank Holding Company Rating System*. Among other things, this guidance was implemented to emphasize the importance of risk management as the more forward-looking aspect of the rating system. The main components of the rating system are: Risk Management (R); Financial Condition (F); and potential Impact (I) of the parent company and non-depository subsidiaries on the subsidiary depository institutions (RFI rating). Guidance for rating the risk management processes of SLHCs is provided in the *Savings and Loan Holding Company Rating System*. The SLHC rating system is an internal rating system used by OTS to define the condition of all SLHCs in a systematic manner. The main components of the SLHC rating system are: Capital Adequacy (C); Organizational Structure

[1] The HOLA requires that safety and soundness regulations and policies that apply to savings associations must be at least as stringent as those that apply to national banks. *See* 12 U.S.C. § 1463(c). Although 12 U.S.C. § 3907 does not apply to savings associations, the HOLA requires the application of similar capital requirements to savings associations as to banks.

Principle 7: Risk Management Process

(O); Risk Management (R); and Earnings (E) (CORE rating). The RFI and CORE rating systems define composite and component ratings which are assigned based on a 1 to 5 numeric scale. A 1 indicates the highest rating, strongest performance and practices, and least degree of supervisory concern; whereas a 5 indicates the lowest rating, weakest performance, and highest degree of supervisory concern.

The agencies are responsible for the supervision of individual banks depending on charter types. Each of the agencies, however, has adopted, and adheres to, uniform guidance for rating the risk management processes of domestically chartered banks (nationally-chartered banks, state-chartered member banks, state-chartered nonmember banks, and savings associations) through the FFIEC's *Uniform Financial Institutions Rating System* (UFIRS).[2] This rating system considers both qualitative and quantitative elements, and explicitly references the quality of risk management processes in the management component and the identification of risk elements within the composite and component rating descriptions. The main components of the rating system are: Capital Adequacy (C), Asset Quality (A), Management (M), Earnings (E), Liquidity (L), and Sensitivity to Market Risk (S) (CAMELS rating).

In addition to the CAMELS rating system, the agencies utilize the *Uniform Interagency Consumer Compliance Rating System,* which outlines the rating scheme for measuring the compliance of banks with consumer protection and civil rights laws. Agency guidance for rating trust activities is provided in the *Uniform Interagency Trust Rating System*, which emphasizes the quality of risk management in assessing trust activities.[3] Finally, the *Uniform Rating System for Information Technology* provides agency guidance for rating information technology for financial institutions and data service providers. This guidance also emphasizes the quality of risk management processes in each of the rating components.[4] Each agency has also adopted, and adheres to, uniform guidance for rating the risk management processes of foreign banking organizations and their offices conducting businesses in the U.S.[5] The main components of the rating system for U.S. offices of foreign banks are: Risk Management (R), Operational Controls (O), Compliance (C), and Asset Quality (A) (ROCA rating).

As with the holding company rating systems, the CAMELS and ROCA rating systems define composite and component ratings which are assigned based on a 1 to 5 numeric scale. A 1 indicates the highest rating, strongest performance and practices, and least degree of supervisory concern; whereas a 5 indicates the lowest rating, weakest performance, and highest degree of supervisory concern.

In assessing a consolidated organization's risk management processes, the Federal Reserve and OTS rely on the work of the functional regulator to the extent possible. The assessment of the consolidated organization takes into consideration the potential impact of the holding company and nonbank subsidiaries on the subsidiary bank. Agencies also take into consideration how the risks associated with functionally-regulated entities may impact the consolidated entity and its bank affiliates. The assessment involves determining the material risks posed to the bank by functionally-regulated affiliates, and the systems in place for monitoring and controlling risks posed by those affiliates.[6]

[2] See Federal Reserve SR Letter 96-38; OTS *Examination Handbook*, Section 071; OCC *Bank Supervision Process* booklet,
[3] See Federal Reserve 98-37; OTS Transmittal No. 215; OCC *Bank Supervision Process* booklet;
[4] See Federal Reserve 99-8; OTS CEO Memorandum 105; OCC *Bank Supervision Process* booklet
[5] See Federal Reserve 00-14, *Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations*; the OCC's *Federal Branches and Agencies Supervision* and *Bank Supervision Process* Handbooks.
[6] See: OCC *Bank Supervision Process* and *Related Organizations* booklets of the Comptroller's Handbook series; See Footnotes 1 through 4.

Principle 7: Risk Management Process
Largely Compliant: Recent events have highlighted structural impediments that have resulted in too little attention to the risks across the entire holding company, including risks created by the affiliates principally involved in trading and other capital market activities. Consolidated supervisors are placing greater focus on assessing risk exposures and associated risk management practices across the entire organization to better understand the potential impact of correlated risk exposures that may reside in different legal entities or distinct business lines. For example, in October 2008, the Federal Reserve released detailed guidance on consolidated supervision which addresses risk management on a consolidated basis. Please see BCP 24 for more details. Similarly in December 2007, the OTS issued its revised SLHC Rating System to better emphasize risk management.[7] More generally, recent market events have highlighted the need for banks and holding companies to have enhanced corporate governance and controls, improved identification of material risks and transfer mechanisms, and better firm-wide risk management practices. The U.S. federal banking agencies are actively involved in various efforts underway by the Basel Committee, the Joint Forum, the Financial Stability Board, and the Senior Supervisors Group (SSG) to identify and implement actions to strengthen supervisory practices and policies for risk management processes. As part of these efforts, the agencies developed a template that is being used by the SSG to assess and benchmark globally active financial firms against the "best practices" for risk management identified in various lessons learned reports. Where the federal banking agencies find deficiencies in U.S. banks' practices, they will direct bank management to take corrective action.

EC 1	Principle 7: Risk Management Process
Criterion	Individual banks and banking groups are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. The supervisor determines that these processes are adequate for the size and nature of the activities of the bank and banking group and are periodically adjusted in the light of the changing risk profile of the bank or banking group and external market developments. If the supervisor determines that the risk management processes are inadequate, it has the power to require a bank or banking group to strengthen them.
Legal Framework	Banks and holding companies are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. Interagency safety and soundness guidelines require institutions to establish internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities. High level requirements are specified in those portions of the interagency safety and soundness guidelines addressing operational and managerial standards, *see, e.g.* 12 CFR Part 208, Appendix D-1, part II; 12 CFR Part 30, Appendix A, part II; the interagency guidelines implementing the 1996 Market Risk Amendment to Basel I (12 CFR Part 3, Appendix B, section (4)(b) (national banks), 12 CFR Part 208, Appendix E (state member banks), 12 CFR 225, Appendix E, section 4(b) (BHCs), 12 CFR 325, Appendix C, section 4(b) (state nonmember banks); and the operational risk management provisions in the interagency guidelines on the advanced Basel II approaches, *see, e.g.,* 12 CFR Part 3, Appendix C, section 22 (h) and (j) (national banks), 12 CFR Part 208, Appendix F, section 22(h) and (j) (state member banks), 12 CFR 225, Appendix G, section 22(h) and (j) (BHCs), 12 CFR 325, Appendix D, section 22(h) and (j) (state nonmember banks); and

[7] 72 FR No. 244 (December 20, 2007).

EC 1	Principle 7: Risk Management Process
	the agencies' Supervisory Guidance on the Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Accord.[8] Assessments of the quality of risk management are included as part of the evaluation of the overall organization. A banking organization's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business is considered unsafe and unsound conduct. If an agency determines that a bank fails to meet any standard established by the agency or by interagency guidelines, the agency may require the institution to submit an acceptable plan to achieve compliance. *See* 12 U.S.C. § 1831p-1(e). The agency also has the flexibility to pursue other courses of action, including enforcement actions or less formal actions, given the specific circumstances and severity of an institution's noncompliance with one or more standards. In the event that an institution fails to submit an acceptable plan within the time allowed by the agency or fails in any material respect to implement an accepted plan, the agency must, by order, require the institution to correct the deficiency. The agency may, and in some cases must, take other supervisory and/or enforcement actions, until the deficiency has been corrected.
Practices and Procedures	U.S. federal banking agencies are required to assess the management of all institutions under their jurisdiction, regardless of their size, and to assign a rating reflecting the assessment. In assessing management, risk-focused supervision places specific emphasis on the quality of risk management. Examiners consider findings relating to the following elements of a sound risk management system: active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls. An institution's policies, procedures, and limits are expected to provide for the adequate identification, measurement, monitoring, and control of the risks posed by its activities. Policies and procedures are also expected to reflect the changing risk profile of the institution by providing for the review of activities new to the institution to ensure that the infrastructures necessary to identify, monitor, and control risks associated with an activity are in place before the activity is initiated. Principles of sound risk management are expected to apply to the entire spectrum of risks facing a consolidated organization as well as individual institutions. U.S. federal banking examiners utilize a risk-focused approach to supervision, and apply flexibility when assessing the appropriateness of a banking organization's risk management processes to address the organization's circumstances and the nature, scope, and complexity of its operations. Large complex banks and holding companies are expected to have far more sophisticated and formal risk management systems in order to address their broader and typically more complex range of financial activities and to provide the board and senior management with the information needed to monitor and direct day-to-day activities. These risk management systems require frequent monitoring and testing by independent control areas and internal, as well as external, auditors to ensure the integrity of the information used in overseeing compliance with policies and limits. Large complex banks and holding companies should have risk management systems or units that are sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest. For smaller banks engaged predominantly in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, risk management systems may be less sophisticated.

[8] 73 Fed. Reg. 44620 (July 31, 2008).

EC 1	Principle 7: Risk Management Process
	The agencies maintain teams of examiners on-site at the large complex banks, and these banks are subject to a continuous risk-focused supervision program. These teams include examiners with specialized expertise in areas such as capital markets, retail and commercial lending, operations, and information technology, and they conduct ongoing risk-focused supervision based upon agency guidance (*see, e.g.,* FRB: SR Letter 97-24, *Risk-Focused Framework for Supervision of Large Complex Institutions,* as updated by SR Letter 99-15*, Risk Focused Supervision of Large Complex Banking Organizations; OCC: Large Bank Supervision booklet of Comptroller's Handbook* and various topical handbooks on specific risk areas and controls, including *Risk Management of Financial Derivatives; Retail Lending, Liquidity Risk, Internal Controls, Leveraged Lending, Rating Credit Risk, and Related Organizations).* Specific risks such as BSA/AML are addressed under their specific Principle. The agencies' supervisory programs emphasize the need to maintain a current assessment of the organization's risk profile which reflects external market developments and other environmental factors which have the potential for swift and dramatic changes in the risk profiles of large complex banks and holding companies. The agencies use similar risk-based supervision for smaller (community) banks. Assessments of these firms are generally made through both periodic on-site examinations that are supplemented with off-site monitoring. *See*, for example, SR Letter 97-25, *Risk Focused Framework for the Supervision of Community Banks* and the OCC's *Community Bank Supervision* Booklet. As with their supervisory programs for large institutions, the agencies' supervisory programs for smaller organizations assess management's ability to identify, measure, monitor and control risks. The risk management processes of BHCs are assessed in accordance with the guidance set forth in SR Letter 95-51, *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies*, the *Bank Holding Company Supervision Manual* (BHCSM), the *Commercial Bank Examination Manual* (CBEM), the *Trading and Capital-Markets Activities Manual* (Trading Manual), and various other guidance documents. The risk management processes of SLHCs are assessed in accordance with the OTS *Holding Companies Handbook*, Sections 400 and 500. The risk management processes of foreign banking organizations (FBOs) are assessed in accordance with guidance set forth in SR Letter 00-14, *Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations* (Federal Reserve) and the OCC's *Federal Branches and Agencies Supervision* Handbook. This program emphasizes coordination and cooperation among home and host country regulators, an assessment of the strength of support provided by the FBO, and a risk-focused approach to examinations. As described in BCP 24, the Federal Reserve conducts consolidated supervision based upon the guidance outlined in FRB SR Letter 08-9/CA Letter 08-12, *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations*. This guidance specifies principal areas of focus for consolidated supervision activities and provides for consistent supervisory practices and assessments across organizations with similar activities and risks. The OTS completes a risk matrix for its most complex SLHCs, which are subject to continuous supervision. The matrix outlines primary activities for which the level and direction (increasing or decreasing) of each type of risk is assessed to reach an enterprise wide assessment of the SLHC's inherent risk and risk mitigation practices. *See* Section 200, Appendix B, of the OTS *Holding Companies Handbook*. Similar to the FRB and OTS, the OCC uses a risk assessment system (RAS) to consistently evaluate the risk profiles of nationally-

EC 1	Principle 7: Risk Management Process
	chartered banks across nine categories of risks. These assessments consider the bank's quantity of risk, quality of risk management and direction of the bank's risk exposures. See OCC's *Bank Supervision Process* Handbook. A bank's or holding company's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business is considered unsafe and unsound conduct, for which the U.S. federal banking agencies may initiate formal or informal supervisory action requiring the immediate implementation of necessary corrective measures, as explained in the enforcement actions section of the banking agencies' web sites and in BCP 23.

EC 2	Principle 7: Risk Management Process
Criterion	The supervisor confirms that banks and banking groups have appropriate risk management strategies that have been approved by the Board. The supervisor also confirms that the Board ensures that policies and processes for risk-taking are developed, appropriate limits are established, and senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies.
Legal Framework	See Overview and response to EC1.
Practices and Procedures	In assessing the adequacy of risk management processes, agencies ensure that banks and holding companies have appropriate risk management strategies that have been approved by the relevant board. Examiners also verify that the board develops policies and processes for risk-taking, establishes appropriate limits, and that senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies. The agencies assess, and ratings reflect, the board's fulfillment of its responsibilities primarily in accordance with the guidance outlined in EC 1 above.[9] Under the agencies' policies and guidelines, boards have ultimate responsibility for the level of risk taken by their organizations. Accordingly, they should approve the overall business strategies and significant policies of their organizations, including those related to managing and taking risk. Directors are also expected to provide clear guidance regarding the level of exposures acceptable to their organizations and that they have the responsibility to ensure that senior management implements the procedures and controls necessary to comply with adopted policies. Compliance with these standards is conducted as part of the supervisory examination process. *See* Overview and EC 1 for further details on how the agencies confirm risk management practices at institutions.

[9] Federal Reserve: SR Letter 95-51, CA Letter 06-8, the BHCSM, and the CBEM; OTS: set forth in the description of the SLHC rating system as attached to CEO Memorandum No. 266, and in the OTS *Holding Companies Handbook*. See also OCC's *Bank Supervision Process Handbook* and OCC's *The Director's Book – The Role of the National Bank Director,*.and FDIC's *Risk Management Manual of Examination Policies* (Section 4.1 – Management).

EC 3	Principle 7: Risk Management Process
Criterion	The supervisor determines that risk management strategies, policies, processes and limits are properly documented, reviewed and updated, communicated within the bank and banking group, and adhered to in practice. The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of and authorization by the appropriate level of management and the Board where necessary.
Legal Framework	*See* Overview and response to EC1.
Practices and Procedures	In assessing the adequacy of risk management processes, agencies ensure that risk management strategies, policies, processes, and limits are properly documented, reviewed and updated, and communicated within the bank and banking group. In addition, examiners determine that exceptions to established policies, processes and limits receive the prompt attention of and authorization by the appropriate level of management and the board where necessary. The agencies generally conduct examinations of the documentation supporting the risk management process and adherence to internal policies, processes, and limits in conjunction with targeted examinations of specific business activities. As noted above, the agencies assess, and ratings reflect, documentation supporting the risk management process, the review, updating, and communication of such documentation, and the monitoring of compliance with policies, procedures, and limits primarily in accordance with the guidance noted in EC 2. Agencies' policies state that boards should approve significant policies, communicate policies throughout the institution, and modify them when necessary to respond to significant changes in the bank's or holding company's activities or business conditions.[10] They also emphasize the importance of an independent review of the internal control structure, and that large organizations require more frequent monitoring and testing by independent control areas and internal, as well as external auditors, to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits. Agencies' policies and examiner guidance provides that exceptions to policies/limits are authorized by the appropriate level of management or board. *See, e.g.*, 12 CFR 34.62 and Appendix A to 12 CFR Part 34; "Interagency Statement on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices"[11]; "Interagency Guidance on Nontraditional Mortgage Products"[12]; "Interagency Guidance on Credit Risk Management for Home Equity Lending"[13]; and "Interagency Policy Statement on Interest Rate Risk."[14]

[10] See, e.g., Federal Reserve SR Letter 95-51 and CA Letter 06-8; Interagency Policy Statement on the Allowance for Loan and Lease Losses; OCC Bulletin 2006-47; OCC Banking Circular 277, "Risk Management of Financial Derivatives," OCC's *The Director's Book – The Role of the National Bank Director*; FDIC's Risk Management Manual of Examination Policies (Section 4.1 – Management), and the OTS Examination Handbook, Section 212; and OTS CEO Memorandum 256, "Interagency Guidance on Nontraditional Mortgage Product Risks."

[11] 71 FR 74580.
[12] 71 FR 58609.
[13] OCC Bulletin 2005-22.
[14] OCC *Interest Rate Risk* booklet of Comptroller's Handbook, FR, OTS TB-13a Management of Interest Rate Risk, Investment Securities and Derivatives Activities

EC 4	Principle 7: Risk Management Process
Criterion	The supervisor determines that senior management and the Board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. The supervisor also determines that senior management ensures that the risk management policies and processes are appropriate in the light of the bank's risk profile and business plan and that they are implemented effectively. This includes a requirement that senior management regularly reviews and understands the implications (and limitations) of the risk management information that it receives. The same requirement applies to the Board in relation to risk management information presented to it in a format suitable for Board oversight.
Legal Framework	*See* Overview and response to EC1.
Practices and Procedures	Federal banking agency examiners review whether senior management and the board understand the nature and level of risk being taken by the institution and how this risk relates to adequate capital levels. Examiners also determine that senior management ensures that the risk management policies and processes are appropriate in the light of the institution's risk profile and business plan and that they are implemented effectively. Senior management is expected to regularly review and understand the implications (and limitations) of the risk management information that it receives. The same requirement applies to the board in relation to risk management information presented to it in a format suitable for board oversight. The agencies assess, and ratings reflect, whether senior management and the board of directors understand the nature and level of risk being taken by the organization primarily in accordance with guidance outlined in EC 1. See Federal Reserve SR Letter 99-18, *Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles;* and OCC's *Community Bank Supervision* and *Large Bank Supervision* Handbooks, *The Director's Book – The Role of a National Bank Director*, and *Detecting Red Flags in Board Reports – A Guide for Directors*, and FDIC's *Risk Management Manual of Examination Policies* (Section 4.1 – Management). As previously noted, federal banking agency guidance states that directors are responsible for understanding the nature of the risks significant to their organizations, and for ensuring that management is taking the steps necessary to identify, measure, monitor, and control these risks. Directors are also responsible for understanding how this risk relates to adequate capital levels. Boards of directors are expected to periodically review and approve the target level and composition of capital, along with the process for setting and monitoring such targets. Banks and holding companies are expected to maintain capital commensurate with the nature and extent of risks taken and the ability of management to identify, measure, monitor, and control these risks. The types and quantity of risk inherent in a bank's or holding company's activities will determine the extent to which it may be necessary to maintain capital levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the organization's capital. Recent events have revealed weaknesses in some banks' and holding companies' ability to identify and aggregate risks across the firm and to conduct effective stress testing. For example, some firms relied too heavily on historical correlations or focused too heavily on specific lines of businesses when conducting stress scenarios and thus failed to capture the breadth of their interconnected risk exposures fully. As noted in the overview, the agencies are actively involved in efforts to strengthen enterprise-wide risk management and stress testing practices for large financial organizations.

EC 4	Principle 7: Risk Management Process

EC 5	Principle 7: Risk Management Process
Criterion	The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile, and reviews and evaluates banks' internal capital adequacy assessments and strategies. The nature of the specific methodology used for this assessment will depend on the size, complexity and business strategy of a bank. Non-complex banks may opt for a more qualitative approach to capital planning.
Legal Framework	See Overview and response to EC1.
Practices and Procedures	Federal banking agencies expect banks and bank holding companies to develop capital and strategic plans that exceed minimum regulatory capital requirements to ensure that the capital they are holding and forecast to need is adequate given their risk profile. Regulatory capital requirements have limitations in their ability to reflect an organization's full risk profile. (For further information on regulatory capital standards, refer to CP 6, EC 1, EC 2, AC 1, and AC 2.) Accordingly, all organizations are expected to understand their underlying risks and hold capital commensurate with those risks – at levels above regulatory minimums – to ensure capital adequacy. The agencies require some organizations to use more sophisticated internal risk measures and capital adequacy assessment processes because of their size, complexity, and the corresponding limitations of regulatory capital requirements to adequately capture their risk profile. Ratings reflect the results of this assessment.[15] Evaluations of the strategic plans and capital adequacy assessments of consolidated organizations and individual institutions are generally conducted as separate targeted examinations. Recent events have highlighted weaknesses in both the Basel II capital standards and firms' own capital planning processes. The agencies are actively involved in the Basel Committee's recent proposals to enhance the Basel II framework for re-securitizations, certain liquidity facilities, and improved value-at-risk models and stress testing. In addition, the agencies recently completed a comprehensive, forward-looking assessment of the financial condition of the nation's 19 largest bank holding companies (BHCs) to determine what capital buffers would be sufficient for these BHCs to withstand losses and sustain lending even if the economic downturn is more severe than is currently anticipated. The agencies are actively working with those BHCs to ensure that they take appropriate steps to obtain any additional capital needed. As part of this process, holding companies are required to submit capital plans that, among other things, identify steps to address weaknesses, where appropriate, in the BHC's internal processes for assessing capital needs and engaging in effective capital planning. In addition, institutions subject to the advanced approaches of Basel II-based capital adequacy guidelines are required to have a

[15] See FRB SR Letter 99-18 and AD Letter 08-11, which provides examiner guidance for conducting reviews of compliance with these standards; OCC's *Large Bank Supervision* and *Community Bank Supervision* booklets of the Comptroller's Handbook.

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	rigorous process for assessing capital adequacy in relation to their risk profiles. Interagency guidance that addresses the supervisory review process of capital adequacy (also known as Pillar 2) was issued on July 15, 2008.

EC 6	Principle 7: Risk Management Process
Criterion	Where banks and banking groups use models to measure components of risk, the supervisor determines that banks perform periodic and independent validation and testing of the models and systems.
Legal Framework	Under the interagency guidelines implementing the advanced Basel II approaches, banks and BHCs are required to validate their advanced systems on an ongoing basis in accordance with specified requirements. See, e.g., 12 CFR Part 3, Appendix C, section 22(j) (national banks); 12 CFR Part 208, Appendix F, section 22(j) (state member banks); 12 CFR Part 225, Appendix G, section 22(j) (BHCs), 12 CFR 325, Appendix D, section 22(j) (state nonmember banks) . In addition, they must periodically stress test the advanced approaches, also in accordance with stated specifications. See id. Internal models adopted by organizations adhering to the 1996 Market Risk Amendment also must be stress tested. 12 CFR Part 3, Appendix B, section 4(b) (OCC); 12 CFR Parts 208 and 225, Appendix E, section 4(b) (Federal Reserve), 12 CFR 325, Appendix C, section 4(b) (FDIC).
Practices and Procedures	In utilizing models and systems to measure risk, banks and BHCs are expected to ensure that risk management models and systems are independently validated and tested with an appropriate frequency. The federal banking agencies offer specialized training courses on various aspects of risk modeling and have staff with specialized econometrics and modeling expertise that can assist examiners in evaluating sophisticated models. The federal banking agencies' supervisory guidance directs that key assumptions, data sources, and procedures utilized in measuring and monitoring risk be appropriate and adequately documented and tested for reliability on an ongoing basis. Models should be independently validated and tested by risk management staff or by internal or outside auditors. The frequency and extent to which organizations should re-evaluate their models and assumptions depends, in part, on the specific risk exposures created by their trading activities, the pace and nature of market changes, and the pace of innovation with respect to measuring and managing risks. Guidance which more specifically addresses model requirements for various types of models is found in the related sections of the agencies' manuals. For example, the OCC assesses, and ratings reflect, risk measurement model validation and testing processes of banks in accordance with the guidance set forth in OCC Bulletin 2000-16, *Risk Modeling, Model Validation*. Similarly, the Federal Reserve assesses, and ratings reflect risk measurement model validation and testing processes of consolidated banks and BHCs in accordance with the guidance set forth in SR letter 95-51. To address supervisory expectations more comprehensively and explicitly, the Federal Reserve plans to issue enhanced guidance covering supervisory expectations for the validation and testing of risk management models and systems in the near future. Organizations implementing the advanced Basel II approaches are required to validate their advanced systems on an ongoing basis in accordance with specified requirements. For those larger organizations subject to the 1996 Market Risk Amendment, qualitative

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	requirements include that these organizations must have an internal model that is fully integrated into its daily management, must conduct independent reviews of its risk management and measurement systems at least annually, and must have policies and procedures for conducting appropriate stress tests and back tests, and for responding to the results of those tests. 12 CFR Part 3, Appendix B, section 4(b) (OCC); 12 CFR Parts 208 and 225, Appendix E, section 4(b) (Federal Reserve), 12 CFR 325, Appendix D, section 4(b) (FDIC). Agencies generally conduct separate targeted examinations of an institution's risk management process relating to risk measurement models and systems, as well as of specific risk measurement models.

EC 7	Principle 7: Risk Management Process
Criterion	The supervisor determines that banks and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It is satisfied that these reports are provided on a timely basis to the Board or senior management and reflect the bank's risk profile and capital needs.
Legal Framework	The agencies' safety and soundness guidelines require banks and BHCs to have information systems that are appropriate to the size of the institutions and the nature, scope and risks of their activities and that provide access to timely and accurate financial, operational, and regulatory reports. See, e.g., 12 CFR Part 30, Appendix A, part II(A) (OCC); 12 CFR Part 208, Appendix D-1, part II(A) (Federal Reserve); 12 CFR 364, Appendix A, section II.A.(FDIC); 12 CFR Part 570 (OTS).
Practices and Procedures	Agency examiners review management information systems to ensure its adequacy in measuring, assessing, and reporting on the size, composition, and quality of exposures. Examiners also ensure that these reports appropriately reflect the bank's or holding company's risk profile and capital needs, and that they are provided to the board or senior management on a timely basis. Examiners generally conduct reviews of management information in conjunction with the targeted examinations of specific business activities and, at larger organizations, during the process of conducting ongoing supervision. The federal banking agencies assess, and their supervisory ratings reflect, the adequacy of risk management information at both the holding company and institution level. Risk monitoring activities must be supported by information systems that provide senior managers and directors with timely reports clearly indicating positions and risk exposures, as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities.[16] Examiners analyze reports flowing to executive management, board committees, and the board of directors for clarity, consistency, timeliness, quality, and coverage of crucial areas of the organization. Examiners ascertain that reporting is sufficiently comprehensive for sound decision making, and that reports relate risks relative to the bank's earnings and capital. Furthermore, guidance and the agencies' supervisory ratings emphasize the need for banks and BHCs s to identify and measure all material risks.

[16] See, e.g., FRB's SR 99-18 and CA 06-8; OCC's Risk Assessment System factors for determining quality of risk management in its "Community Bank Supervision" and "Large Bank Supervision" booklets, and FDIC's Risk Management Manual of Examination Policies (Section 4.1 – Management).

EC 8	Principle 7: Risk Management Process
Criterion	The supervisor determines that banks have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board.
Legal Framework	*See* Overview and response to EC 1.
Practices and Procedures	Agency examiners verify that banks and BHCs have policies and processes in place to ensure that management identifies and reviews all risks associated with new activities or products, and that the infrastructure and internal controls necessary to manage the related risks are in place.[17] Furthermore, agencies consider as a sound practice, having a new product approval policy that requires review and approval by all operational areas affected by such transactions, and is evidenced by an audit trail of approvals before a new product is introduced.[18] The agencies expect the risk management process to reflect the size and the complexity of the product or service offered. Although the board may delegate performance of managerial duties to others, it has the ultimate responsibility for ensuring that the bank or holding company is run in a safe and sound manner. In fulfilling its responsibilities, the board or its designee must ensure that a new, expanded, or modified bank product or service is consistent with the strategic goals.[19] Although the comprehensiveness and specificity of supervisory guidance relating to the approval of new products and major risk management initiatives varies among the agencies, examiners generally employ similar procedures in conducting supervisory assessments. The federal banking agencies assess a bank's new activity/product approval process at both the bank and holding company levels. As noted, agency guidance states that before embarking on new activities or introducing products new to the organization, management should identify and review all risks associated with the activity or product and ensure that the infrastructure and internal controls necessary to manage the related risks are in place.[20] When a new product or activity requires explicit agency approval, such conditions are often imposed as part of the approval process and are enforceable conditions under 12 U.S.C. § 1818.[21] The agencies expect that management identifies the risks associated with new activities or products before they are launched and ensures that the appropriate infrastructure and internal controls are established. Furthermore, the agencies consider as a sound practice, having a new product approval policy that requires review and approval by all operational areas affected by such transactions, and is evidenced by an audit trail of approvals before a new product is introduced.

[17] See FRB's SR Letter 95-51, OCC Bulletin 2004-20, *Risk Management of New, Expanded, or Modified Bank Products and Services*, and FDIC's Risk Management Manual of Examination Policies (Sections 4.1 and 4.2- Management & Internal Routine and Controls); and. OTS TB-13a Management of Interest Rate Risk, Investment Securities, and Derviative Activities,

[18] See FRB's TCMM (Section 2000.10, *Overview of Risk Management in Trading Activities*), Bulletin 2004-20; see also OCC Banking Circular 277, Risk Management of Financial Derivatives .

[19] See, e.g., FRB's 95-51, 04-18, and CA 06-8; OCC Bulletin 2004-20, "Risk Management of New, Expanded, or Modified Bank Products and Services"

[20] Id.

[21] See, e.g., OCC Interpretive Letter 1101 (July 7, 2008); OCC Interpretive Letter 1065 (July 24, 2006); OCC Interpretive Letter 1039 (September 15, 2005).

EC 8	Principle 7: Risk Management Process
	In the wake of recent events, the Federal Reserve is re-evaluating its existing guidance to incorporate more explicit requirements regarding new products and major initiatives, with emphasis on the need for board approval of new products or major initiatives.[22] Agency examiners generally conduct separate targeted examinations of the new activity/product approval process, and may verify approvals of specific activities and/or products during targeted examinations of specific business activities.

EC 9	Principle 7: Risk Management Process
Criterion	The supervisor determines that banks and banking groups have risk evaluation, monitoring, and control or mitigation functions with duties clearly segregated from risk-taking functions in the bank, and which report on risk exposures directly to senior management and the Board.
Legal Framework	The interagency guidelines implementing the 1996 Market Risk Amendment require an independent risk control unit that reports directly to senior management and is independent from business trading units. See, e.g., 12 CFR Part 3, Appendix B, section 4(b)(1)(national banks); 12 CFR Part 208, Appendix E, section 4(b)(1) (state member banks), 12 CFR Part 225, Appendix F, section 4(b)(1) (BHCs). Institutions adhering to the advanced approaches to Basel II rules must have control, oversight, and validation mechanisms that maintain the integrity, reliability, and accuracy of those systems. The bank's validation process must be independent of the advanced systems' development, implementation, and operation, or the validation must be subjected to an independent review of its adequacy and effectiveness. The bank's senior management must ensure that all components of the bank's advanced systems function effectively and the bank's board of directors (or a designated committee) must at least annually review the effectiveness of, and approve, the bank's advanced systems. See e.g., 12 CFR Part 3, Appendix C, Section 22(h) (national banks); 12 CFR Part 208, Appendix F, section 22(h) (state member banks); 12 CFR Part 225, Appendix G, section 22(h) (BHCs).
Practices and Procedures	The federal banking agencies require BHCs and individual banks to have risk evaluation, monitoring, and control or mitigation functions with duties clearly segregated from risk-taking functions and which report on risk exposures directly to senior management and the board or board committee. Federal banking agencies expect large banks and BHCs to have risk management systems or units that are sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest. While organizations are generally given flexibility in how they accomplish this objective, most large, complex banks and BHCs have established dedicated units to manage risk at the group level.

[22] Current Federal Reserve guidance (SR Letters 95-51, 04-18, and CA Letter 06-8) does not explicitly require that new products be approved by the board, or a specific committee of the board; however, examiners expect the board or its designee to ensure the institution operates in a safe and sound manner, and to ascertain that a new product or activity is consistent with the institution's strategic goals.

EC 9	Principle 7: Risk Management Process
	As noted above, organizations subject to the 1996 Market Risk Amendment and to the advanced approaches under Basel II have more rigorous requirements for independent risk control units.

EC 10	Principle 7: Risk Management Process
Criterion	The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.
Legal Framework	The agencies expect BHCs and banks to have in place comprehensive risk management policies and processes for identifying, evaluating, monitoring and controlling or mitigating all material risks, including, but not limited to, credit, market, liquidity, interest rate, and operational risk. The agencies have issued supervisory guidance related to each of these risk types pursuant to various statutory and regulatory provisions, including those governing safety and soundness (see 12 U.S.C. § 1831p-1; 12 CFR Part 30, Appendix A (OCC); and 12 CFR Part 208, Appendix D-1 (Federal Reserve); 12 CFR 364, Appendix A (FDIC) and capital adequacy (see, e.g., 12 USC §§ 3907(a), 3909; 12 CFR Part 3, Appendices A,B, and C (national banks); 12 CFR Part 208, Appendices A, E, and F; 12 CFR Part 225, Appendices A, E, and G (BHCs)). 12 CFR 570, Appendix A; OTS's *Holding Companies Handbook*, sections 400, 500, and 900.
Practices and Procedures	U.S. federal banking agencies have issued standards related to credit, market, liquidity, interest rate risk in the banking book, and operational risk in the form of supervisory guidance and through the issuance of examination procedures and handbooks. Ratings reflect the results of the assessment of compliance with expectations appearing in these documents. Guidance addressing specific aspects of risk management is discussed in further detail in the sections covering the relevant risk principles.

AC 1	Principle 7: Risk Management Process
Criterion	The supervisor requires larger and more complex banks to have a dedicated unit(s) responsible for risk evaluation, monitoring, and control or mitigation for material risk areas. The supervisor confirms that this unit (these units) is (are) subject to periodic review by the internal audit function.
Legal Framework	Banking institutions subject to the interagency capital guidelines on market risk or the advanced Basel II approaches are required to have dedicated risk management units. See, e.g., 12 CFR Part 3, Appendix B, section 4(b) and 12 CFR Part 3, Appendix C, section 22(h) (OCC); 12 CFR Parts 208 and 225, appendix E, section 4(b), 12 CFR Part 208, Appendix F, section 22(h), and 12 CFR Part 225, Appendix G, section 22(h) (Federal Reserve).
Practices and Procedures	The agencies generally expect larger, more complex banks and holding companies to have a dedicated unit(s) responsible for risk evaluation, monitoring, and control or mitigation for material risk areas. Agency examiners confirm that this unit (these units) is (are) subject to periodic review by the internal audit function. Given the unique characteristics of each organization, however, the

AC 1	Principle 7: Risk Management Process
	agencies have historically held the view that there is no single risk management structure that is appropriate for all organizations and institutions. For example, some companies have chosen to have a single consolidated enterprise risk oversight function, while others have more functionally organized risk management functions that are independent of risk-taking units and have sufficient standing within the organization to elevate concerns to senior management and the board. With this said, most large, complex banks and BHCs have established dedicated units to manage risk at the corporate level. As noted above, organizations subject to the 1996 Market Risk Amendment and to the advanced approaches under Basel II have more rigorous requirements for independent risk control units.

AC 2	Principle 7: Risk Management Process
Criterion	The supervisor requires banks to conduct rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the bank.
Legal Framework	Institutions subject to the advanced Basel II approaches are required to conduct rigorous, forward looking stress testing to identify circumstances that could adversely impact the bank. See, e.g., 12 CFR Part 3, Appendix C, section 22(j) (OCC); 12 CFR Part 208, Appendix F, section 22(j), and 12 CFR Part 225, Appendix G, section 22(j) (Federal Reserve).
Practices and Procedures	The agencies require large, complex banks to conduct rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the bank.[23] Examinations of stress tests conducted by banks are typically conducted as separate targeted examinations. An example of this is the Supervisory Capital Assessment Program (SCAP) that was conducted by the agencies[24] in May of this year. The SCAP is a forward-looking capital assessment of the largest 19 U.S. bank holding companies under different stress scenarios. See www.federalreserve.gov/newsevents/press/bcreg/20090424a.htm for the White Paper that explains the SCAP process. As previously noted, the agencies are working both domestically and with other global regulators to evaluate methods for improving supervisory processes to enhance the identification of systemic risk, and the linkage and coordination between systemic risk and the supervision of banks and holding companies. As noted above, institutions implementing the advanced approaches under Basel II are required to stress test their advanced systems. Under the agencies' guidance on Pillar 2, they must also conduct broader stress tests to assess the overall adequacy of capital.[25]

[23] See, e.g., FRB's SR Letter 99-18, which states that, in measuring risks, large banking organizations and others with complex risk profiles should perform comprehensive and rigorous stress tests to identify possible events or changes in markets that could have serious adverse effects in the future. Further discussion of stress testing expectations appears in the TCMM (Section 3020 – *Market Risk*, Section 3010.10 – *Interest Rate Risk*, Section 3000.10 – *Securities*, and Section 3020.10 – *Securitization*).; OCC Handbooks: *Large Bank Supervision, Liquidity, Risk Management of Financial Derivatives* .

[24] The agencies that participated in the SCAP are the Board of Governors of the Federal Reserve System, the Federal Reserve Banks, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

[25] See, e.g., "Supervisory Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework" 73 Fed. Reg. 44620 (July 31, 2008); "Stress Tests Used in Assessment of Capital Adequacy"; and SR Letter 99-18.

AC 2	Principle 7: Risk Management Process
	Likewise, institutions with significant portfolio concentrations are also expected to conduct stress tests or sensitivity analyses to quantify the potential impact on the bank's earnings and capital.[26] Routine stress testing is not required for smaller, less complex institutions, however, such institutions are expected to identify and assess how changes in economic and borrower conditions may affect their earnings and capital; to manage concentrations exposures; to measure and control the exposure to earnings and capital of changing interest rates; and to develop and maintain contingency funding plans that consider the bank's potential liquidity needs over a range of adverse scenarios. For further detail, refer to Principle 13, EC 4; Principle 14, EC4 and AC1; and Principle 16, EC 3 and AC3.

AC 3	Principle 7: Risk Management Process
Criterion	The supervisor requires banks and banking groups to have in place appropriate policies and processes for assessing other material risks not directly addressed in the subsequent CPs, such as reputational and strategic risks.
Legal Framework	The authority to impose risk management standards stems primarily from the agencies' statutory authority for ensuring the safety and soundness of banks. 12 U.S.C. § 1831p-1. While existing safety and soundness guidelines and minimum capital requirements do not specifically capture all risks to which banks and holding companies may be exposed, the agencies have broad authority under those guidelines to impose risk management requirements related to risk types not otherwise addressed. These are addressed by supervisory guidance and related materials. In addition, the agencies' capital adequacy guidelines provide authority to require higher minimum capital ratios of an individual bank in view of its circumstances. 12 CFR 3.10 (OCC); 12 CFR Parts 208 and 225, appendix A, § IV, 12 CFR Part 208, appendix F, section 1(c), 12 CFR Part 225, appendix G, section 1(c) (Federal Reserve); 12 CFR 325, Appendix A, section II.A.3 and Appendix D, section 1(c) (state nonmember banks) 12 CFR 567.11 (OTS). Institutions subject to the advanced approaches of Basel II-based capital adequacy guidelines are required to have a rigorous internal capital adequacy assessment process that captures all material risks, including those not directly addressed in minimum regulatory capital requirements (which may include liquidity, reputational and strategic risks, among others). Supervisory guidance related to the supervisory review process of capital adequacy (also known as Pillar 2) was published in the Federal Register on July 31, 2008.[27]
Practices and	Although the agencies differ as to whether or not they consider reputational and strategic risks as separately identifiable risks, each

[26] See, e.g., "Interagency Guidance: Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices". 71 Fed. Reg. 74580 (December 12, 2006).

[27] See supra, n.26.

AC 3	Principle 7: Risk Management Process
Procedures	agency requires its organizations and institutions to have in place appropriate policies and processes for assessing *all* material risks, including those not directly addressed in the subsequent Principles, such as reputational and strategic risk.[28] The agencies consistently expect reputational risk to be factored into the formulation of business strategy, and a part of the approval process for new activities and products. Agencies also hold the board of directors responsible for ensuring that strategic plans are implemented in a safe and sound manner. The agencies issue specific guidance when necessary to address unique reputational and/or strategic risks associated with a particular activity for which existing guidance may not adequately address supervisory expectations. An example of interagency guidance issued to address a specific activity which poses heightened reputational risk is SR Letter 07-5, *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities*. This interagency guidance addresses the risk principles that assist organizations in identifying, evaluating, and managing the heightened legal and reputational risks that may arise from their involvement in complex structured finance transactions. For those institutions subject to the advanced approaches of Basel II-based capital adequacy guidelines, the agencies have issued supervisory guidance related to the supervisory review process of capital adequacy, which addresses the need for banks to consider all material risks in their internal assessments of capital adequacy, including, reputational and strategic risks.[29]

[28] The Federal Reserve and OTS define and specifically include reputational risk as a risk type for which the principles of sound management (SR Letter 95-51) and the SLHC Rating System applies; see also, SR Letter 99-18, *Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles*. The OCC's Risk Assessment System specifically includes both reputation and strategic risks (see OCC Handbook *Bank Supervision Process*).

[29] See supra, n.26.

Principle 8: Credit risk
Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Overview Banks and holding companies are subject to credit-risk management requirements pursuant to U.S. federal banking regulations. References: Federal Reserve [12 CFR 208, appendix D-1, part II(C) & (D) (addressing loan documentation and credit underwriting); 12 CFR 225, appendix G (capital adequacy guidelines); 12 CFR 208, subpart E (addressing real estate lending standards and setting requirements for lending policies)]; OCC [12 CFR 30, appendix A, part II (C) & (D) (addressing loan documentation and credit underwriting); 12 CFR 3, appendix C (capital adequacy guidelines); 12 CFR 34, subpart D (addressing real estate lending standards and setting requirements for lending policies)]; and OTS [12 CFR 560, subpart B]. These are further developed in extensive supervisory guidance and related materials. Refer to U. S. federal banking agencies' manuals[1] as well as "Proposed Supervisory Guidance on Internal Ratings Based Systems for Credit Risk," 72 *Fed. Reg*. 9084, 9088 (Feb. 28, 2007). Together, these sources require that banks and holding companies establish, review, update (as appropriate), and implement credit-risk management strategies, policies, and procedures for identifying, measuring, controlling and reporting on credit risk (including counterparty risk). Also, the U. S. federal banking agencies support the BCBS's releases of *Principles for the management of credit risk*, September 2000, *and Sound credit risk assessment and valuation for loans, June 2006*. As noted in Principle 7, the U. S. federal banking agencies adhere to the UFIRS and evaluate every bank against UFIRS guidelines during on-site examinations[2]. UFIRS has a specific component to rate Asset Quality (A), which directly couples supervisory assessments of each bank's assets and the credit-risk management of those assets. These assessments incorporate quantitative measurements of the levels of delinquent, troubled, and classified assets and qualitative evaluations of the adequacy of board and senior management oversight, credit policies, procedures and limits, risk-management practices, internal control mechanisms, and management information systems. The relative importance of the qualitative considerations depends on the risk characteristics and circumstances particular to the bank. Further, peer practice comparisons and data analyses are also integral parts of the evaluation process and, when available and relevant, may be used in assigning a rating.

EC 1	Principle 8: Credit risk
Criterion	The supervisor determines, and periodically confirms, that a bank's Board approves, and periodically reviews, the credit risk

[1] For the Federal Reserve see the *Commercial Bank Examination* and *Bank Holding Company Inspection Manuals*; for the OCC see the *Comptroller's Handbooks for*; *Loan Portfolio Management, Rating Credit Risk, Commercial Real Estate and Construction Lending, Leveraged Lending, Retail Lending, Accounts Receivable and Inventory Financing, Credit Card Lending, Agricultural Lending, Mortgage Banking, Securitization*, and others (e.g., installment loans, floor plan loans, etc.), for the FDIC see the *Risk Management Manual of Examination Policies* as well as the *Credit Card Activities and Credit Card Securitization Manuals*; for OTS see *Examination and Holding Companies Handbooks*.

[2] Bank holding companies and savings and loan holding companies are evaluated using the RFI and CORE rating systems respectively. Branches and agencies of foreign banks are evaluated against the ROCA guidelines. See Principle 7 for further details.

EC 1	Principle 8: Credit risk
	management strategy and significant policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk (including counterparty risk). The supervisor also determines, and periodically confirms, that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.
Legal Framework	The authorities cited above provide for active board of directors (board) involvement in the approval, periodic review, and continual oversight of senior management's implementation of a bank's and holding company's overall business strategies and significant policies — especially those related to originating and managing credit risk. A board also must ensure that senior management is fully capable of managing the lending and other credit-extension activities that the bank or holding company conducts. The board is responsible for understanding the level and nature of credit risk to the bank and holding company, setting the firm's risk appetite, and ensuring that management implements appropriate risk-management practices to identify measure, monitor and control these risks.
Practices and Procedures	U.S. federal banking supervisors assess whether the board understands (1) the credit risk involved in the activities; (2) communicates risk appetite to its management; and (3) delegates the development of comprehensive policies, procedures, and controls. Supervisors review the quality of aggregated management information provided to the board to test whether these reports are comprehensive and timely and accurately reflect the level and nature of credit risk. To assess board involvement in credit-risk oversight, supervisors will review minutes of board meetings and meetings of board committees, management committees, and other records, as needed. Furthermore, supervisors determine whether the board approves and regularly reviews the adequacy of significant policies and procedures for credit underwriting and for identifying, measuring, monitoring, and controlling credit-risk activities. See AC 2 for a description of how U. S. federal banking agencies evaluate counterparty credit risk. U.S. federal banking supervisors will review compliance with supervisory guidance on credit-risk management as well as compliance with internal credit-risk management strategies and risk-management policies by conducting interviews, reviewing internal policies and procedures, and performing transaction testing.

EC 2	Principle 8: Credit risk
Criterion	The supervisor requires, and periodically confirms, that such policies and processes establish an appropriate and properly controlled credit risk environment, including: ● a well documented strategy and sound policies and processes for assuming credit risk; ● well defined criteria and policies and processes for approving new exposures as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposures; ● effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral, and a classification system that is consistent with the nature, size and complexity of the bank's activities or, at the least, with the asset grading system prescribed by the supervisor; ● comprehensive policies and processes for reporting exposures on an ongoing basis; ● comprehensive policies and processes for identifying problem assets; and

EC 2	Principle 8: Credit risk
	● prudent lending controls and limits, including policies and processes for monitoring exposures in relation to limits, approvals, and exceptions to limits.
Legal Framework	Pursuant to the authorities cited at the outset of this Principle, the U.S. federal banking agencies generally expect that the bank's and holding company's policies and processes for managing credit risk will establish an appropriate and properly controlled credit-risk environment. U.S. federal banking agencies' expectations in this regard are enumerated in supervisory guidance and generally include the features listed in this EC.
Practices and Procedures	The U.S. federal banking agencies have issued supervisory guidance on sound risk-management practices for credit-risk and loan portfolio management. The agencies have published examination manuals that are supplemented by specific topical guidance articulated in Federal Reserve SR letters, FDIC Financial Institution letters (FIL) and Statements of Policy (SOP), OCC Bulletins, and OTS Thrift Bulletins. During the course of examinations, U.S. federal banking supervisors review banks' and holding companies' compliance with the guidance including evaluating whether banks and holding companies have established effective risk management systems for identifying, measuring, monitoring, and controlling credit risk in their banking activities. When evaluating the adequacy and effectiveness of credit-risk management practices, supervisors generally consider, as applicable based on the size, complexity, and risk profile of the bank or holding company, whether o Credit-risk policies are comprehensive and well documented and accurately reflect existing credit-risk strategies and objectives. Policies and procedures must provide for adequate identification, measurement, monitoring, and control of the credit risks posed by the lending, investing, trading, trust, fiduciary, and other significant activities. o Proposed and current credit activities are consistent with the overall business strategy, stated goals and objectives, and established risk tolerances, as well as the overall financial strength. o Policies and procedures requiring the review and approval by key risk and control personnel of all new credit products. Policies ensure that the bank or holding company establishes the necessary risk and control infrastructures to identify, monitor, and control the varied risks associated with new credit activities before these activities are initiated. o Credit administration practices include initial and ongoing borrower and counterparty analyses, comprehensive legal documentation, credit covenant and collateral documentation, transaction due diligence, credit-underwriting criteria, pricing decision tools, borrower and portfolio limit and concentration monitoring, payment and collections procedures, workout and restructuring processes, and loan loss reserving. o Banks and holding companies must maintain documentation supporting their analysis of the customer's ability and willingness to repay a loan or other exposure at the time it is extended, renewed, or restructured; and maintain information relating to and/or analyzing the borrower's financial condition, collateral and its valuation, and other pertinent documents, such as guarantor information, loan agreements, proof of security interest in collateral, and adherence to loan covenants. o Employs a risk rating/grading system that accurately assesses the absolute and relative credit risk across the bank's credit portfolios. The risk-rating system accurately defines and delineates borrower/counterparty credit quality, allows measurement of credit migration, and drives management decision-making. o Stress testing processes are effective in identifying the impact of portfolio-level stress events on asset quality, earnings, and capital; the impact of business-level stress on credit concentrations; and the impact of downside scenarios on individual credit exposures.

EC 2	Principle 8: Credit risk

	o Has effective management information systems for reporting, managing, and monitoring portfolio-level and business-level credit risk exposures.
	    o Management information systems are structured to monitor current and potential exposures against established limits and strategic goals and objectives.
	    o Reports to management are timely and contain sufficient information for decision makers to evaluate the level and trend of credit risk faced by the bank and holding company, including reports that make the following information readily available and routinely reviewable: total credit exposure, including loans and commitments; loans in excess of existing credit limits; new extensions of credit, credit renewals, and restructured credits; a listing of all delinquent and/or nonaccrual loans; credits adversely graded or requiring special attention; credits to insiders and their related interests; credits not in compliance with internal policies, laws, or regulations; and specific lending activity aspects, "outsized" credit exposures, and analyses of the bank's credit exposure by type, geographic areas, and collateral.
	o Has policies and procedures governing problem loan management including delinquency and charge-off practices. Supervisors will determine whether policies, procedures and processes are in place for the timely identification of problem loans; criteria for providing a full awareness of the risk position, informing management and directors of that position, taking steps to mitigate risk, and properly assessing the adequacy of the allowance for credit losses and capital.
	o Loan review process discharges its duties appropriately. These may include verifying loan grading processes, assessing portfolio-management processes, evaluating credit-risk management, and confirming credit administration procedures, depending on the size and risk.
	o Management promptly and accurately identifies loans or portfolios with potential or well-defined credit weaknesses and ensures the development and implementation of an appropriate action plan, including restructuring and workout processes, to minimize credit losses.
	o Policies and procedures for the Allowance for Loan and Lease Losses comply with both accounting and supervisory guidance.
	o Has implemented a system that clearly identifies portfolio business, risks, and transaction and portfolio risk limits, including processes to confirm compliance with these limits, to require review and approval of limits, and to detect, address, and report exceptions to limits. Supervisors determine if risk limits are established to address borrower/counterparty, industry, and geographic concentration risks as well as unique risk factors, such as commodity-reliant industries or complex structured securitizations. If an exception to a limit is made, supervisors validate that the bank's process ensures that specific credit oversight and approval procedures are required.
	o Has adequate risk-management practices for approving, monitoring, and controlling third party (i.e., indirect) originations. Supervisors determine whether banks and holding companies perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, supervisors determine whether adequate audit procedures and controls are verified that third parties are not generating credit exposure outside of the established underwriting criteria. Supervisors determine whether third-party audit procedures include monitoring the quality of loans by origination source and enable management to identify such problems as early payment defaults and incomplete packages and take appropriate action, as needed.
	o Has comprehensive, formal strategies for managing risks in secondary market activities. Supervisors determine whether contingency planning includes how the bank and holding company will respond to reduced demand in the secondary market.

EC 2	Principle 8: Credit risk
	References: "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (May 23, 2002) - OCC [OCC Bulletin 2002-22]; Federal Reserve [SR letter 02-16]); FDIC [FIL-54-2002]; and OTS [CEO letter 163]. As noted above, the agencies' expectations for each of the above components will vary, based on size and complexity. Smaller, less complex banks and holding companies will generally not require every element in the above list but are required to have effective policies and procedures to identify, measure, monitor, and control their credit-risk exposures. The agencies regularly review and update their supervisory guidance and examination processes to address emerging practices and risks. Quite often, interagency working groups are assembled to revise existing guidance to address a current supervisory concern.

EC 3	Principle 8: Credit risk
Criterion	The supervisor requires, and periodically confirms, that banks make credit decisions free of conflicts of interest and on an arm's length basis.
Legal Framework	The statutes on transactions with related parties, discussed under Principle 11, require credit decisions to be made free of conflicts of interest and on an arm's length basis. In certain situations, credit decisions are required to be made by the board without participation of the interested party. Terms must be in accordance with those offered to members of the general public. Compliance is reviewed as part of the normal supervisory process. Reference: Regulation O or 12 CFR 215 addresses insider transactions. See Principle 11 for more information on the statutes.
Practices and Procedures	U.S. federal banking agencies require banks and holding companies to develop policies that (1) define and address real and potential conflicts of interest; (2) acknowledge that these credit decisions are to be given independent and complete credit evaluation; and, (3) in certain situations, require board approval. The agencies require banks and holding companies to establish a functionally independent credit-approval function to maintain consistency with credit-origination criteria, review the credit analysis, and check adherence to credit limits. U.S. federal banking agencies also expect that the risk-management function and the process of measuring, monitoring, and controlling risks are sufficiently independent from those individuals who have the authority to initiate transactions. These actual practices will vary, depending on the size and complexity of the supervised bank or holding company. U.S. federal banking supervisors will determine whether banks and holding companies have developed policies and risk-management practices to prevent conflicts of interest from influencing credit-underwriting decisions. Supervisors will review credit-approval policies, credit analysis and approval procedures, credit files and approval records, credit committee minutes, loan/credit review, and internal audit procedures to ensure that conflicts of interest are appropriately identified and properly controlled. During the course of examinations, supervisors perform transaction testing to ensure loans are underwritten and approved on an arm's length basis. Supervisors may review extensions of credit issued to employees, officers, and directors, principal shareholders, or to the related interests of such persons. Such loans are reviewed to determine whether they were made on substantially the same

EC 3	Principle 8: Credit risk
	terms as those prevailing at the time for comparable transactions with other persons; whether they involve more-than-normal risk of repayment; or whether they have other unfavorable features, such as not being supported by adequate credit information or being in violation of lending limitations. Regulation O specifically addresses procedures for extensions of credit to executive officers, directors, principal shareholders and their related interests. Further, supervisors review approved credit decisions to ensure that policies and procedures, and actual actions and reasons, including a borrower's ability to repay the credit, were followed. Similar procedures apply to wholesale and consumer credit, trading, investment, and available for sale approvals, all of which are reviewed by credit review and internal loan review.

EC 4	Principle 8: Credit risk
Criterion	The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.
Legal Framework	Under the U.S. federal banking agencies' statutory examination authority, supervisors may review all books and records maintained by a bank (and its affiliates) subject to the agencies' supervision. References: 12 U.S.C. §§ 161, 325-26, 481, 483, 602, 625, 1464(d) and (v), 1467(h), 1467a(b), 1817(a), 1817(a)(2), 1817(a)(3), 1820(b), 1844(c), 1867, 3102(b), 3105(c). This includes access to the employees involved in a matter under review and bank service companies and independent servicers that are subject to the Bank Service Company Act. The agencies also evaluate significant third-party service providers (the OCC may exercise its authority under 12 U.S.C. § 1867(c) to examine a third-party service provider). The agencies require banks and holding companies, in their contracts with third-party service providers, to include agency access to the books, records, and operations of these entities. (*FFIEC Information Technology Examination Handbook*). Supervisory guidance specifies the information that is expected to be maintained by banks and holding companies with respect to credit management, including details on credit and investment portfolios. Supervisors are allowed and generally given full access to this information, and to all employees involved in assuming, managing, controlling and reporting on credit risk, during examinations. Also, section 5 of the Bank Holding Company Act of 1956, which authorizes the Federal Reserve to examine each BHC and nonbank subsidiary thereof; section 7 of the International Banking Act of 1978, which authorizes the Federal Reserve to examine each branch or agency of a foreign bank; and Section 25(a) of the Federal Reserve Act and Section 211.7 of Regulation K, which authorize the Federal Reserve to examine Edge and agreement corporations. The OTS has authority under the Home Owners' Loan Act to examine each SLHC and its savings associations and other subsidiaries, except banks. See 12 U.S.C. § 1467a(b)(4).
Practices and Procedures	The U.S. federal banking agencies may issue regulations or guidance to further supplement or clarify the authorities cited above regarding access to books, records and personnel of the bank and holding company. References: Federal Reserve [SR letter 97-17, which summarizes the Federal Reserve's examination authority; OCC [PPM 5310-10, which provides guidance to supervisors in securing access to a bank's books and records]; and OTS [12 CFR §§ 562.1, 563.17] and section 10 of the FDI Act.

EC 4	Principle 8: Credit risk
	During the course of examinations, management is to provide supervisors with full access to all records and employees of the bank and holding company. This includes access to internal and external audit reports and other material (such as board or committee minutes and reports). Banks and holding companies that do not supply requested information or access to premises and personnel may be subject to supervisory sanctions and prosecution.

AC 1	Principle 8: Credit risk
Criterion	The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.
Practices and Procedures	U.S. federal banking supervisors review policies and procedures to ensure that banks establish limits on their credit exposures and that limits and approval authorities are clearly defined. Supervisors ensure that credit policies describe the manner in which exposures will be approved and ultimately reported to the board. Supervisors review the approved credit authorities to ensure that the levels of authority are granted to appropriate, experienced staff. Supervisors ensure that policies require that concentrations that involve excessive or undue risks receive close scrutiny by the bank and holding company, and may test credit transactions to ensure that credit approvals comply with policy requirements. For example, the agencies' "Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," directs banks and holding companies with concentrations to evaluate the degree of correlation between related real estate sectors, establish internal lending guidelines and concentration limits, and maintain adequate capital for those exposures. The board, or a committee thereof, is to periodically review and approve those risk-exposure limits. The guidance also sets forth exposure thresholds, expressed as a percentage of a bank's or holding company's capital that may signify potential significant exposures that may warrant increased supervisory scrutiny. [3] U.S. federal banking supervisors also review policies and procedures controls to ensure they address adherence to regulatory mandated limits. For example, the OCC establishes limits for nationally chartered banks on credit allowed for related organizations. State-chartered banks have limits imposed by each state regulator, but such limits are generally consistent with those established by the OCC. Similarly, the agencies' Real Estate Lending Standards Regulation [12 CFR 34, subpart D (OCC) establish supervisory loan-to-value limits for categories of real estate loans and capital limitations on the aggregate amount of loans that exceed those limits. The aggregate amount of those exceptions must also be reported at least quarterly to the board. Supervisors also review compliance with regulatory restrictions on granting credit for the purpose of purchasing stock or other securities as defined in Regulations G, T, U, and X.

[3] See Federal Reserve SR letter 07-01, OCC Bulletin 2006-46, FDIC FIL-104-2006, OTS 72 *Fed. Reg*. 1372 (Jan. 11, 2007).

AC 1	Principle 8: Credit risk
	The U.S. federal banking agencies have issued guidance on risk-management practices for specific product types, and they review practices during on-site examinations to ensure application. For example, the "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities"[4] specifies that transactions and exposures identified as posing an elevated level of risk are subject to heightened review. The policies and procedures should be designed to identify, manage, and control the risks in those transactions. The agencies require that the risk dimensions of these transactions be fully understood, monitored, and controlled by management. Also see "Interagency Credit Risk Management Guidance for Home Equity Lending,"[5] "Interagency Guidance on Nontraditional Mortgage Product Risks,"[6], and "Interagency Guidance on Leveraged Financing Sound Risk Management Practices."[7]

AC 2	Principle 8: Credit risk
Criterion	The supervisor determines that banks have in place policies and processes to identify, measure, monitor and control counterparty credit risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual products or transactions. These processes should be commensurate with the size or complexity of the individual bank.
Legal Framework	Under the general authorities cited at the outset of this Principle, banks and holding companies are expected to implement policies and processes to identify, measure, monitor, and control counterparty credit-risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual products or transactions. The expectations for these policies and processes are described in supervisory guidance. References: Federal Reserve [SR letter 99-3 (SUP)], OCC [Banking Circular 277 and *Risk Management of Financial Derivatives* booklet of OCC's handbook series], FDIC [FIL-96-066 (Supervisory Guidance for Credit Derivatives)], and OTS [Regulatory Bulletin 32-30]. The processes are expected to be commensurate with the size or complexity of the individual bank's and holding company's trading activities. Under the agencies' risk-based capital regulations, banks and holding companies must hold capital for the current credit exposure and potential future capital exposure for off-balance-sheet counterparty exposures. Banks and BHCs operating under the interagency guidelines implementing the advanced Basel II approaches must have highly sophisticated policies and processes in place to identify, measure, monitor, and control counterparty credit-risk exposure.
Practices and Procedures	The U.S. federal banking agencies have issued supervisory guidance for banks and holding companies on sound risk-management practices for counterparty credit risk. During the course of examinations, supervisors review compliance with the guidance, including evaluating whether banks and holding companies have established an adequate risk-management program that allows them to effectively identify, measure, and monitor counterparty credit-risk exposure. In conducting this evaluation, supervisors obtain the policies and reports to review whether the board and senior management have identified and understood the types of counterparty

[4] See Federal Reserve SR letter 07-5, OCC Bulletin 2007-1, FDIC FIL-3-2007, and OTS CEO Memorandum 252.
[5] See Federal Reserve SR letter 05-11; OCC Bulletin 2005-22 and 2006-43, FDIC FIL-58-2008, and OTS CEO Memorandum 256.
[6] See Federal Reserve SR letter 06-15; OCC Bulletin 2006-41; FDIC FIL 89-2006; and OTS CEO Memorandum 244.
[7] See Federal Reserve SR letter 01-9, OCC Bulletin 2001-18; and OTS Press Release 01-27

AC 2	Principle 8: Credit risk
	credit risk inherent in the activities and whether appropriate policies were reviewed and approved to limit counterparty credit risks associated with those activities. In evaluating the adequacy of the counterparty risk-management process, supervisors consider the size and complexity of an individual bank and holding company. Supervisors evaluate the following key elements of a bank's and holding company's counterparty risk-management process: o The assessment of counterparty creditworthiness, both initially and on an ongoing basis, as evidenced by a counterparty's capital strength, leverage, on- and off-balance-sheet risk factors and contingencies, liquidity, operating results, reputation, and ability to understand and manage the risks inherent in the counterparty's line of business, as well as the risks involved in the particular products and transactions that define the customer relationship. o The standards, methodologies, and techniques used in measuring counterparty credit-risk exposures on an individual instrument, counterparty, and portfolio basis. o The use and management of credit enhancements for mitigating counterparty credit risks, including collateral arrangements and collateral management systems, contractual downgrade or material change triggers, and contractual "option to terminate" or closeout provisions. o The risk limit and monitoring systems that entail the setting of meaningful limits on counterparty credit risk, monitoring exposures against these limits, and initiating meaningful risk assessments and risk-controlling actions in the event that exposures exceed limits. Additionally, supervisory guidance generally specifies that supervisors determine whether banks and holding companies o Devote sufficient resources and adequate attention to the management of the risks involved in growing highly profitable or potentially high-risk activities and product lines. o Have internal audit and independent risk-management functions that adequately focus on growth, profitability, and risk criteria in targeting their reviews. o Achieve an appropriate balance among all elements of credit-risk management, including both qualitative and quantitative assessments of counterparty creditworthiness; measurement and evaluation of both on- and off- balance-sheet exposures, including potential future exposure; adequate stress testing; reliance on collateral and other credit enhancements; and the monitoring of exposures against meaningful limits. o Employ policies that are sufficiently calibrated to the risk profiles of particular types of counterparties and instruments to ensure adequate credit-risk assessment, exposure measurement, limit setting, and use of credit enhancements. o Ensure that actual business practices conform with stated policies and their intent. o Are moving in a timely fashion to enhance their measurement of counterparty credit-risk exposures, including the refinement of potential future exposure measures and the establishment of stress testing methodologies that better incorporate the interaction of market and credit risks. To adequately evaluate these factors, supervisors conduct sufficient and targeted transaction testing on activities, business lines, and

AC 2	Principle 8: Credit risk
	products experiencing significant growth, above normal profitability or large potential future exposures. As part of transaction testing, supervisors review potential future exposure calculations to determine whether they reflect realistic measures of exposure in both normal and stressed markets and whether banks and holding companies need to enhance their methodologies. Supervisors also determine whether methodologies employed to measure exposures are applied across all products and whether appropriate management information systems are in place for counterparty credit-risk limits and monitoring.

AC 3	Principle 8: Credit risk
Criterion	The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit.
Legal Framework	As discussed under Principles 10 and 11, banks and holding companies also are subject to limits on exposures to single borrowers or groups of borrowers. In addition, the interagency guidelines on safety and soundness require banks and holding companies, in connection with credit-underwriting activity, to take adequate account of concentrations of credit risk. References: 12 CFR 208, Appendix D-1, part II(D)(5). Supervisory guidance elaborates further on expectations regarding monitoring credit concentrations. Together, these sources require banks and holding companies to have policies and processes in place to monitor the total indebtedness of entities to which they extend credit.
Practices and Procedures	U.S. federal banking supervisors review credit policies to determine that they address permissible amounts and types of credit that the bank and holding company may provide and compliance with regulatory limits and supervisory guidance for monitoring concentrations of risk. Supervisors review policies, procedures, and controls to determine that the bank and holding company have has established effective systems for measuring and monitoring credit exposures, ensuring compliance with internal and regulatory limits, and ensuring that any new and existing asset concentrations are reported to the board or other appropriate committee.

Principle 9: Problem assets, provisions, and reserves
Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves. (Reference documents: *Principles for the management of credit risk*, September 2000 *and Sound credit risk assessment and valuation for loans, June 2006*.)

EC 1	**Principle 9: Problem assets, provisions, and reserves**
Criterion	Laws, regulations or the supervisor require banks to formulate specific policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require periodic review by banks of their problem assets (at an individual level or at a portfolio level for credits with homogenous characteristics) and asset classification, provisioning and write-offs.
Legal Framework	The safety-and-soundness provision of the FDI Act, 12 U.S.C. § 1831p-1(b) requires the U.S. federal banking agencies to establish standards related to asset quality. The interagency safety-and-soundness guidelines implementing this provision require a bank to establish and maintain a system to identify problem assets and prevent deterioration in those assets. The system should be commensurate with the bank's size and the nature and scope of its operations. In addition, the bank is expected to (a) conduct periodic asset quality reviews to identify problem assets; (b) estimate the inherent losses in those assets and establish allowances/reserves that are sufficient to absorb estimated losses; (c) compare problem asset totals to capital; (d) take appropriate corrective action to resolve problem assets; (e) consider the size and potential risks of material asset concentrations; and (e) provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk. *See* 12 CFR 30, appendix A, § II(G); 12 CFR 208, appendix D-1, § II(G); 12 CFR 570, appendix A and 12 CFR 30, appendix A-1, § II(G). U.S. federal law provides that the accounting principles applicable to reports or statements required to be filed with federal banking agencies generally must be uniform and consistent with U.S. generally accepted accounting principles (U.S. GAAP). *See* 12 U.S.C. § 1831n(a)(2)(A); see also id. § 1463(b). In certain situations, the U.S. federal banking agencies can prescribe alternate accounting principles, provided the alternate principles are "no less stringent" than U.S. GAAP. *See* 12 U.S.C. § 1831n(a)(2)(B); see also id. § 1463(b)(3). U.S. GAAP includes guidance on accounting for impairment in a loan portfolio and other credit exposures. *See* Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114). The U.S. federal banking agencies have issued and, as warranted, periodically updated interagency policy statements on the Allowance for Loan and Lease Losses (ALLL), addressing the supervisory expectations about supervised banks' application of and documentation supporting FAS 5 and 114 to bank credit portfolios. These policy statements elaborate on the asset quality obligations, noted above, set forth in the interagency safety-and-soundness guidelines. The ALLL represents one of the most significant estimates in financial statements and regulatory reports. The current interagency policy statement discusses important aspects of loan loss allowance practices and is designed to assist banks in establishing a sound process for determining an appropriate ALLL and documenting that process in accordance with U.S. GAAP. *See* "Interagency

EC 1	Principle 9: Problem assets, provisions, and reserves
	Policy Statement on the Allowance for Loan and Lease Losses[1]" (December 13, 2006). These include, among other matters (a) the responsibilities of boards of directors, management, and supervisors of banks regarding the ALLL; (b) factors to be considered in the estimation of the ALLL; and (c) and the objectives and elements of an effective loan review system, including a sound credit-grading system. The statement emphasizes that each bank is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. To fulfill this responsibility, each bank is expected to ensure that controls are in place to consistently determine the ALLL in accordance with U.S. GAAP, stated policies and procedures, management's best judgment, and relevant supervisory guidance. This Interagency Statement on the ALLL identifies losses that are to be estimated in accordance with FAS 5, including credit losses in off-balance-sheet credit exposures, resulting from commitments and explicit and implicit recourse. Separate interagency guidance addresses the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account. *See* "Interagency Guidance on Certain Loans Held for Sale" (March 26, 2001). FAS 5 and FAS 114 provide guidance on how to estimate the inherent loss on individual and groups of loans for financial reporting purposes, but this guidance does not affect the U.S. federal banking agencies' processes or decisions related to asset classifications and write-offs, which are addressed in separate interagency guidance. *See* "Revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts" (June 15, 2004); "Revised Uniform Retail Credit Classification and Account Management Policy" (June 12, 2000). Supervisors monitor adherence with this guidance and with the other supervisory issuances discussed above, during on-site examinations. Both the Federal Reserve and the OTS expect holding companies to follow the Interagency Statement noted above and confirm this during examinations of holding companies.
Practices and Procedures	U.S. federal banking agencies require each bank to establish and maintain a system that is commensurate with the size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. U.S. federal banking supervisors confirm that the bank 1. Conducts periodic credit reviews to identify problem assets; 2. Estimates the incurred losses in those assets and establishes reserves that are sufficient to absorb these losses; 3. Compares problem asset aggregates to capital; 4. Takes appropriate corrective action to resolve problem assets; 5. Considers the size and potential risks of material asset concentrations; and 6. Provides periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk. (12 CFR 30 appendix A, § II(G); 12 CFR 208 appendix D-1; 12 CFR 364 appendix A; and 12 CFR 570 appendix A). The Interagency Statement on the ALLL requires banks to adopt and adhere to written policies and procedures that are appropriate to its size and the nature, scope, and risk of its lending activities. At a minimum, supervisors confirm that these policies and procedures

[1]The "Interagency Policy Statement on the Allowance for Loan and Lease Losses" will be referred to as the Interagency Statement on ALLL throughout this principle. For the Federal Reserve, it is part of SR letter 06-17; for the OCC, it is in Bulletin 2006-47; for the FDIC, it is FIL-105-2006; for the OTS it is CEO Memorandum 250.

EC 1	Principle 9: Problem assets, provisions, and reserves
	ensure that the bank has an effective loan review system and controls (including an effective loan classification or credit-grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner. To be effective, the bank's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio. Regardless of the structure of the loan review system, supervisors evaluate that an effective loan review system should have, at a minimum, the following objectives: • To confirm that management promptly identifies loans with potential or demonstrated credit weaknesses. In situations where management does not accurately and timely identify such loans, loan review has the responsibility and authority to make such determinations. • As necessary, to appropriately grade or adversely classify loans, especially those with well-defined credit weaknesses that jeopardize repayment, so that timely action can be taken and credit losses can be minimized. • To determine or require that management identifies relevant trends that affect the collectability of the portfolio and isolates segments of the portfolio that are potential problem areas. • To assess the adequacy of, and adherence to, internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations. • To evaluate the activities of lending personnel including their compliance with lending policies and, as needed, the quality of their loan approval, monitoring, and risk assessment. • To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio. • To provide management with accurate and timely credit-quality information for financial and regulatory reporting purposes, including the determination of an accurate internal problem loan identification process that is necessary to establish and maintain an appropriate ALLL. As a bank's or holding company's risk profile changes whether due to new products, increased volumes or changes in concentrations, the quality of its portfolio, or the overall economic environment, supervisors confirm that the institution updates its risk-management practices and measures. In general, in measuring these risks, U.S. federal banking agencies expect banks and holding companies to perform reasonable stress tests to identify possible events or changes in markets that could have serious adverse effects in the future. The agencies expect banks and holding companies to consider the impact of contingent exposures arising from loan commitments, securitization programs, and other transactions. For two examples of formal agreements directing banks to review the adequacy of the ALLL and setup an ALLL Program see http://www.occ.treas.gov/FTP/EAs/ea2008-040.pdf http://www.federalreserve.gov/newsevents/press/enforcement/enf20090622a1.pdf

EC 2	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor confirms the adequacy of the classification and provisioning policies and processes of a bank and their

EC 2	Principle 9: Problem assets, provisions, and reserves
	implementation; the reviews supporting this opinion may be conducted by external experts.
Practices and Procedures	U.S. federal banking supervisors confirm the adequacy of a bank's loan classification, loss provisioning process, and overall capital adequacy during each supervisory cycle. Under the agencies' Uniform Financial Institutions Rating system (UFIRS), supervisors assess and assign a composite rating based on an evaluation and rating of six essential components of a bank's financial condition and operations. One of these component factors addresses the quality of assets In assigning this component rating, supervisors consider the adequacy of the bank's ALLL and other asset valuation reserves as well as the adequacy of the its credit administration practices. Supervisors review the policies, procedures, and internal controls for classification of, and provisioning for, credit risk as well as compliance with laws and regulations. To support this assessment, supervisors generally conduct transaction testing to assess the effectiveness of these internal control processes. Supervisors also review the internal and external audit reports, internal management reports, models, and model validation processes to determine that classifications and provisioning provide boards of directors and senior management an accurate and timely picture of the bank's or holding company's credit risks. The agencies' respective examination manuals contain detailed procedures that supervisors follow in conducting their reviews.[2] For example, supervisors evaluate and test each bank's credit-risk-rating policy and procedures. In addition, as outlined in the Interagency Statement on the ALLL, supervisors review and adjust the classification or grading of the bank's loan portfolio; assess the credit quality of a its loan portfolio; and check the appropriateness of its ALLL methodology, documentation and reported amount. (*See* Interagency Statement on the ALLL p. 13 and beyond). The "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans"[3] instructs supervisors to evaluate commercial real estate credits for possible supervisory classification and requires supervisors to evaluate the methodology and process that management has followed to estimate the ALLL to ensure that all of the relevant factors affecting the collectability of the portfolio have been appropriately considered. The "Interagency Uniform Retail Credit Classification and Account Management Policy" (June 12, 2000) provides guidance to supervisors on classifying retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and on criticizing account management practices that are deficient. It also instructs supervisors to ensure that the bank's ALLL provides adequate coverage for probable losses inherent in the portfolio. (*See* FFIEC Uniform Retail Credit Classification and Account Management Policy (p. 8)). The "Interagency Uniform Agreement on The Classification of Assets and Appraisal of Securities Held by Banks and Thrifts" instructs supervisors to use the published ratings provided by nationally recognized statistical ratings organizations as a proxy for the supervisory classification definitions but allows supervisors to assign a more or less severe classification for an individual security depending upon a review of applicable facts and circumstances and the adequacy of internal credit-grading processes. (*See* Federal Reserve SR letter 04-9, p. 1; OCC Bulletin 2004-25; FDIC FIL-70-2004; OTS CEO Memorandum 200, June 15, 2004.)

[2] *See*, *e.g*.: OCC's *Community Bank Supervision, Large Bank Supervision, Loan Portfolio Management, Rating Credit Risk and Retail Lending* booklets of Comptroller's Handbook series or the Federal Reserve's *Commercial Bank Examination Manual, Section 2040.3, Loan Portfolio Management Examination Procedures.*
[3] *See* Federal Reserve SR letter 91-24; OCC, the *Commercial Real Estate and Construction Lending* booklet of the Comptroller's Handbook series; and FDIC FIL-74-94.

EC 2	Principle 9: Problem assets, provisions, and reserves
	The guidance on the ALLL contained in these interagency policies is consistent with U.S. GAAP. Through the agencies' Shared National Credit Program, teams of supervisors from the agencies conduct an annual review of the classification of large syndicated loans held by multiple banks and holding companies. These reviews are conducted on-site at agent/lead banks and holding companies with assigned classifications applicable to all participating institutions. The 2008 review covered 8,750 credit facilities with commitments totaling $2.8 trillion. An example of a relevant enforcement action is a Cease and Desist order issued requiring a bank's ALLL to conform to GAAP and the relevant interagency guidance. www.occ.treas.gov/FTP/EAs/ea2008-126.pdf

EC 3	Principle 9: Problem assets, provisions, and reserves
Criterion	The system for classification and provisioning takes into account off-balance sheet exposures
Legal Framework	Pursuant to the FDI Act, 12 U.S.C. § 1831n(a)(3)(C), all assets and liabilities, including contingent assets and liabilities, of banks and holding companies must be reported in, or otherwise taken into account in the preparation of, any balance sheet, financial statement, report of condition, or other report required to be filed with a federal banking agency. Implementing supervisory guidance makes clear that systems for classification and provisioning should take into account off-balance-sheet exposures.
Practices and Procedures	Agency guidelines state that the risk ratings used by banks and holding companies should be applied to off-balance-sheet exposures such as letters of credit and unfunded commitments that the bank or holding company is obligated to fund (*see*, *e.g*., OCC's *Loan Portfolio Management Handbook* or Federal Reserve's *Commercial Bank Examination Manual*). The Interagency Statement on the ALLL requires the recognition of credit losses in off-balance-sheet exposures, including loan commitments, standby letters of credit, guarantees, and recourse liabilities on loan transfers. U.S. federal banking supervisors assess the structure of off-balance-sheet instruments to understand the explicit and implicit credit risk to the bank. Such activities include securitizations, underwritings of exposures requiring distribution in capital markets, structured securities, and derivatives. U.S. federal banking agencies expect banks and holding companies to estimate credit exposures in accordance with U.S. GAAP. U.S. GAAP requires any allowance for credit losses on off-balance-sheet exposures to be reported on the balance sheet as an "Other Liability," and not as part of the ALLL. *See* Interagency Statement on the ALLL, p. 3.

EC 4	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations.

EC 4	Principle 9: Problem assets, provisions, and reserves
Legal Framework	Under the interagency safety-and-soundness guidelines, a bank should establish and maintain a system that, among other things, identifies and resolves problem assets. *See* 12 CFR 208, appendix D, § II(G); and 12 CFR 30, appendix A, § II(G). Under related supervisory guidance, banks and holding companies are expected to establish appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations.
Practices and Procedures	In accordance with long standing supervisory guidance as recently clarified in the Interagency Statement on the ALLL, U.S. federal banking supervisors confirm that banks and holding companies evaluate the ALLL reported on the balance sheet as of the end of each quarter, or more frequently if warranted, and charge or credit the provision to bring the ALLL to an appropriate level as of each evaluation date. The determination of the ALLL and the necessary provision are to be based on the bank's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectability as of the evaluation date. Nevertheless, the ALLL estimates do reflect rigorous quantitative analyses supplemented by considerable amounts of management judgment. U.S. federal banking supervisors review bank policies, processes, and practices to ensure that they promptly charge off loans, or portions of loans, where available information confirms the exposure to be uncollectible. Using the Interagency "Classification of Credit" definitions, supervisors can direct banks and holding companies to recognize loan losses or change loan classifications. Also, if the supervisor concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, supervisors are empowered to require a bank or holding company to correct these deficiencies as dictated in the Interagency Policy Statement on the ALLL.

EC 5	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past-due obligations.
Legal Framework	Under supervisory guidance implementing the interagency safety-and-soundness guidelines on identifying and resolving problem assets, banks and holding companies are expected to have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past-due obligations.
Practices and Procedures	To facilitate early identification of deteriorating assets, U.S. federal banking agencies require banks and holding companies to have effective loan administration and loan review systems that make use of a risk-rating system that rates or grades loans and other assets. The agencies require banks and holding companies to initiate additional or heightened oversight as the rating for a credit exposure deteriorates and to initiate appropriate corrective action, including potential escalation into the restructuring, foreclosure, or collection processes. Based on a combination of on-site examinations and off-site monitoring, U.S. federal banking supervisors assess the quality and timeliness of the bank's or holding company's rating system, classification process, and credit workout processes to determine if they are appropriate. Supervisors also assess the trend in credit ratings migration and may direct a bank or holding company to re-grade any credit where the rating does not reflect the credit's actual condition. In the review and classification or grading of assets, supervisors consider all significant factors that affect the collectability of the obligation, including

EC 5	Principle 9: Problem assets, provisions, and reserves
	the value of any collateral. *See* Interagency Statement on the ALLL, pp. 6 – 8 and Attachment 1. For retail transactions, supervisors evaluate a bank's account management, collection and foreclosure processes to determine whether institutional intervention is appropriately mitigating or reducing potential losses.

EC 6	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor is informed on a periodic basis, and in relevant detail, or has access to information concerning the classification of credits and assets and provisioning.
Legal Framework	Under the U.S. federal banking agencies' statutory examination authority, supervisors may review all books and records maintained by a bank or holding company (and its affiliates) subject to the agencies' supervision. *See*12 U.S.C. §§ 325-26, 481, 483, 484, 602, 625, 1464(d), 1467a(b), 1820(b), 1844(c), 3105(c). This includes access to the bank's or holding company's employees who are involved in a matter under review. Supervisory guidance specifies the information that is expected to be maintained by banks and holding companies with respect to credit management, including details on credit and investment portfolios. Supervisors have full access to this information, and to all employees involved in assuming, managing, controlling and reporting on credit risk, during examinations. Further, banks and holding companies are required to submit quarterly regulatory financial reports of their financial condition to supervisors (referred to as Call Reports or Thrift Financial Reports). This information includes details on classification of credits and assets, delinquencies, and provisioning. Supervisors have full and complete access to this information during on-site examinations and may request additional details, as appropriate.
Practices and Procedures	During the course of examinations, U. S. supervisors are provided with full access to all records and employees of the bank or holding company. This includes access to individual loan files, risk-management reports, internal and external audit reports and other material (such as board or committee minutes and reports). Banks and holding companies that do not supply requested information or access to premises and personnel are subject to supervisory sanctions and prosecution. The U.S. federal banking agencies utilize the quarterly regulatory financial reports, as well as regular reports from the bank's management, to monitor and assess the condition of banks and holding companies and to identify trends in loan and asset performance. This information also assists supervisors in identifying potential areas for further supervisory review. Supervisors use the reports at the level of granularity necessary to make evaluations of the bank's or holding company's internal processes and management competence. As clarified in the Interagency Statement on the ALLL, the U.S. federal banking agencies require banks to submit a report to the board of directors that summarizes the results of the loan review process, the loan loss allowance calculation process, and an evaluation of the appropriateness of the current ALLL level at least quarterly. The policy indicates that the board of directors should be informed more frequently than quarterly when material adverse trends are noted. As the size and complexity of a bank increases, supervisors use more granular reports to make their assessments and to find potential areas of weakness. In addition to reporting current credit quality findings, the board of directors should receive reports on comparative trends that identify significant changes or trends in the overall quality of the portfolio. Findings should also address the adequacy of, and

EC 6	Principle 9: Problem assets, provisions, and reserves
	adherence to, internal policies and procedures, as well as compliance with laws and regulations, in order to facilitate timely correction of any noted deficiencies. Reports submitted to a bank's or holding company's board of directors are also provided to supervisors. The regulatory reports submitted by banks and holding companies, generally on a quarterly basis, include a reconciliation of the ALLL, charge-offs, provisions, and past-due and nonaccrual information (*See* Interagency Statement on the ALLL, Attachment 1; Call Reports, TFRs, Y-9 reports).

EC 7	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor has the power to require a bank to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern.
Legal Framework	If provisions are deemed to be inadequate, the federal banking agencies will require corrective measures. In any case, the U.S. federal banking agencies have the authority to require additional provisions or to impose other remedial measures. *See generally* 12 U.S.C. § 1818(b). Also, banks and holding companies must file with the federal banking agencies quarterly financial reports (12 U.S.C. §§ 161(a) and (c) and 1464(v)(savings associations)), and civil money or other penalties may be assessed for significant failures, such as an inaccurate ALLL. U.S. federal banking supervisors assess the credit quality of a bank's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the bank's regulatory reports. Identified deficiencies in the loan review program, including in the level of problem assets, should be noted in examination reports. Banks and holding companies are expected to correct any noted deficiencies, including, if appropriate, by increasing their levels of provisions and reserves and/or overall financial strength. Additional supervisory action may be taken based on the magnitude of the observed shortcomings. *See* Interagency Statement on the ALLL (December 13, 2006).
Practices and Procedures	As most recently clarified in the Interagency Statement on the ALLL, if a U.S. federal banking supervisor determines the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, supervisors will require the bank or holding company to take corrective action to address these deficiencies. Supervisors will note serious concerns regarding the ALLL in their reports of examination. The U.S. federal banking agencies may also take enforcement action against the bank or holding company, based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL. When a bank's or holding company's ALLL is inadequate, supervisors will require it to adjust its ALLL by an amount sufficient to bring the ALLL reported on its regulatory reports to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate for the circumstance. (*See* Interagency Statement on the ALLL, p. 15). The federal banking agencies can require the addition of capital or an adjustment of capital to reflect the insufficient levels of provisions and ALLL. *See* 12 CFR 3, Subpart C – Establishment of Individual Minimum Capital Ratios for an Individual Bank. Evaluations of capital adequacy fully incorporate assessments of asset quality, allowance/reserve appropriateness and earnings

EC 7	Principle 9: Problem assets, provisions, and reserves
	strength. Material shortfalls in allowance/reserves or regulatory capital are immediately met with supervisory action.

EC 8	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor assesses whether the classification of the credits and assets and the provisioning is adequate for prudential purposes. If provisions are deemed to be inadequate, the supervisor has the power to require additional provisions or to impose other remedial measures.
Legal Framework	If provisions are deemed to be inadequate, the federal banking agencies will require corrective measures. In any case, the U.S. federal banking agencies have the authority to require additional provisions or to impose other remedial measures. *See generally* 12 U.S.C. §1818(b); and 12 U.S.C. §1831p-1(e). Also, banks and holding companies must file with the federal banking agencies quarterly financial reports (12 U.S.C. §§ 161(a) and (c) and 1464(v)(savings associations), and civil money or other penalties may be assessed for significant failures, such as an inaccurate ALLL. *See* 12 U.S.C. § 1818(i).
Practices and Procedures	As most recently clarified in the Interagency Statement on the ALLL, the U.S. federal banking agencies require banks to have an effective loan review system and controls (including an effective loan classification or credit-grading system) that identifies, monitors, and manages asset quality problems in a prudent manner. Through periodic on-site and off-site supervisory activities, the agencies assess whether classification and provisioning processes are adequate. If the U.S. federal banking supervisor concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, supervisors will require the bank or holding company to adjust the ALLL and address the process deficiencies. Supervisors do not rely on management's current estimate of credit losses when supervisors find a bank's or holding company's internal credit administration practices ineffective. When an examination identifies material credit administration weaknesses or a significant volume of problem loans and the ALLL amount appears deficient in such cases, supervisors require the bank's or holding company's management to expeditiously address the appropriateness of its ALLL estimate and to make provisions as necessary to address deficiencies identified through the supervisors' review. Supervisory recommendations on an appropriate level for the ALLL are included in the federal banking agency's report of examination, and supervisors may require a formal written response from the bank or holding company on the action to be taken. Supervisors monitor the bank's or holding company's corrective actions to ensure that deficiencies have been addressed. (Interagency Statement on the ALLL, pp. 6 and 15) As clarified in the Interagency Statement on the ALLL and the "Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation," supervisors ensure that valuation approaches and techniques are consistent with U.S. GAAP.

EC 9	Principle 9: Problem assets, provisions, and reserves

EC 9	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor requires banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. The valuation of collateral is required to reflect the net realizable value.
Legal Framework	The interagency safety-and-soundness guidelines require banks to establish and maintain systems for identifying problem assets and preventing deterioration of those assets which include guidelines for loan documentation. *See* 12 CFR 30, appendix A, § II (G); 12 CFR 208, appendix D-1, § II(G); and 12 CFR 570, appendix A, § II(G) . As part of this system, the bank is expected to establish a credit administration function and conduct periodic asset quality reviews to identify problem assets. The U.S. federal banking agencies expect banks and holding companies to establish and implement appropriate policies and procedures for periodically assessing the value of risk mitigants, including guarantees and collateral, at net realizable value. For real estate based credits, the agencies have appraisal and real estate lending standards regulations that govern collateral valuation practices, underwriting standards (e.g., loan-to-value limits), credit administration, and portfolio management expectations. (*See* 12 CFR 34, subpart D; 12 CFR 208 subpart E; 12 CFR 225, subpart G; and12 CFR 564.)
Practices and Procedures	As clarified in the Interagency Statement on the ALLL and the "Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation," supervisors ensure that valuation approaches and techniques are consistent with U.S. GAAP. For loans individually evaluated for impairment, supervisors confirm that estimates of credit losses reflect consideration of all significant factors that affect the collectability of the loan as of the evaluation date, including risk mitigants, pursuant to FAS 114. There are three methods that are allowed to determine the impairment: fair value of collateral, observable market price of the loan, and a discounted cash flow method. For loans solely dependent on the liquidation of collateral, only the collateral valuation approach is allowed. The collateral valuation approach allows a valuation "as-is" less transaction costs to determine the impairment -- a "fire sale" estimate is not considered. For real estate secured credits, supervisors assess compliance with appraisal regulations and accompanying guidance to determine the market value of real estate securing the credit. As part of the appraisal regulations, the U.S. federal banking agencies incorporate the appraisal standards as set forth in the U.S. Uniform Standards of Professional Appraisal Practice. For loans evaluated for impairment on a pool basis, estimates of credit losses should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods with written documentation and support for conclusions and rationales for the use and valuation of risk mitigants and collateral. For example, loans that are fully secured by deposits maintained at the bank or would be evaluated for collectability with a thorough analysis of the borrowers' ability to repay that includes the value of the deposit. (*See* Interagency Statement on the ALLL, pp. 6 and 15 and the July 2001 interagency "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions"; Federal Reserve SR letter 01-17, pp. 13 16; OCC Bulletin 2001-37 (July 20, 2001); and FDIC FIL-63-2001 (July 25, 2001).)

EC 10	Principle 9: Problem assets, provisions, and reserves
Criterion	Laws, regulations or the supervisor establish criteria for assets to be identified as impaired, e.g. loans are identified as impaired when there is reason to believe that all amounts due (including principal and interest) will not be collected in accordance with the

EC 10	Principle 9: Problem assets, provisions, and reserves
	contractual terms of the loan agreement.
Legal Framework	Pursuant to the safety-and-soundness provision of the FDI Act, 12 U.S.C. § 1831p-1(b), the U.S. federal banking agencies have established criteria for identifying an asset as "impaired." *See* Interagency Statement on the ALLL (December 13, 2006).
Practices and Procedures	U.S. federal banking supervisors evaluate assets considered for impairment, the impairment evaluation processes, and the impairment amounts taken under the ALLL review process. Deficiencies in the process are identified and corrective action is expected. The accounting guidance defines impaired assets in several pronouncements – individual loans under FAS 114 and loans assessed collectively (as part of a pool) under FAS 5. Fundamentally, an impaired loan is defined as a loan where management does not think that it will collect payment in full of contractual interest, fees, and principal payments. Banks and holding companies have the discretion to determine which individual loans are considered for evaluation of impairment under FAS 114 and define them in their internal accounting practice documents. Generally, loans exceeding a certain materiality criterion, nonaccrual assets, severely delinquent credits, and problem loan or "watch" lists generate the loans evaluated to determine which loans are "impaired. Once a loan is identified as impaired, an estimate of the amount of impairment is determined. The amount of impairment for a pool of loans is based on a bank's or holding company's ongoing loan review process and analysis of loan performance. One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the bank's or holding company's historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) and current conditions over a defined period of time. *See* July 2001 "Interagency Policy Statement on Allowance for Loan and Leases Methodologies and Documentation for Banks and Savings Institutions"; Federal Reserve SR letter 01-17, pp. 13 – 16; OCC Bulletin 2001-37 (July 20, 2001); and FDIC FIL-63-2001 (July 25, 2001).

EC 11	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor determines that the Board receives timely and appropriate information on the condition of the bank's asset portfolio, including classification of credits, the level of provisioning and major problem assets.
Legal Framework	Pursuant to the sources identified under EC 10 and the interagency guidelines on safety and soundness, banks and holding companies should have policies and procedures in place to ensure that the board of directors receives timely and appropriate information on the condition of the bank's or holding company's asset portfolio, including classification of credits, the level of provisioning, and major problem assets. See 12 CFR 30, appendix A § II(G); 12 CFR 208, appendix D-1, § II(G).
Practices and Procedures	During the course of examinations, a bank's or holding company's management provides supervisors with full access to all records and employees. This includes access to internal and external audit reports and other material, such as board or committee report and

EC 11	Principle 9: Problem assets, provisions, and reserves
	meeting minutes. Banks and holding companies that do not supply requested information or access to premises and personnel are subject to supervisory sanctions and prosecution. U.S. federal banking agencies utilize the quarterly regulatory financial reports, as well as reports from the bank's or holding company's management, to monitor and assess the condition of banks and holding companies and to identify trends in loan and asset performance. This information also assists supervisors in identifying potential areas for further supervisory review. Agency supervisors determine whether bank management provides clear, concise, and timely information about the loan portfolio and its attendant risks to the board of directors. Supervisors determine that management has clearly communicated strategic objectives and risk limits to the board and that the board has approved them. Supervisors also ensure that risk levels, trends, provisioning levels, significant problem assets, policy exceptions, and compliance with laws and regulations are adequately reported to both senior management and the board. Supervisors determine whether the reports' descriptions of loan portfolio risks are sufficient to enable the board to exercise its supervisory responsibilities. The agencies expect that a unit independent of the lending function will periodically evaluate the accuracy, completeness, and timeliness of the information in these reports. This evaluation is normally part of loan review or audit activities. If concerns exist about internal testing, supervisors conduct sufficient testing to reach an independent assessment. As most recently clarified in the Interagency Statement on the ALLL, the agencies require bank management to submit quarterly reports, at a minimum, to the board of directors, summarizing the results of the loan review process. The agencies expect management to make more frequent reports to the board of directors when material adverse trends are noted. The agencies expect management to provide the board of directors with comparative reports that identify significant changes in the level and trend of credit risk in the portfolio. Such reports should address the adequacy of, and adherence to, internal policies and procedures, as well as compliance with laws and regulations, in order to facilitate timely correction. These management reports are also provided to supervisors. During on-site examinations, supervisors evaluate the effectiveness bank corporate governance, including the type and quality of information provided to the board of directors. (*See* Interagency Statement on ALLL, Attachment 1, for a brief synopsis of federal banking agencies examination handbook/manual sections on boards of directors' duties and responsibilities.)

EC 12	Principle 9: Problem assets, provisions, and reserves
Criterion	The supervisor requires that valuation, classification, and provisioning for large exposures be conducted on an individual item basis.
Legal Framework	Pursuant to the Interagency Statement on the ALLL (December 13, 2006), banks are expected to value, classify, and allocate provisions for large exposures on an individual item basis.
Practices and	U.S federal banking agencies expect management to focus attention on, and consider capital allocations for, concentrations of credit,

EC 12	Principle 9: Problem assets, provisions, and reserves
Procedures	including large individual exposures. As most recently clarified in the Interagency Statement on the ALLL, the agencies require banks to review significant credits at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular loan, loan product, or group of loans. Also, the agencies require banks and holding companies to individually allocate provisions for large exposures.

AC 1	Principle 9: Problem assets, provisions, and reserves
Criterion	Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g. 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classification for such loans.
Practices and Procedures	Supervisors have issued specific supervisory classification for retail credits, *see* "Uniform Retail Credit Classification and Account Management Policy"; 65 *Fed. Reg*. 36903 (June 12, 2000); Federal Reserve SR letter 00-8; OCC Bulletin 2000-20; FDIC FIL-40-2000 (June 29, 2000); and OTS CEO Memorandum 128 (July 27, 2000). In the U. S., the agencies have generally found that, for most retail products, the quality of retail credit is best indicated by the repayment performance of individual borrowers. As a result, under these guidelines, banks and holding companies are expected to classify loans and recognize losses when payments are contractually a minimum number of days in arrears. Also, banks and holding companies are required to establish explicit standards that control the use of extensions, deferrals, renewals, and rewrites. The policy does not preclude supervisors from classifying individual loans or entire portfolios regardless of delinquency status or criticizing account management practices that are deficient or improperly managed. If underwriting standards, risk management, or account management standards are weak and present unreasonable credit risk, supervisors may deviate from the minimum classification guidelines outlined in the policy. *See* Federal Reserve's CBEM, section 2060.1; OCC's *Retail Lending Examination Procedures* Handbook and FDIC FIL-40-2000; and OTS CEO Memorandum 128 (July 27, 2000). For loans not covered by the policy on retail credit, above, the U.S. federal banking agencies consider credit risk factors beyond just arrearage. Credits are required to be classified when well defined weaknesses that jeopardize liquidation of the credit exist. In classifying such credits, the agencies use the following asset designations – "Special Mention," "Substandard," "Doubtful," and "Loss." The Federal Reserve's criteria are in *Commercial Bank Examination Manual*, section 2060.1; OCC's is in the *Rating Credit Risk* Handbook; and the FDIC's FIL-40-2000 as well as chapter 3.2.of the RMMEP and the OTS's is in OTS Examination Handbook, Section 260, Classification of Assets.

Principle 10: Large exposure limits

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

(Reference documents: *Measuring and controlling large credit exposures*, January 1991; and *Principles for managing credit risk*, September 2000.)

Overview

Banks, including branches and agencies of foreign banking organizations, are subject to limits on exposures to a single counterparty or a group of connected counterparties. National banks are subject by statute to limits tied to express percentages of a bank's unimpaired capital and surplus. *See* 12 U.S.C. § 84. These limits are further defined by regulation. *See* 12 CFR 32. Section 84 authorizes the OCC to establish lending limits "for particular classes or categories of loans or extensions of credit" that are different from those expressly provided by the statute's terms. *See* 12 U.S.C. § 84(d). The OCC has exercised this authority to add special lending limits for certain small business loans, small farm loans, and residential loans for eligible banks. *See* 12 CFR 32.7. A bank's total outstanding loans and extensions of credit to one borrower are typically limited to 15 percent of the bank's capital and surplus. A bank can extend an additional 10 percent of its capital and surplus to one borrower if the loan is fully secured by readily marketable collateral on which a perfected security interest has been obtained (i.e., there is an aggregate limit of 25 percent of a bank's capital). *See* 12 U.S.C. § 84. Other limits apply in special situations. In addition to the 15 percent and 10 percent restrictions for loans to one borrower, a bank may not loan more than 50 percent of its capital and surplus to corporate groups. *See* 12 CFR 32.5(d).

The OCC's lending limit regulation for national banks applies to other types of banks as well. By statute, the limits in section 84 applicable to national banks apply to all savings associations, with narrow exceptions. *See* 12 U.S.C. § 1464(u). The OTS has issued implementing regulations. *See* 12 CFR 560.93. In general, state chartered banks are subject under state banking laws to percentage limitations similar to those applicable to national banks. The FDIC and the Federal Reserve have not promulgated separate regulations governing single borrower limits, although, as discussed under Principle 11, the national and state lending limits are incorporated by reference into the Federal Reserve's regulations governing exposures to related parties. In addition, all banks and holding companies are subject to the interagency guidelines on safety and soundness. *See* Federal Reserve [12 CFR 208, appendix D-1, which effectively requires diversification in the credit portfolio and prohibit undue concentrations of assets] and OCC [12 CFR 30, appendix A].

The limits imposed by regulation apply to all outstanding loans and extensions of credit to a single borrower. These lending limits are in addition to the investment securities limits of 12 U.S.C. § 24(Seventh) and 12 CFR 1[1] which impose separate and independent limits on exposures to single issuers arising from securities held by banks for their own account. These limits restrict the amount of securities that a bank may deal in, underwrite, purchase, or sell, based on the characteristics of the security's obligor. 12 CFR 24 imposes similar investment limits on a national bank's investment in certain community and economic development entities. Both sets of limits are expressed as a percentage of a bank's capital. The aggregate par value of securities issued by one borrower and held by a bank may not exceed 10 percent of the bank's capital and surplus for Type II securities (*e.g.,* obligations issued by individual states or by certain international and multinational development bank); 10 percent of capital and surplus for Type III securities (*e.g.,* certain corporate or municipal bonds); 25 percent of capital and surplus for Type IV securities (*e.g.,* small business-related securities rated in the third or fourth highest rating categories by an NSRO); and 25 percent of capital and surplus for Type V securities (*e.g.,* certain investment-grade rated,

[1] 12 CFR 1 applies to banks but not savings associations

Principle 10: Large exposure limits
marketable securities). *See* 12 CFR 1.3. Those investment securities restrictions impose separate and independent limits on exposures to single issuers arising from securities held by banks for their own account. The single borrower limits also do not apply to transactions with affiliates, which are subject to separate restrictions as discussed in the assessment of Principle 11. A federal savings association's total investment in commercial paper and corporate debt securities of any one issuer, or issued by any one person or entity affiliated with that issuer, together with other loans, may not exceed the general lending limit. *See* 12 CFR 560.40(a)(3). Different statutory limits apply to the aggregate amounts of various types of loans and investments by a federal savings association, These limits, which are based on total capital or assets, apply to the aggregate amount of all loans or investments of the same type. *See* 12 U.S.C. § 1464(c)(2); 12 CFR 560.30. For example, commercial loans may not exceed 20 percent of the total assets of the federal savings association, and amounts in excess of 10 percent may only be for small business loans. *See* 12 U.S.C. § 1464(c)(2)(A). Nonresidential real property loans may not exceed 400 percent of capital. 12 U.S.C. § 1464(c)(2)(B). All consumer loans and all investments in commercial paper and corporate debt securities, when added together, may not exceed 35 percent of total assets. *See* 12 U.S.C. § 1464(c)(2)(D). Largely Compliant: Prior to the market turmoil, many banks' default models relied on historical correlations and, especially for various residential mortgage related exposures, focused on geography and borrower characteristics, but not on the aggregate risk exposure of subprime portfolios, including exposures from highly-rated senior CDOs and other structured securities. In addition, some off balance sheet structures and transactions were not fully considered. In many cases the bank did not have any legal obligation to support those transactions but later chose to do so in order to maintain investor relationships, In retrospect, these omissions proved to be critical, and are being addressed in current supervisory activity. The agencies are directing banks to improve their ability to aggregate risks across legal entities and product lines to identify potential risk concentrations and correlations.

EC 1	Principle 10: Large exposure limits
Criterion	Laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case-by-case basis.
Legal Framework	Regulations define those individuals and entities whose interests will be attributed to the single borrower for purposes of computing the lending limits. Under the regulations, the OCC and OTS generally have discretion to apply the attribution rules in a manner that reflects actual risk exposure. Regulations also define corporate groups for purposes of the lending limits. *See* 12 U.S.C. § 84(d)(2) and 12 CFR 32.5. Although there are no statutory or regulatory concentration limits for holding companies, as discussed below, concentrations at holding companies are monitored and subject to limits through the supervisory process.

EC 1	Principle 10: Large exposure limits
Practices and Procedures	The U.S. federal banking agencies expect banks to adhere to legal lending limits. U.S. federal banking supervisors review a bank's and holding company's risk-management practices to define, identify, measure, monitor, and control large credits[2]. Determining a large exposure depends in part on "facts and circumstances," specifically, credit exposure to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, credit exposure to borrowers with common characteristics within an industry, and loans with a single source of repayment. Supervisors review the policies, systems, and internal controls a bank or holding company uses to monitor and manage its concentration risks.

EC 2	Principle 10: Large exposure limits
Criterion	Laws, regulations or the supervisor set prudent limits on large exposures to a single counterparty or a group of connected counterparties. "Exposures" include all claims and transactions, on-balance sheet as well as off-balance sheet. The supervisor confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.
Legal Framework	The sources cited in the overview establish limits on "loans and extensions of credit" to a single counterparty or a group of connected counterparties. In general, on-balance-sheet as well as off-balance-sheet extensions of credit are included in calculating the limit. The legal lending limits, however, do not cover all claims and transactions that expose a banking organization to credit risk of third parties. Counterparty credit risk from derivatives is not explicitly included. Unlike other credit risk exposures, the potential credit risk arising from a derivative transaction is more uncertain: for most transactions, the risk is bilateral, with each party of the contract having a current credit exposure to the other party at various points in time over the contract's life and the amount at risk is not a fixed amount but rather varies over time with movement in market rates. As a result banks do not know, and can only estimate, how much the value of the derivative contract might be at various points of time in the future. While these exposures are not included in a bank's legal lending limit, institutions are expected to establish internal limits on such exposures and these limits are reviewed and monitored by examiners. In many cases, these exposures are collateralized by cash. Combination rules apply to determine whether extensions of credit to one borrower will be attributed to another person, such that each person will be deemed a borrower. *See* 12 CFR 32.5. For example, under the combination rules, loans will be attributed to another person when proceeds of a loan or extension of credit are to be used for the direct benefit of the other person or when a common enterprise is deemed to exist between the persons. Id. When the agencies identify overages to the legal lending limit, they may seek restitution and civil money penalties against officers, directors and agents of the bank *See* 12 U.S.C.§ 1818(b) and (c) and 12 U.S.C. § 93. While subject to the same lending limits as a bank, 12 CFR 560.93, a federal savings association's total investment in commercial paper and corporate debt securities of any one issuer, or issued by any one person or entity affiliated with that issuer, together with

[2] For Federal Reserve *see* section 2050 of CBEM; for OCC *see* the Comptroller's Handbooks for *Community Bank Supervision, Large Bank Supervision* (assessment of diversification management and concentration limits are assessed as part of OCC's Risk Assessment System), *Concentrations of Credit* p. 1 and *Loan Portfolio Management*; for FDIC *see* FIL-22-2008 and subsection G of RMMEP; for OTS *see Examiner Handbook,* section 211.

EC 2	Principle 10: Large exposure limits
	other loans, may not exceed the general lending limit. *See* 12 CFR 560.40(a)(3).
Practices and Procedures	The U.S. federal banking agencies confirm, as part of the normal supervisory process, that senior management establishes reasonable credit and issuer limits and monitors the bank's and holding company's exposures and that it has adequate controls and management information systems to ensure that these limits are not exceeded on an individual legal entity or consolidated basis. The agencies expect management to define, identify, measure, monitor, and control borrower limits, which are defined as direct or indirect extensions of credit and contingent obligations (both on- and off-balance sheet). U.S. federal banking supervisors determine whether a bank's or holding company's lending policies and practices adhere to applicable laws and regulations and initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted. The supervisor is charged with understanding and evaluating the effectiveness of the internal policies, systems, and controls that the bank or holding company uses to monitor and manage the risk associated with asset limitations. The supervisor is also responsible for verifying the accuracy of large borrower relationships identified by the bank or holding company. *See* Banking Manuals noted in Principle 7 and footnote 1 of EC 1.

EC 3	Principle 10: Large exposure limits
Criterion	The supervisor determines that a bank's management information systems identify and aggregate on a timely basis exposure to individual counterparties and groups of connected counterparties.
Legal Framework	Banks and holding companies are expected, in adhering to the interagency safety-and-soundness standards, to have management information systems (MIS) in place that adequately and timely identify and aggregate risk exposures, including to individual counterparties and groups of connected counterparties. For holding companies, these systems must provide aggregate data across legal entities.
Practices and Procedures	The U.S. federal banking agencies have directed banks and holding companies to maintain adequate records that may be used to identify large borrower relationships. *See* footnote 1 of EC 1. The degree of sophistication of a bank's or holding company's reporting systems and records will vary depending on the size, complexity, and global footprint of the bank or holding company. All new and existing large borrowers should be reported regularly to the board of directors or other appropriate committee for review. U.S. federal banking supervisors are responsible for reviewing, evaluating, and verifying these reports during on-site examination. Supervisors determine that management reporting is timely and in a format that clearly indicates absolute and relative changes in the exposure to individual counterparties and groups of connected counterparties. In addition, supervisors assess if management reporting includes a well-defined process through which management reviews and evaluates large borrower and risk-management reports. Supervisors also evaluate if a bank or holding company should have a more advanced practice that includes measures of these exposures relative to internal and regulatory capital measures, not just notional exposures.

EC 4	Principle 10: Large exposure limits
Criterion	The supervisor confirms that a bank's risk management policies and processes establish thresholds for acceptable concentrations of credit and require that all material concentrations be reviewed and reported periodically to the Board.
Legal Framework	The legal authorities and supervisory guidance cited in the overview to Principle 8 provide for active board involvement in the approval, periodic review, and oversight of senior management's implementation of a bank's and holding company's overall business strategies and significant policies —including strategies and policies related to taking and managing credit risk. Under supervisory guidance, banks and holding companies are expected to establish internal thresholds for acceptable concentrations of credit and to report all material concentrations to the board for review.
Practices and Procedures	The U.S. federal banking supervisors confirm that management identifies, defines, measures, monitors, and controls concentrations. Concentrations are generally defined by the agencies as direct or indirect extensions of credit and contingent obligations (both off- and on-balance sheet) that, when aggregated, exceed 25 percent of the bank's tier 1 capital plus the allowance for loan and lease losses. *See* footnote 2 in EC 1. The U.S. federal banking agencies expect that the bank and holding company board of directors establish prudent concentration control processes in relation to the level and complexity of its lending activities, its risk appetite and sophistication, and its capital levels. These processes should include escalation procedures and approval processes for exceptions to policy limits. Supervisors verify that new and existing concentrations are reported regularly to the board of directors or other appropriate management committees for review. Supervisors review policies, management reports, and audit reports dealing with aggregate exposures and concentrations to ensure that the policies and practices are sufficient to control concentrations and that reports are sufficiently detailed to provide appropriate information to the board of directors or other appropriate committee to take appropriate action. The U.S. federal banking agencies have established policies and guidance regarding concentration by industry, such as "Interagency Guidance on Concentration in Commercial Real Estate"[3], and concentration by product, such as "Interagency Guidance on Nontraditional Mortgage Products Risks"[4]. The "Interagency Guidance on Concentrations in Commercial Real Estate" specifies that MIS should provide management with sufficient information to identify, measure, monitor, and control concentration risk. This includes meaningful information on portfolio characteristics that is relevant to the bank's or holding company's lending strategy, underwriting standards, and risk tolerances.

EC 5	Principle 10: Large exposure limits
Criterion	The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical

[3] For Federal Reserve, *see* SR letter 07-1; for OCC, *see* Bulletin 2006-46; for FDIC, *see* FIL-22-2008; for OTS, *see* CEO Memorandum 252.
[4] For Federal Reserve, *see* SR letter 06-15; for OCC, *see* Bulletin 2006-41; for FDIC, *see* FIL-89-2006, for OTS, *see* CEO Memorandum 256.

EC 5	Principle 10: Large exposure limits
	and currency exposures, to be reviewed. The supervisor has the power to require banks to take remedial actions in cases where concentrations appear to present significant risks.
Legal Framework	The U.S. federal banking agencies regularly obtain, through regulatory financial reports and on-site examinations, information that enables review of concentrations within a bank's and holding company's portfolio, including sectoral, geographical, and currency exposures. Supervisors may follow up on any areas of concern, requesting additional information or directing a banking organization to reduce concentrations that present significant risks. The agencies may take more formal action as necessary to protect the safety and soundness of the bank and holding company. *See* 12 U.S.C. § 1818(b) & (c).
Practices and Procedures	As indicated in ECs 1-4 above, supervisors regularly obtain information from banks regarding credit concentrations. There are numerous factors for determining concentrations within a loan portfolio, including by collateral support, geography, risk characteristics, industry or economic sector, product type, or by factors that link performance to similar economic, financial, or business developments. *See* manuals noted in footnote 1 of EC 1 and Uniform Bank Performance Report page 07B, *Analysis of Concentrations of Credit*. If a supervisor identifies weaknesses, the agencies have the authority to require a bank or holding company to take remedial actions in cases where concentrations present significant risks. Generally, these actions require institutional evaluation of concentrations relative to risk-management prowess and capital levels. Supervisory recommendations on concentrations are included in the agency's report of examination, and the agency may require a formal written response on the action to be taken. *See, e.g.,* OCC Bulletin 95-7. The agency monitors the corrective actions to ensure that deficiencies have been addressed.

AC 1	Principle 10: Large exposure limits
Criterion	Banks are required to adhere to the following definitions: • Ten percent or more of a bank's capital is defined as a large exposure; and • Twenty-five percent of a bank's capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties. Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.
Legal Framework	A bank's total outstanding loans and extensions of credit to one borrower are typically limited to 15 percent of the bank's capital and surplus. A bank can extend an additional 10 percent of its capital and surplus to one borrower if the loan is fully secured by readily marketable collateral on which a perfected security interest has been obtained (i.e., there is an aggregate limit of 25 percent of a bank's capital). *See* 12 U.S.C. § 84. Other limits apply in special situations. In addition to the 15 percent and 10 percent restrictions for loans to one borrower, a bank may not loan more than 50 percent of its capital and surplus to corporate groups. See 12 CFR 32.5(d). In addition to the credit exposure limits discussed above, there are separate limits on the amount of securities issued by any one obligor that can be held by one bank. The aggregate par value of securities issued by one borrower and held by a bank may not

AC 1	Principle 10: Large exposure limits
	exceed 10 percent of the bank 's capital and surplus for Type II securities (*e.g.,* obligations issued by individual states or by certain international and multinational development banking organizations); 10 percent of capital and surplus for Type III securities (*e.g.,* certain corporate or municipal bonds); 25 percent of capital and surplus for Type IV securities (*e.g.,* small business-related securities rated in the third or fourth highest rating categories by an NSRO); and 25 percent of capital and surplus for Type V securities (*e.g.,* certain investment-grade rated, marketable securities). *See* 12 CFR 1.3. While subject to the same lending limits as a bank, 12 CFR 560.93, a federal savings association's total investment in commercial paper and corporate debt securities of any one issuer, or issued by any one person or entity affiliated with that issuer, together with other loans, may not exceed the general lending limit. *See* 12 CFR 560.40(a)(3).
Practices and Procedures	Lending limits, investment limits, and requirements for internal operating limits effectively identify the maximum amounts that can be provided to one entity, and by so doing define "large exposure." The U.S. federal banking agencies expect that all banks and holding companies define, identify, measure, monitor, and control concentrations. Compliance with all lending limits is monitored and reviewed by supervisors. Moreover, as noted above, supervisors have broad authority to assess the risk posed by a credit risk concentration and consider the adequacy of a bank's capital to absorb the risk posed by the concentration. For additional details concerning OTS practices and procedures, *see* OTS CEO Memorandum 246.

Principle 11: Exposures to related parties

In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflicts of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

(Reference document: *Principles for the management of credit risk*, September 2000.)

Overview

Two major sets of laws establish limits on transactions with "related parties" covered by the Overview to this principle. (The Overview defines related parties to include "the bank's subsidiaries and affiliates, and any party that the bank exerts control over or that exerts control over the bank. It may also include the bank's major shareholders, directors, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.")

Limits on Transactions with Affiliates. Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. §§ 371c and 371c-1), and their implementing regulation, Federal Reserve Regulation W (12 CFR 223), are designed to prevent the misuse of a bank's resources through preferential transactions with its affiliates and otherwise to limit the risks posed to the bank from transactions with affiliates. Section 23A (12 U.S.C. § 371c) prohibits a member bank (state or national) from engaging in "covered transactions" with an "affiliate" unless the bank limits the aggregate amount of such transactions with that particular affiliate to generally 10 percent of the bank's capital and surplus. In addition, the aggregate amount of covered transactions to all affiliates is limited to 20 percent of the bank's capital and surplus. Moreover, any loan or extension of credit by a bank to an affiliate (or guarantee or letter of credit issued by a bank on behalf of an affiliate) generally must be fully secured and purchases of "low-quality assets" are generally prohibited.

In general, "covered transactions" include loans and extensions of credit to an affiliate, investments in securities issued by an affiliate, a purchase of assets from an affiliate, and the issuance of a guarantee or letter of credit on behalf of an affiliate. Sections 23A and 23B and Regulation W also have an attribution rule, which provides that a transaction between a bank and a third party where funds are transferred to—or used for the benefit of—an affiliate is considered a covered transaction with that affiliate.

The term "affiliate" is defined broadly to include any entity that directly or indirectly controls, or is under common control with, the bank. Control of a company is defined to include ownership of 25 percent or more of the voting securities of the other company or exercise of a controlling influence over the management or policies of the other company. The definition of affiliate also includes certain investment funds that are advised by the bank or by an affiliate of the bank. Moreover, the definition of an affiliate in both the statute and Regulation W provides that an affiliate includes any company that the appropriate federal banking agency determines to have a relationship with the bank or any affiliate of the bank, such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank. The definition of affiliate generally does not cover subsidiaries of the bank – subsidiaries of the bank are treated as part of the bank for purposes of sections 23A and 23B and Regulation W.

Safety and soundness is an overriding principle of the U.S. transactions with affiliate regime. All covered transactions, including those that qualify for available exemptions, must be consistent with safe and sound banking practices. Even if transactions are structured in a manner that is fully consistent

Principle 11: Exposures to related parties

with the requirements of the statute and regulation, supervisors can still criticize the transactions if they are abusive, involve undue transfer of risk or circumvent the purpose of the regulation.

Section 23B (12 U.S.C. § 371c-1) covers a wider range of activities than section 23A. It covers virtually any type of financial transaction between a bank and an affiliate. Section 23B provides that transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies.

Sections 23A and 23B also apply to all savings associations (12 U.S.C. § 1468(a)) and to state nonmember insured banks (12 U.S.C. § 1828(j)).

Limits on Transactions with Insiders. Sections 22(g) and (h) of the Federal Reserve Act (12 U.S.C. §§ 375a and 375b) impose a number of restrictions on extensions of credit by a member bank to its insiders and to insiders of its affiliates. Insiders include bank or affiliate executive officers, directors, principal shareholders, as well as companies controlled by such insiders. These restrictions also apply to savings associations (12 U.S.C. § 1468(b), 12 CFR 563.41) and state nonmember insured banks (12 U.S.C. § 1828(j)).

12 CFR 215 (the Federal Reserve's Regulation O) implements the restrictions imposed under sections 22(g) and (h) of the Federal Reserve Act. 12 CFR 31.2(a) requires a national bank and its insiders to comply with the provisions contained in 12 CFR 215.[1] 12 CFR 563.43 requires a savings association and its insiders to comply with the provisions contained in 12 CFR 215.[2] In general, the regulation provides that extensions of credit by a bank to an insider must be made on the same terms and conditions as extensions of credit to non-insiders and must not represent more than the normal risk of repayment. *See* 12 CFR 215.4(a). In addition, the regulation imposes on extensions of credit to insiders the single borrower limits discussed under Principle 10. *See* 12 CFR 215.2(i) and 215.4(c). The regulation also places a quantitative limit on extensions of credit by a bank to all its insiders in the aggregate. Large extensions of credit to insiders must be reviewed and approved by the bank's board of directors prior to disbursement. Id. § 215.4(b). Extensions of credit by a bank to its executive officers are subject to an additional set of restrictions. Notably, other than certain loans with a residential housing or educational purpose, a bank may not extend more than $100,000 in credit to an executive officer.

Although the regulatory restrictions on transactions with insiders apply only to the bank subsidiaries of holding companies, the U.S. federal banking agencies encourage banks to adopt these policies corporate-wide to avoid disadvantageous transactions with affiliates or insiders. While related party transactions that do not involve a supervised bank may be legal, the agencies still may consider them "unsafe and unsound." In addition, as consolidated supervisor, the Federal Reserve and the OTS monitor material intra-group transactions and exposures. They also ensure that holding companies have adequate risk-management processes in place for the bank as a whole pertaining to such transactions.

EC 1	**Principle 11: Exposures to related parties**

[1] Also see *Comptroller's Handbook,* "Insider Activities."
[2] Also see OTS *Examination Handbook,* Section 380, Transactions with Affiliates and Insiders.

EC 1	Principle 11: Exposures to related parties
Criterion	Laws or regulations explicitly provide, or the supervisor has the power to provide, a comprehensive definition of "related parties." This should consider the parties identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.
Legal Framework	The statutes and regulations cited in the overview to this principle carefully define the individuals and entities to which the affiliate and insider transaction limits apply. The definitions are broad and provide discretion to the supervisor in individual cases to determine whether a particular individual or entity is considered a related party subject to the restrictions.
Practices and Procedures	The U.S. federal banking agencies regularly review bank exposure to affiliates, insiders, and other related parties in order to assess compliance with the statutes and regulations such as sections 22(g), 22(n), 23A and 23B of the Federal Reserve Act, as well as Regulation O and Regulation W. The agencies train their supervisors extensively to facilitate their understanding of the rules governing these transactions, and supervisory guidance contains detailed information regarding the rules, inspection objectives, and inspection procedures for reviewing transactions between a bank and its affiliates, insiders, and related parties.

EC 2	Principle 11: Exposures to related parties
Criterion	Laws, regulations or the supervisor require that exposures to related parties may not be granted on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding exposures to non-related counterparties.
Legal Framework	Under the statutes and regulations cited in the overview to this principle, exposures to affiliates and insiders may not be granted on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding exposures to non-affiliates or non-insiders.
Practices and Procedures	Section 23A (12 CFR 371c) requires that all covered transactions between a bank and an affiliate be on terms and conditions that are consistent with safe and sound banking practices. Section 23B (12 CFR 371c-1) requires that financial transactions between a bank and an affiliate be on terms and under circumstances, including credit standards, that are at least as favorable to the bank, as those prevailing at the time for comparable transactions with nonaffiliates. U.S. federal banking supervisors are directed to determine if affiliate transactions are on terms and conditions that are consistent with safe and sound banking practices and if the terms and conditions of affiliate transactions are the same as or more favorable than those that would be offered or applied to nonaffiliated companies in comparable transactions. *See*: FRB [SR letter 03-2], OCC [*Comptroller's Handbook,* "Related Organizations"] OTS [*Examination Handbook*, Section 380, "Transactions with Affiliates and Insiders"]. Related training materials provide extensive supervisor guidance to facilitate review and verification of compliance with the market terms requirement of the statutes. Regulation O requires that extensions of credit by a bank to an insider (1) be made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with non-insiders and (2) not involve more than the normal risk of repayment. Regulation O requires banks to maintain records to document compliance with its restrictions, including its market terms requirement.

EC 2	Principle 11: Exposures to related parties
	Violations of Regulation O or section 23B can give rise to reimbursement and formal enforcement actions against a bank. A 23A violation also can give rise to an enforcement action. For example, a Cease and Desist order was issued against a bank requiring approval from the supervisor prior to transactions with inside or related parties. www.occ.treas.gov/FTP/EAs/ea2008-008.pdf

EC 3	Principle 11: Exposures to related parties
Criterion	The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process.
Legal Framework	Regulation O requires that extensions of credit by the bank to an insider be reviewed and approved by the bank's board of directors if the aggregate credit exposure of the bank to the insider would exceed $500,000 upon consummation of the new credit facility. A lower review threshold applies to smaller banks. *See* 12 CFR 215.4(b). Extensions of credit to insiders above the review threshold must be pre-approved by a majority of the bank's board of directors, and the insider who is obtaining the credit must abstain from participating either directly or indirectly in the vote. (Participation in the discussion or any attempt to influence the voting would be regarded as indirect participation.) The U.S. bank regulatory framework does not, however, require board pre-approval of transactions between a bank and an affiliate. In addition, the U.S. bank regulatory framework does not impose a board approval requirement on write-offs of related party transactions.
Practices and Procedures	U.S. federal banking supervisors review a bank's policies and procedures to ensure that the bank properly identifies and documents approvals of certain transactions with related parties and that the bank's board of directors approves material transactions with related parties. For example, a bank or its subsidiary cannot knowingly purchase or acquire any security during the existence of an underwriting or selling syndicate for that security, if an affiliate of the bank is a principal underwriter in the syndicate. An exception to this would require that the purchase was approved by a majority of the bank's directors before the security was initially offered for sale to the public, based upon a determination that it is a sound investment for the bank, irrespective of the fact that an affiliate is a principal underwriter of the securities. In general, under Federal regulations and supporting guidance, and as a matter of sound corporate governance, board members with conflicts of interest must recuse themselves from consideration of any matter in which they have an interest. Supervisors are directed to identify and criticize any situation in which an interested director involves himself or herself in the consideration of a matter in which he/she has an interest.

EC 3	Principle 11: Exposures to related parties
	Examples of enforcement actions taken by the agencies include An enforcement action taken against International City Bank which prohibits transactions with affiliates without prior independent and documented board approval. www.occ.treas.gov/FTP/EAs/ea2009-011.pdf An enforcement action taken against CIB Marine Bancshares, Inc., directed CIB to enhance and improve its centralized functions and services provided to subsidiary banks. www.federalreserve.gov/boarddocs/press/enforcement/2004/20040601/attachment.pdf

EC 4	Principle 11: Exposures to related parties
Criterion	The supervisor requires that banks have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure.
Legal Framework	The regulatory provision discussed under EC 3 prevents persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure. Banks are expected to have policies and procedures in place to ensure compliance with these restrictions.
Practices and Procedures	U.S. federal banking supervisors are directed to identify and criticize any situation in which an interested director involves himself or herself in the consideration of a matter in which he/she has an interest. Supervisors review policies and procedures established to facilitate compliance with the laws and regulations governing affiliate transactions. Supervisors also review compliance with Regulation O for extensions of credit to insiders. As noted above, under Regulation O, the insider who is obtaining credit must abstain from participating either directly or indirectly in any related votes. Violations of these regulations or weaknesses in policies and procedures to ensure compliance with the regulations may subject the bank to formal enforcement action.

EC 5	Principle 11: Exposures to related parties
Criterion	Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralisation of such exposures. When limits are set on aggregate exposures to related parties those are at least as strict as those for single counterparties, or groups of connected counterparties.
Legal Framework	The sources cited in the overview to this principle establish quantitative limits on affiliate and insider transactions and collateral requirements on certain affiliate transactions. The aggregate limits on exposures to a group of affiliates or insiders generally are equivalent or stricter than those applicable to groups of connected counterparties that are not affiliates or insiders. As with any other extension of credit, the supervisor can address problems identified with such exposures by requiring their deduction from capital when assessing capital adequacy and, consistent with section 23A and Regulation W, requiring the posting of collateral.

EC 5	Principle 11: Exposures to related parties
Practices and Procedures	Each bank's credit transaction with an affiliate must be fully collateralized as required by Regulation W (12 CFR 223.14); U.S. Federal banking supervisors may request a list of transactions with affiliates, including the terms of any collateral, to assess compliance with the regulation. Affiliate transactions in excess of regulatory limits are prohibited unless the Federal Reserve has exempted a transaction upon a finding that such exemption would be in the public interest and consistent with the purposes of section 23A. A detailed written submission must be provided to the general counsel of the Federal Reserve in order for such a request to be considered. Approval of such requests is rare and, if granted, is subject to any conditions that the Federal Reserve might wish to apply. Moreover, investments by a bank in subsidiaries that are not consolidated for accounting or supervisory purposes and, on a case-by-case basis, investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve, are deducted from total capital components (for more information see Principle 6). Investments by a bank in a financial subsidiary (that is, a subsidiary that is engaged in activities that are not permissible for the lead bank to conduct directly) generally are deducted from total capital components as well.

EC 6	Principle 11: Exposures to related parties
Criterion	The supervisor requires banks to have policies and processes to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process. The supervisor confirms that exceptions to policies, processes and limits are reported to the appropriate level of senior management and, if necessary, to the Board, for timely action. The supervisor also confirms that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.
Legal Framework	Banks must identify, through an annual survey, all insiders of the bank and maintain records of all extensions of credit to insiders (12 CFR 215.8(b)).
Practices and Procedures	Banks must establish policies and procedures for compliance with all applicable laws, rules, and regulations, including Regulation O and Regulation W. These policies, as well as individual transactions, are reviewed during the examination process. U.S. federal banking agencies require the banks to develop policies to help ensure that credit decisions are based on an independent and complete credit evaluation. The agencies expect that a bank's management information system identifies and quantifies credits to related parties and that these transactions are routinely reviewed by loan review and management. U.S. federal banking supervisors determine whether loans to insiders and affiliates exceed the imposed lending limits and that appropriate board approvals were obtained if prior approval by the bank's board was required for a loan to an insider. In addition, supervisors determine the adequacy of the bank's procedures used to ensure that loans to related parties are not made on conditions indicating preferential treatment. As previously discussed, violations of these regulations or weaknesses in policies and procedures may subject the bank to formal enforcement action.

EC 7	Principle 11: Exposures to related parties
Criterion	The supervisor obtains and reviews information on aggregate exposures to related parties.
Practices and Procedures	All top-tier bank holding companies and foreign banking organizations that own a U.S. subsidiary bank must file the FR Y-8 report, *Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates*. The information in this quarterly report is used to enhance the Federal Reserve's ability to monitor the holding company's exposure to affiliates and to ensure compliance with section 23A of the Federal Reserve Act. The FR Y-8 report contains multiple items requiring filers to disclose their aggregate exposures to affiliates – both transactions that are subject and transactions that are not subject to section 23A's collateral requirements. OTS requires similar reporting on aggregate transactions with affiliates on the consolidated Supplemental Information Schedules of the Thrift Financial Report. The U.S. federal banking agencies also require reporting of insider lending transactions, and federal banking supervisors ensure that the amount of credit extended to an insider, both to a single insider borrower and in the aggregate to all insiders, conforms to the provisions of Regulation O. As supervisors review individual transactions, as discussed in EC 5 above, they note any transactions with affiliated organizations and insiders that do not appear in the bank's or holding company's reports of related exposures.

Principle 12: Country and transfer risks

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Overview

The U.S. federal banking agencies are required to evaluate banks' and holding companies' foreign country exposure and transfer risk for use in examinations and supervision. *See* 12 U.S.C. § 3903(a).[1] The agencies also must ensure that these risks are taken into account in evaluating a bank's or holding company's capital adequacy. *See id.*§ 3903(b). Banks and holding companies meeting certain reporting criteria based on cross-border exposure are required to identify and monitor these risks and to provide quarterly reports to supervisors on their foreign country exposure. Id. § 3906. The quarterly reports detail each bank's or holding company's significant claims on foreign entities, specifying, among other things, the types of claims and country in which the borrowers are located. Necessarily, banks and holding companies must have established policies and procedures for monitoring the countries with which they are doing business and monitoring and evaluating their exposures to those countries.

Representatives of three of the federal banking agencies (the Federal Reserve, OCC, and the FDIC) are part of an "Interagency Country Exposure Review Committee" (ICERC), which meets once a year (the committee reserves the option to meet at any other time during the year should circumstances warrant attention) to review conditions in countries that have defaulted by not complying with their external service obligations or are unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, forced restructuring, or rollovers and where U.S. banks and holding companies have large exposures. Based on this review, the ICERC assigns a transfer risk rating to the country and determines whether U.S. banks and holding companies must hold a reserve (an "Allocated Transfer Risk Reserve" or "ATRR") against exposures where the country of residence of the ultimate obligor is from the defaulting country. *See* 12 CFR 211.43 and *Guide to the Interagency Country Exposure Review Committee Process* (November 2008).[2] The agencies also support the Basel Committee on Bank Supervision's paper *Management of banks' international lending*, March 1982.[3]

As required by statute, the agencies have issued regulations and guidance governing international lending. *See* 12 CFR 211, subpart D. However, the provisions of the International Lending Supervision Act, 12 U.S.C. §§ 3901-3911, do not apply to savings associations and SLHCs supervised by the OTS, which historically have not had large foreign country exposures and transfer risk. For purposes of Principle 12, therefore, the word "bank" does not include a savings association. OTS examines large and complex SLHCs for country risk, however, and would require a SLHC to establish an ATRR pursuant to the ICERC's guidelines. Most of the discussion below includes any SLHC with foreign country exposure. *See* footnote 1.

[1] The statute that imposes a requirement for banks and bank holding companies does not apply to savings associations and SLHCs, which typically do not have foreign country exposures. However, the OTS's examination procedures extend the requirement to complex SLHCs. *See* the OTS's *Holding Companies Handbook*, Section 940.

[2] www.occ.treas.gov/ftp/bulletin/2009-8b.pdf.

[3] www.bis.org/publ/bcbsc122.pdf?noframes=1.

EC 1	Principle 12: Country and transfer risks
Criterion	The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
Legal Framework	Banks and holding companies are required to monitor and evaluate developments in country risk and in transfer risk and, as appropriate, establish an ATRR or take other appropriate countermeasures. *See* 12 CFR 211.43; and 12 CFR 28.52; the OTS's *Holding Companies Handbook,* section 940.
Practices and Procedures	Country risk and transfer risk are monitored and measured through two independent supervisory processes: the bank examination process and the work of the ICERC. ICERC was established to provide a forum for U.S. federal banking agencies to coordinate their assessments of cross-border risk and to promote a consistent approach to the supervisory process. The ICERC standards are communicated to the banking industry by supervisors and provide the banking industry with a general expectation for a bank's or holding company's sovereign risk-management practices. During examinations, supervisors assess the bank's or holding company's overall identification and management of country and transfer risk (*See* CBEM, section 7040.3; OCC's *Country Risk Management Handbook;* FDIC's *Risk Management Manual of Examination Policies (Section 11.1 – International Banking)*[4]*, and* FDIC's: FIL 23-2002[5], and OTS's *Holding Companies Handbook*, section 940). Banks and holding companies are expected to assess the level of their country-risk exposure and evaluate the effect of prevailing and future economic, political, and social conditions on a country's ability to sustain external debt service, and reflect the impact of these conditions on the credit risk of individual counterparties located in the country. The agencies expect banks and holding companies to have a comprehensive risk-management system to identify their cross-border exposure by borrower and by country, and to quantify exposure, including cross-border guarantees, derivatives, and reference assets, where appropriate. In order effectively to control country risk, supervisors expect that this risk-management system includes oversight by the bank's or holding company's board of directors, well-defined policies and procedures for managing country risk, an accurate country exposure reporting system, an effective country analysis process, a country-risk rating system, established country exposure limits, and adequate internal controls. The agencies hold the banks' or holding company's management responsible for implementing sound, well-defined policies and procedures for managing country risk that establish risk tolerance limits, specify authorized activities, and identify desirable types of business. Supervisors confirm that banks and holding companies have appropriate risk-management systems in place, including a rating scale and a regular cycle of reviews, to evaluate sovereign risk. Supervisors also review the systems in place to evaluate an individual country's economic, social, and other conditions and developments where the organization is exposed to risk. Supervisors expect that procedures are established for dealing with exposures in troubled countries, including contingency plans for reducing risk, and if necessary, exiting the country. In addition, the U.S. federal banking agencies send representatives with experience in international supervision to meet on a regular basis with ICERC, to evaluate sovereign risk for countries to which U.S. banks and

[4] FDIC: Risk Management Manual of Examination Policies
[5] FDIC: FIL-23-2002

EC 1	Principle 12: Country and transfer risks
	holding companies have exposure exceeding certain thresholds, and to establish reserve requirements, ATTRs for different types of exposures for countries that are currently in severe trouble or default.

EC 2	Principle 12: Country and transfer risks
Criterion	The supervisor confirms that banks have information systems, risk management systems and internal control systems that accurately monitor and report country exposures and ensure adherence to established country exposure limits.
Practices and Procedures	U.S. federal banking supervisors assess a bank's or holding company's information and risk-management systems to evaluate whether a bank or holding company has appropriate risk controls, information systems, and monitoring structure to ensure that cross-border exposures are managed consistently with the bank's or holding company's strategy and risk-management philosophy. Supervisors evaluate whether banks and holding companies have comprehensive reporting systems to accurately capture country-risk exposure, ensure adherence to the directives of the board, provide for at least an annual review of portfolio composition by country, and establish a methodology for reporting exceptions. As part of the examination process, supervisors evaluate the frequency and size of exceptions to country limits imposed by banks and holding companies and, if appropriate, discuss issues with management if weaknesses are noted. Banks and BHCs are required to report their various asset exposures quarterly on the Country Exposure report, FFIEC 009. The agencies maintain an aggregated, publicly available database (FFIEC E16 report) that contains bank's and BHC's cross-border and sovereign exposure in detail by country. A restricted version of this database, which contains the same information by organization, is used by supervisors in their sovereign exposure monitoring process. In assessing the quality of a bank's or BHC's country-risk exposure management systems, supervisors verify the accuracy of data submitted on the FFIEC 009 report. Supervisors also obtain and review country-risk reports provided to the board of directors to ensure completeness and accuracy of information.

EC 3	Principle 12: Country and transfer risks
Criterion	There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to risk-based results. These include: The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country. The supervisor (or some other official authority) sets percentage ranges for each country, and the banks may decide, within these ranges, which provisioning to apply for the individual exposures. The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even

EC 3	Principle 12: Country and transfer risks
	decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.
Legal Framework	The expectations of the U.S. federal banking agencies for banks' and holding companies' sovereign risk practices are embedded in the International Lending Supervision Act (ILSA) passed by the U.S. Congress in 1983. The ILSA includes provisions affecting both the international lending activities of U.S. banks and bank holding companies and the federal banking agencies' supervision of those activities. The ILSA requires banks and bank holding companies, in certain circumstances, to set up an allocated reserve for assets subject to severe transfer risk. The three federal banking agencies have published regulations implementing the ATRR requirement. The regulations require that each affected organization charge off or establish and maintain an ATRR for each asset with impaired value due to transfer risk. (*See* 12 CFR 28, subpart C; 12 CFR 211, subpart D; or 12 CFR 347.) *See* footnote 1 to the Overview regarding savings associations and SLHCs.
Practices and Procedures	U.S. federal banking agencies set country and transfer risk provisions for only selected countries. These provisions or ATRRs are determined through the ICERC process which evaluates transfer risk for the U.S. banking system on an ongoing basis. At an annual meeting, ICERC evaluates high-risk regions and countries and mandates specific credit reserves for countries in default, by type of exposure and by tenor. The minimum threshold for ICERC consideration for review of a country is an aggregate exposure of $1 billion or more for at least two consecutive quarters. In addition, countries to which aggregate exposure is between $200 million and $1 billion are reviewed by the ICERC if the exposure at five or more U.S. banks or bank holding companies exceeds 25 percent of tier 1 capital plus the allowance for loan and lease losses. The agencies require banks and holding companies to establish an ATRR for each applicable international asset where the ultimate obligor resides in a defaulted country. However, the ATRR requirement does not apply to U.S. branches, agencies, or commercial lending company subsidiaries of foreign banking organizations. Nevertheless, each U.S. federal banking agency will determine the need, if any, for other special measures that may be warranted by conditions in the branch, including, for example, increased monitoring of due-from/due-to head office accounts, asset maintenance requirements, and/or specific reserves. Cross-border exposure monitoring is performed pursuant to the ILSA. This act codified the process for cross-border country-risk monitoring which was put in place by ICERC. At the time that ICERC was established, supervisors observed a number of factors that heightened the need for a better understanding of banks' and bank holding companies' sovereign risk exposures, including Significant and growing level of country-risk exposure on the balance sheets of U.S. banks and bank holding companies, Growing stress in sovereign credits, Limited sophistication in sovereign risk analysis at banks and bank holding companies and rating agencies, and Limited availability of data on sovereign credits. Supervisors assess the aforementioned risks by using various procedures and measures, which include comparing a bank's or holding company's country-risk exposures as a percentage of its assets and capital and analyzing the strength of sovereign obligors based on publicly available information. However, the agencies recognize also that the level of sophistication in the supervisory review of a bank's or holding company's sovereign credits varies. Therefore, ICERC devotes significant effort to the development

EC 3	Principle 12: Country and transfer risks
	of a set of standards for supervisors to follow in their assessment of banks' and holding companies' sovereign credit risk. The ICERC standards also provide the banking industry with general expectations for a bank's or holding company's sovereign risk-management practices. In addition to the specific mandated reserves, the agencies expect banks and holding companies to evaluate the fundamental and sovereign credit profile of their foreign exposures (both cross-border and local), appropriately grade certain countries' and individual obligor exposures, and establish limits that are consistent with the bank's or holding company's strategy, risk profile, and capital. Supervisors evaluate the establishment, appropriateness, and compliance with such limits during the examination process.

EC 4	Principle 12: Country and transfer risks
Criterion	The supervisor obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of individual banks.
Practices and Procedures	The federal banking agencies obtain the completed FFIEC 009 reports for individual banks and BHCs on a quarterly basis. These reports contain information for on- and off-balance-sheet exposure by type of obligor (government, banking, other). The agencies analyze the quarterly reports for levels, significant variations and trends. Also, agency economists evaluate, on an ongoing basis, political, economic, and social events for high impact countries. These analyses are supplemented by a more thorough review of country-risk exposure during regular supervisory activities. The agencies expect banks and holding companies under their supervision to continue to monitor their cross-border exposure to all countries closely; to have robust country-risk assessment systems; to have appropriate sovereign exposure limits in place for each sovereign entity; to perform financial analysis on the sovereign entities to which the bank or holding company is exposed; and generally to continue to apply sound risk management to all their country exposures, not just to the countries rated by ICERC.

Principle 13: Market risk

Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Overview

As noted in the overview to Principle 7, the U.S. federal banking agencies expect all banks and holding companies, to have in place comprehensive risk-management policies and processes for identifying, evaluating, monitoring, and controlling or mitigating all material risks, including market risk. The authority to impose and enforce risk-management requirements stems from the safety and soundness and capital adequacy statutes and guidelines. *See* for safety and soundness: 12 U.S.C. § 1831p-1 and 12 CFR 30, 208, 364, and 570; and for capital adequacy: 12 U.S.C. §§ 1831o(c) and 3907 and 12 CFR 3, 208, 225, 325, and 567. Each agency supplements these regulatory requirements with examination procedures and programs that set forth more specific supervisory guidance on risk-management expectations.[1]

As part of their supervisory programs, supervisors assess each bank's or holding company's exposure to, and management of, market risk. Under the agencies UFIRS supervisory rating system (CAMELS), supervisors assess and assign each bank a supervisory rating for its Sensitivity to market risk. The market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect earnings or economic capital. For most U.S. banks and holding companies, interest-rate risk in their banking books is the predominant market-related risk exposure.

Large banks and BHCs that have significant trading or foreign exchange exposures are subject to the agencies' market- risk capital rules that implement the 1996 Market Risk Amendment to Basel I (*See* 12 CFR 3, appendix B)[2]. These rules require market risk to be calculated for significant trading firms based primarily on a bank's or bank holding company's internal models. Compliance with these rules, as well as supplementary guidance, requires a bank or bank holding company to implement a comprehensive risk-management program, including adequate policies, procedures, and limits; active board and senior management oversight; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls. Supervisory expectations regarding these programs are detailed in supervisory guidance and examination manuals issued by the federal banking agencies. These resources emphasize that individual programs should be appropriate to the size and activities of individual banks and holding companies. Regular risk-management evaluations ensure that the programs are adjusted, as appropriate, in light of changing risk profiles and external developments. Failure to implement and enforce adequate market-risk management programs can trigger an enforcement action and/or an array of other remedial measures.

[1] *See* OCC's *Community Bank Supervision, Large Bank Supervision, and Risk Management of Financial Derivatives* booklets of the Comptroller's Handbook series.

[2] The OTS did not join the other federal banking agencies in adopting the market risk rules in 1996, as the rules were not applicable to the trading activities levels of savings associations at that time. The OTS plans to join the other agencies in any future market risk amendment proposals due to increased trading book activities. Although SLHCs also currently do not have the trading activities levels to be subject to the 1996 Market Risk Amendment, OTS examiners consider market risk. *See* OTS's *Holding Companies Handbook,* sections 400, 500, and 900.

EC 1	Principle 13: Market risk
Criterion	The supervisor determines that a bank has suitable policies and processes that clearly articulate roles and responsibilities related to the identification, measuring, monitoring and control of market risk. The supervisor is satisfied that policies and processes are adhered to in practice and are subject to appropriate Board and senior management oversight.
Practices and Procedures	U.S. federal banking agencies require banks and holding companies to implement sound risk-management policies and procedures, and market-risk management is one element of overall sound risk management. Senior management is expected to fully understand the risks involved in the bank's and holding company's activities, question business line management about those risks, and have prompt and open discussions about any market-risk control problems or losses. This commitment to market-risk management is expected to be delineated in practice and codified in written policies and procedures approved by the board of directors. The agencies' expectations are documented in exam manuals and published statements regarding the implementation of internal controls including internal controls for market-risk management.[3] Each of these identifies the crucial role played by senior management oversight, and the approval of policies and procedures for market-risk management by the board of directors. U.S. federal banking supervisors confirm that adequate market-risk policies and procedures for conducting long-term and day-to-day activities are in place, and this includes ensuring clear delineations of responsibility for managing risk, adequate systems for measuring risk, appropriately structured limits on risk taking, effective internal controls, and a comprehensive risk-reporting process. U.S. federal banking supervisors also confirm that a bank's or holding company's market-risk management identifies and assesses risks; establishes policies, procedures, and risk limits; monitors and reports compliance with limits; delineates capital allocation and portfolio management; develops guidelines for new products and includes new exposures within the current framework; and applies new measurement methods to existing products. The supervisory expectations as described in these written documents are implemented via monitoring of risk profiles and risk management at supervised banks and holding companies as well as examinations of the banks and holding companies. Continuous monitoring and analysis by on-site teams at larger banks and holding companies entails ongoing analysis of internal reports and discussions with internal management. Supervisors confirm that these reports provide sufficient detail to determine if the market risk is appropriately measured, monitored and controlled. They also assess the adequacy of board and management risk oversight. Examinations are conducted to identify both deviations from policies and procedures as well as weaknesses in the policies and procedures followed by the firms. A key element of examinations is the review of new product policies and procedures to ensure that the risks of these products are adequately identified so that they may be incorporated into the risk measurement, management, and control processes. Examinations emphasize the need to use multiple measures of market risk and avoid the over-reliance on any single measure of risk. These should include a variety of stress tests, value-at-risk measures, position sensitivities, and balance sheet

[3] *See* Federal Reserve's *Trading and Capital Markets Activities Manual* (www.federalreserve.gov/boarddocs/supmanual/trading/200704/0704trading.pdf); OCC's Risk Assessment System as outlined in the *Bank Supervision Process, Community Bank Supervision*, and *Large Bank Supervision* booklets of the Comptroller's Handbook series and its *Risk Management of Financial Derivatives* booklet and Banking Circular 277; and SEC's Joint Statement: Broker Dealer Risk Management Practices. Note: Under the OCC's Risk Assessment System, market risk is evaluated as "price risk."

EC 1	Principle 13: Market risk
	measures which may form a set of limits. Internal controls are checked to assure that approvals, verifications, and reconciliations are conducted and documented so that market-risk management is effective in measuring risk and that market-risk management elevates large risk positions to senior management. In cases where these internal controls are weak, supervisors may require they be improved, impose higher capital requirements, or restrict business activities.

EC 2	Principle 13: Market risk
Criterion	The supervisor determines that the bank has set market risk limits that are commensurate with the institution's size and complexity and that reflect all material market risks. Limits should be approved by the Board or senior management. The supervisor confirms that any limits (either internal or imposed by the supervisor) are adhered to.
Practices and Procedures	As noted in EC 1, banks and holding companies are expected to establish market-risk limits that are commensurate with their size and complexity and that reflect all material market-risk exposures. Supervisors confirm that banks and holding companies have appropriate limits in place that are developed under the direction of, and approved by, senior management and the board of directors. Supervisors review risk-management reports and confirm that the reports highlight positions, limits, and excesses on a basis commensurate with trading activity, and are submitted to senior management for review. As part of their examinations, supervisors check the adherence to these limits and discuss with senior management policies and procedures for limit exceptions. These discussions allow supervisors to confirm that senior management is aware of large risk positions and the proper approvals for excesses as described in the policies and procedures of the firm have been granted. Limits need not be absolute under the regime of any U.S. supervisor; however, supervisors confirm that appropriate dialogue with non-trading senior management takes place and is documented before limits are exceeded. Supervisors also confirm that policies and procedures address the frequency of review of the limit structure, identify the authority to set and change limits, and ensure that limits are set by personnel independent of the trading activity. Supervisors check approvals for limit excesses to ensure policies are adhered to through transaction testing. In cases where limits are imposed by the agency, for example, limits on activities that can be undertaken by a specific legal entity (for example, 23A which limits transactions with affiliates of a bank), banks are expected to seek approval of transactions with the appropriate agency or agencies prior to consummating such a transaction, and receive the appropriate supervisory approvals prior to entering into the transactions. In other cases, as part of its approval of a new transaction, activity, or corporate action, an agency may require or establish limits for the size or exposure of the activity. Such limits are enforceable under the agencies' enforcement powers and can result in a variety of regulatory sanctions or actions if they are violated. U.S. federal banking agencies consider that a well constructed system of limits and policies on acceptable levels of risk exposure is a particularly important element of risk control in trading operations. Supervisors check to ensure that banks and holding companies establish limits for market risk that relate to their risk measures and are consistent with maximum exposures authorized by their senior management and their board of directors. Examinations ensure that these limits are allocated to business units, product lines, or other appropriate organizational units and that these units, as well as the risk management or control function understand these

EC 2	Principle 13: Market risk
	limits. A variety of limits is expected to be used to control risk taking by the business unit or an individual trader.

EC 3	Principle 13: Market risk
Criterion	The supervisor is satisfied that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' marked-to-market positions are revalued frequently, using reliable and prudent market data (or, in the absence of market prices, internal or industry-accepted models). The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments/reserves for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.
Practices and Procedures	All public corporations in the U.S. are expected to disclose the value of their positions quarterly on their public financial reports. Trading assets and other assets valued on a mark-to-market basis are reported at fair value in accordance with U.S. GAAP, specifically FAS 157. For banks and holding companies required to file public reports, Sarbanes-Oxley legislation requires that all critical controls relating to financial reports must be documented and tested, and that weaknesses in these controls must be disclosed in their quarterly public financial reports. Banks and holding companies are subject to these same standards; however, the standards for control and frequency of valuation imposed by financial supervisors are higher for those banks and holding companies with significant trading operations. Implicitly, many of the requirements imposed on banks and holding companies effectively require that trading positions be revalued daily and verified by a unit independent of the business unit on a frequent basis in order to meet the standards for risk-management control or regulatory capital. This is explicit for broker/dealers who must be in continuous compliance with their regulatory capital requirement. For banks and bank holding companies, the agencies' market-risk capital rules establish qualitative and quantitative requirements for a bank's or bank holding company's value-at-risk (VaR) model that it uses to compute its regulatory market-risk capital requirements. Among these is that its VaR model is used to measure its daily VaR. As discussed in Principle 22, U.S. federal banking supervisors confirm that FAS 157 is appropriately applied for instruments that fall under this statement, and that the bank's or holding company's process is documented and approved by its external auditor. As documented in the Senior Supervisors Group report, Observations on Risk Management Practices during the Recent Market Turbulence, released in March 2008, many banks and holding companies found that their valuation procedures were not robust to a change in market liquidity. Their valuation procedures had established a single method to value a particular asset that may have relied on suitable prices being observed in a liquid market. When the market for these assets became illiquid, banks and holding companies found that they could not apply a method that relied on observed prices. These banks and holding companies had to develop complex pricing models that met high control standards in an expedited timeframe. This experience indicated the need to develop a "waterfall" of valuation procedures that provided the banks and holding companies with the ability to value positions under a variety of market conditions.

EC 4	Principle 13: Market risk

EC 4	Principle 13: Market risk
Criterion	The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk. The supervisor confirms that the approaches are integrated into risk management policies and processes, and results are taken into account in the bank's risk-taking strategy.
Legal Framework	The agencies' risk-based capital guidelines set forth qualitative and quantitative requirements for banks and bank holding companies subject to market risk and advanced approaches capital rules. *See* 12 CFR 3, appendices B and C; 12 C.F.R. 225, appendices E and G.[4].
Practices and Procedures	Scenario analysis, stress testing, and periodic validation of systems used to measure market risk are key components of the market risk and advanced approaches capital adequacy guidelines. U.S. federal banking agencies expect all banks and holding companies to perform scenario analysis or stress testing in the management of market risk, and confirm this during on-site examinations. Stress testing is part of the qualitative requirements for the management of market risk contained in the market risk amendment (MRA) which have been adopted by the agencies. In the U.S., only banks and bank holding companies with trading assets and liabilities of over $1 billion or 10 percent of total assets are subject to the MRA. However, stress testing is an important risk measurement tool and banks and holding companies are expected to use this in measuring the risk from trading activities even if they are not subject to the market-risk amendment. Supervisors review the results of stress tests and discussions are held with the internal management. Supervisors evaluate stress tests for their use in risk management and compare established limits against stress test results. If supervisors determined that stress testing is inadequate or insufficient, corrective actions would be required. Specialty staff from the agencies is brought in to aid supervisors in the evaluation of complex models. Supervisors also confirm that periodic validation of market-risk management systems is completed. Supervisors review the independent validation of the models during an exam, and an independent validation is required once a year of market risk measurement systems. For broker-dealer organizations, an external validation of the models is required once a year. For all banks and bank holding companies, the validation of market-risk models is an ongoing process that includes a number of activities such as backtesting of VaR models; profit and loss attribution; pricing model validation and testing; as well as direct discussions between front office, back office and risk-management personnel about how well the models reflect prices observed in the markets. Supervisors review validation documents and interview personnel responsible for validation during exams to determine how these ongoing validation activities affect planned model improvements.

AC 1	Principle 13: Market risk
Criterion	The supervisor requires that market data used to value trading book positions are verified by a function independent of the lines of

[4] *See* Response to Principle 6 for explanation of capital requirements for SLHCs and the OTS's *Holding Companies Handbook,* sections 300 and 940.

AC 1	Principle 13: Market risk
	business. To the extent that the bank relies on modelling for the purposes of valuation, the bank is required to ensure that the model is independently tested.
Legal Framework	Under the federal banking agencies' market risk and advanced approaches capital adequacy guidelines (12 CFR 3, appendices B and C; 12 CFR 225, appendices E and G), banks and bank holding companies must have a risk control unit that reports directly to management and is independent from business units[5]. In addition, banks and bank holding companies must conduct independent reviews of risk measurement and risk-management systems at least annually.
Practices and Procedures	Supervisors determine whether banks' and holding companies' valuation systems enable senior management to judge if the performance of the risk-taking activity justifies the risks taken. To ensure that financial results are appropriately controlled and present an accurate description of the performance of the firm, supervisors confirm that the market values are generated within an objective, independent framework. Supervisors are instructed to ensure that financial control units are "sufficiently" independent of the business unit. Supervisors verify that the personnel responsible for independent valuation do not have their compensation determined by the business unit and report to senior management that is independent of the business unit. More granularly, supervisors check that the personnel responsible for independent valuation have the appropriate authority to contest valuations and that this ultimate authority is written into policies and procedures. Independent valuation units must have adequate resources to determine valuations without undue reliance on the business unit, and that they have sources of pricing information outside of the business unit. Supervisors confirm that where pricing models are used, firms have comprehensive policies and procedures specifically for creating, validating, revising and reviewing the pricing models used in the valuation process. Supervisors are directed to ensure that pricing models are validated by individuals who are not directly involved in the development process before they are put into use. This includes ensuring that pricing model validation by the bank and holding company involves an evaluation of the sensitivity of models to material sources of model risk. This validation not only applies to new models but also models that are approved for use should be re-evaluated frequently. Supervisors also confirm that model validation is conducted and documented by individuals with sufficient technical expertise to conduct the evaluation. The federal banking agencies evaluate the internal validation processes. They offer specialized training courses on various aspects of risk modeling and have staff with specialized econometrics and modeling expertise that can assist supervisors in evaluating sophisticated models of the bank and holding company.

[5] OTS similarly examines SLHCs for independence of risk control units from business units. *See* "Savings and Loan Holding Company Rating System," 72 *Fed. Reg.* 72442, 72448 (Dec. 20, 2007) and OTS *Holding Companies Handbook*, Section 500 Risk Management.

Principle 14: Liquidity risk

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Overview

Liquidity risk has and continues to be a primary concern of the U.S. federal banking agencies, and, as recent market events have shown, its effective management is essential to ensuring the safety and soundness of banks and holding companies and has been an important component of in the supervisory efforts of U.S. federal banking agencies. The U.S. federal banking agencies expect banks and holding companies, at a minimum, to implement liquidity management programs that (a) assess, on an ongoing basis, the current and expected future needs for funds and ensure that sufficient funds or access to funds exist to meet those needs at the appropriate time; (b) provide for an adequate cushion of liquidity to meet unanticipated cash-flow needs that may arise from a continuum of potential contingent events that can range from high-probability/low-severity events that occur in daily operations to low-probability/high severity events that occur less frequently but could significantly affect a bank's and holding company's safety and soundness; and (c) strike an appropriate balance between the benefits of providing for adequate liquidity to mitigate potential adverse events and the cost of that liquidity. The primary role of liquidity-risk management is to prospectively assess the need for funds to meet obligations and ensure the availability of cash or collateral to fulfill those needs at the appropriate time by coordinating the various sources of funds available to the bank and holding company.

The safety and soundness and capital adequacy statutes and guidelines provide the legal basis for the imposition and enforcement of liquidity-risk management requirements by the federal banking agencies. *See* for safety and soundness: 12 U.S.C. § 1831p-1 and 12 CFR 30, 208, 364, & 570; and for capital adequacy: 12 U.S.C. §§ 1831o(c) & 3907 and 12 CFR 3, 6, 208, 225, 325, & 567. Specific expectations are enumerated in supervisory guidance listed below and related materials such as the Basel Committee's *Sound Practices for Managing Liquidity in Banking Organizations* (February 2000) as well as the Committee's *Principles for Sound Liquidity Risk Management and Supervision* (September 2008). Failure to implement and enforce adequate liquidity-risk management programs can trigger an enforcement action and/or an array of other remedial measures.

On June 30, 2009 the agencies released for public comment an interagency policy statement on liquidity-risk management to provide consistent interagency expectations on sound practices for managing funding liquidity risk. The guidance summarizes the principles of sound liquidity-risk management that the agencies have issued in the past and are currently outstanding, and, where appropriate, brings these principles into conformance with the international guidance recently issued by the Basel Committee on Bank Supervision titled *Principles for Sound Liquidity Risk Management and Supervision*. Existing supervisory guidance can be found in the following publications: For national banks, *see* the *Liquidity, Community Bank Supervision and Large Bank Supervision* booklets *of* the Comptroller's Handbook series. For state member banks and bank holding companies, *see* the Federal Reserve's *Commercial Bank Examination Manual* - section 4020.1; *Bank Holding Company Supervision Manual* - section 4010; and *Trading and Capital Markets Activities Manual* - section 3005.1 & appendixes (Trading Manual). For state non-member banks, *see* the FDIC's *Revised Examination Guidance for Liquidity and Funds Management* - Trans. No. 2002-01, Nov. 19, 2001. For savings associations and SLHCs, *see* the OTS's *Examination Handbook* - section 430, Operations Analysis and *Holding Company Handbook*, Section 600. The Federal Reserve and OTS similarly evaluate holding companies' management of liquidity risk.

As noted in Principle 7, the U. S. federal banking agencies adhere to the UFIRS, and U.S. federal banking supervisors evaluate every bank against

Principle 14: Liquidity risk

UFIRS guidelines. UFIRS has a component to rate Liquidity (L) in the CAMELS ratings. Liquidity is also evaluated in the financial components of the holding company ratings systems[1]. U.S. federal banking supervisors consider the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the bank's and holding company's size, complexity, and risk profile during each full scope examination. Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of liquidity sources compared to present and future needs and the ability of the bank and holding company to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undue loss.
- The ability to access money markets and other sources of funding.
- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the bank's and holding company's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Each federal banking agency evaluates a bank's and holding company's liquidity risk and risk-management systems as part of their on-going supervisory programs.

Largely Compliant: Although established U.S. federal banking agency guidance is considered wholly compliant with international standards, market events during the current crisis have moved the agencies to fully assess the overall effectiveness of the implementation of the supervisory processes used in enforcing such guidance. Based on such assessments the agencies consider their current status as largely compliant with Principle 14. Recognizing the need for improvement in implementation of this principle, the agencies have enhanced the supervision of liquidity risk management as follows: 1) issuing consistent supervisory expectations through an interagency statement on sound practices; 2) introducing new Federal Reserve guidance on consolidated supervision that stresses a focus on group-wide as well as legal entity liquidity management; 3) increasing monitoring of the liquidity risk profiles of banks and holding companies as well as monitoring systemically important institutions liquidity levels on a continuing basis, and 4) improving coordination among the supervisory agencies in assessing quantitative risk profiles as evidenced by the recent Supervisory Capital Assessment Program exercise.

[1] See Federal Reserve SR 04-18, www.federalreserve.gov/boarddocs/press/bcreg/2004/20041201/attachment.pdf; OTS's CEO Memorandum 266 & attachment (72 *Fed. Reg.* 72442)(Dec. 20, 2007)) (SLHCs), http://files.ots.treas.gov/73377.pdf.

EC 1	Principle 14: Liquidity risk
Criterion	The supervisor sets liquidity guidelines for banks. These guidelines take into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities.
Practices and Procedures	The U.S. federal banking agencies' approach with respect to liquidity is qualitative in nature – focusing on sound practices instead of specific quantitative standards and tests. U.S. federal banking agencies also do not have a one-size-fits-all qualitative standard for assessing liquidity. In general, U.S. federal banking supervisors confirm that regulated banks and holding companies have a process in place for managing liquidity that is commensurate with the size and complexity of its operation and its overall risk profile. As noted above, the agencies assess each bank's and holding company's liquidity as part of the UFIRS or holding company rating systems as noted above. The rating system directs that: "In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions." As a result, the agencies expect a range of sound practices based on the business activities, objectives, and risk profile of the bank and holding company. Through the examination process, supervisors evaluate each bank's and holding company's process for managing liquidity risk to ensure that it is appropriate for the nature and scale of the bank's and holding company's business activities and commensurate with the bank's and holding company's liquidity risk arising from both on and off-balance-sheet activities. The agencies' regulatory Call Reports and Thrift Financial Reports collect information on each bank's and holding company's liability and deposit mix, including information on deposit maturities and repricing characteristics. These reports also capture the level of large deposits that may not be covered by FDIC deposit insurance, non-maturity deposits, non-deposit borrowings that may be credit sensitive, and off-balance-sheet commitments. Each agency uses this and other market related data in various surveillance and monitoring tools to identify banks and holding companies that may have high potential liquidity-risk exposures.

EC 2	Principle 14: Liquidity risk
Criterion	The supervisor confirms that banks have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. The supervisor also confirms that the Board has an oversight role in ensuring that policies and processes for risk-taking are developed to monitor, control and limit liquidity risk, and that management effectively implements such policies and processes.
Practices and Procedures	U.S. federal banking supervisors confirm that banks and holding companies have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposures. Strategies should identify primary sources for meeting

EC 2	Principle 14: Liquidity risk
	daily operating cash outflows as well as seasonal and cyclical cash flow fluctuations. In addition, the bank's and holding company's strategies and policies and procedures should address alternative responses to various adverse business scenarios such as the bank's and holding company's methods for managing daily operating cash flows, providing for seasonal and cyclical cash flow fluctuations, and addressing various adverse liquidity scenarios. When necessary, policies, procedures, and limits should address liquidity separately for major currencies in which the bank and holding company conducts business. Supervisors also confirm that these policies and procedures are approved by the board of directors of the bank and holding company or an appropriate committee of the board, and reflect the objectives, risk tolerances and goals of the board of directors. While formal supervisory approval of a bank's and holding company's policies and procedures is not required, the policies and procedures are reviewed through the supervisory process. Deficiencies and recommendations to rectify the deficiencies are noted in the report of examination (or similar communications) and discussed with senior management and, if necessary, the board of directors. *See* Supervisory Guidance publications noted in the overview.

EC 3	Principle 14: Liquidity risk
Criterion	The supervisor determines that a bank's senior management has defined (or established) appropriate policies and processes to monitor, control and limit liquidity risk; implements effectively such policies and processes; and understands the nature and level of liquidity risk being taken by the bank.
Practices and Procedures	The U.S. federal banking agencies require banks and holding companies to have sound liquidity-risk management practices that involve effective oversight of a comprehensive process to adequately identify, measure, monitor, and control risk exposures which is consistent with guidance issued by the Basel Committee noted in the overview. Supervisors determine that the critical elements of a sound liquidity-risk management process are evident. These include adequate corporate governance, including active involvement by the board of directors and senior management; appropriate strategies, policies, procedures, and limits for controlling liquidity risk; adequate systems and processes for measuring, monitoring, and reporting liquidity risk; comprehensive contingency funding plans for addressing potential adverse liquidity events and meeting emergency cash flow needs; and appropriate internal controls for all aspects of liquidity-risk management. Supervisors evaluate the customization of each of these elements to ensure they account for the sophistication, complexity, and business activities of the bank and holding company. As noted in the agencies' manuals, supervisors assess the adequacy of board and senior management oversight. These assessments are made by reviewing the bank's and holding company's policies and procedures and management reports, as well as through discussions with the bank's and holding company's management. Supervisors' reviews will also assess whether the board and senior management: have identified lines of authority and responsibility; have articulated the bank's and holding company's general liquidity strategies and its approach to liquidity risk; understand the bank's and holding company's liquidity contingency funding plans; and periodically review the bank's and holding company's liquidity-risk profile. *See* Supervisory Guidance publications noted in the overview.

EC 4	Principle 14: Liquidity risk
Criterion	The supervisor requires banks to establish policies and processes for the ongoing measurement and monitoring of net funding requirements. The policies and processes include considering how other risks (e.g. credit, market and operational risk) may impact the bank's overall liquidity strategy, and require an analysis of funding requirements under alternative scenarios, diversification of funding sources, a review of concentration limits, stress testing, and a frequent review of underlying assumptions to determine that they continue to be valid.
Practices and Procedures	The U.S. federal banking agencies require banks and holding companies to have policies and processes to measure and monitor liquidity needs appropriate to the bank's and holding company's risk profile; agencies do not mandate or consider specific implicit or explicit scenarios in their assessment of the liquidity position of a bank and holding company given the diversity of the U.S. banking industry. Rather, the U.S. federal banking supervisors review the robustness of the scenario analyses and stress tests conducted by banks and holding companies based on the size, complexity, and risk profile. The resiliency of a bank's and holding company's funding liquidity to firm-specific and market-wide stress conditions is also assessed through the supervisory process, which includes off-site monitoring and target examinations. For the largest banks and holding companies, the agencies maintain on-site examination teams that review and assess a variety of risk management and funding reports on an ongoing basis. As indicated in the agencies' examination manuals, in evaluating the adequacy of a bank's and holding company's liquidity position, supervisors consider the current level and prospective sources of liquidity compared with funding needs, as well as the adequacy of funds-management practices relative to the bank's and holding company's size, complexity, and risk profile. In general, supervisors confirm that funds-management practices ensure that a bank and holding company is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the bank and holding company to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, supervisors evaluate that funds-management practices limit a bank's and holding company's reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. Supervisors review to ensure a bank and holding company conducts stress testing or scenario analysis of its liquidity position. Supervisors evaluate that the stress tests or scenario analyses include an assessment of the potential impact of plausible stress events that are bank and holding company-specific and/or externally-driven events. Also, supervisors determine whether events are stressed under different levels of severity, funding needs are quantified, funding sources are identified, and management processes, reporting and external communication are addressed throughout a stress event. During the stress testing process, effective liquidity managers ensure that they choose potential adverse liquidity scenarios that entail appropriate degrees of severity; maintain an appropriate level of diversified funding sources; and model cash flows consistent with each level of stress. *See* Supervisory Guidance publications noted in the overview.

EC 5	Principle 14: Liquidity risk
Criterion	The supervisor obtains sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. Where a bank or banking group's foreign currency business, either directly, or indirectly through lending in foreign exchange to domestic borrowers, is significant, or where a particular currency in which the bank has material exposure is experiencing problems, the supervisor requires the bank to undertake separate analysis of its strategy for each currency individually and, where appropriate, set and regularly review limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant individual currency.
Practices and Procedures	U.S. federal banking agencies require banks and holding companies to have a system in place to measure, monitor, and control the liquidity positions for each major currency in which business is conducted. The treatment of foreign currencies in a bank's and holding company's internal liquidity assessment is largely determined by the bank and holding company. Currency mismatches are reviewed during the examination process. Banks and holding companies are expected to be able to manage, monitor, and control their currency exposures. The assumptions regarding currency convertibility are left to each individual bank and holding company to determine. Supervisors review the reasonableness of these assumptions, under both normal and stressed conditions, and supporting documentation. Under the Interagency Country Exposure Review Committee (ICERC), agencies review countries in default to provide an assessment of the degree of transfer risk that is inherent in the cross-border and cross-currency exposures of U.S. banks and, if applicable, determine minimum allocated transfer risk reserves (ATRR). Agencies also evaluate cross-border concentrations. *See* Supervisory Guidance publications noted in the overview to Principle 14 as well as those noted in Principle 12.

EC 6	Principle 14: Liquidity risk
Criterion	The supervisor determines that banks have contingency plans in place for handling liquidity problems, including informing the supervisor.
Practices and Procedures	U.S. federal banking agencies expect banks and holding companies to have appropriate contingency funding plans (CFP) in place. Supervisors review and assess a bank's and holding company's CFP during examinations. These assessments consider whether the CFP includes policies, procedures, and action plans for responding to contingent liquidity events, including changes in the funding markets or the bank's and holding company's market access (e.g., access to commercial paper markets) caused by either firm-specific or market-wide events. Action plans are expected to include the bank's and holding company's plans for dealing with retail customers and large funds providers, the press, and the bank's and holding company's supervisors. Supervisors evaluate if the CFP is commensurate with the complexity, risk profile, and scope of operations of the bank and holding company and aligned with its business and risk-management objectives, strategies, and tactics. Supervisors confirm that senior management periodically review the CFP as well as the bank's and holding company's liquidity-risk management strategies, policies, and procedures, to ensure that they remain appropriate and sound. Supervisors evaluate if management also coordinates the CFP with the bank's and holding company's liquidity-risk management efforts for disaster, contingency, and strategic planning. As part of the consideration of potential firm-specific events, a bank and holding company is also expected to consider the impact of potential declines in regulatory capital that would cause them to be less than "well capitalized" for purposes of the agencies' Prompt Corrective Action (PCA) legislation (*See* 12 U.S.C. § 1831o). For example, a bank that relies upon brokered deposits should also

EC 6	Principle 14: Liquidity risk
	incorporate PCA related downgrade triggers into its CFPs since a change in PCA status could have a material bearing on the availability of this funding source. As outlined in the Joint Agency Advisory on Brokered and Rate Sensitive Deposits[2], banks that are considered only "adequately capitalized" must receive a waiver from the FDIC before they can accept, renew or roll-over any brokered deposit. When a bank becomes undercapitalized under the PCA legislation, limits are placed on its asset growth and its ability to acquire an interest in another bank. *See* 12 U.S.C. § 1831o(e). Additional limitations are placed on the bank if it becomes significantly or critically undercapitalized or if it fails to carry out its approved capital restoration plan. *See* section 29 of the FDI Act. Critically undercapitalized banks generally may not borrow from the discount window. *See* 12 U.S.C. § 1831o, as well as Principle 23.

AC 1	Principle 14: Liquidity risk
Criterion	The supervisor determines that, where a bank conducts its business in multiple currencies, foreign currency liquidity strategy is separately stress-tested, and the results of such tests are a factor in determining the appropriateness of mismatches.
Practices and Procedures	U.S. federal banking agencies stress the need for liquidity-risk management programs to take full account of the range of the bank's or holding company's lending, investment, and other activities and should ensure that adequate liquidity is maintained at the holding company and any of its bank and non-bank subsidiaries. These programs should fully incorporate real and potential constraints on the transfer of funds among subsidiaries and between affiliates and the parent company, including legal and regulatory restrictions. U.S. federal banking agencies require banks and holding companies to have a system in place to measure, monitor, and control the liquidity positions for each major currency in which business is conducted. Stress testing is another important element of risk management and involves identifying possible events or changes in market behavior that could have unfavorable effects on the bank and holding company. Stress-test analyses used to assess the bank's and holding company's ability to withstand a stress event should also include contingency funding plans (CFP) for possible management actions in certain situations. Banks and holding companies may be required to utilize separate CFPs for the holding company and the consolidated banks in a multibank holding company, for separate subsidiaries (when appropriate), or for each significant foreign currency and global political entity, as necessary.

AC 2	Principle 14: Liquidity risk
Criterion	The supervisor confirms that banks periodically review their efforts to establish and maintain relationships with liability holders, maintain the diversification of liabilities, and aim to ensure their capacity to sell assets.

[2] *See* Federal Reserve SR letter 01-14; OCC Advisory Letter 2001-5 (May 11, 2001); FDIC PR-37-2001 (May 11, 2001); and OTS CEO Memorandum 141 (July 13, 2001).

AC 2	Principle 14: Liquidity risk
Practices and Procedures	U.S. federal banking supervisors, during the examination process, review and assess the adequacy of the liquidity-risk management policies and procedures, and conduct periodic reviews of the reliability of liquidity sources. Because U.S. banks and holding companies rely on different sources of funding (wholesale, retail, secured, and unsecured), federal banking supervisors confirm that banks and holding companies establish policies that set out their liquidity risk tolerances and guidelines appropriate for the complexity and liquidity-risk profile of the bank and holding company. Supervisors evaluate if banks and holding companies employ both quantitative targets and qualitative guidelines that adjust as circumstances change. These limits, tolerances, and guidelines may include funding concentrations that address diversification issues such as large liability and borrowed funds dependency, single funds providers, market segment funds providers, and types of brokered deposits or wholesale funding. During both on-site examinations and off-site reviews, supervisors review and assess the bank's and holding company's holdings of marketable assets as liquidity reserves in addition to assessing the bank's and holding company's strategy to anticipate sourcing liquidity during stress situations from repos and sales of securities, asset securitization and sales activities, wholesale borrowings, and access to the discount window. Because the bank's and holding company's business activities may have a significant impact on its liquidity needs, examiners also review and assess the nature of the bank's and holding company's activities including the operational risks associated with the bank's and holding company's business activities, risks inherent in the corporate structure, or external factors that may have an impact on the bank's and holding company's liquidity including access to debt markets as a source of liquidity. Some smaller banks and holding companies may engage in activities in stress situations (repo and/or sales of securities, asset securitization and/or sales, wholesale borrowings, and access to the discount window) that are similar to those undertaken by larger and more complex ones. However, small banks and holding companies may have fewer funding options available and therefore are more reliant on maintaining an established liquidity warehouse, which is a portion of the investment account identified as a reserve to meet both normal and stress liquidity needs. Smaller banks may also rely more heavily on secured or unsecured wholesale borrowings in the form of FHLB advances or brokered deposits. In light of this, supervisors review and assess the bank's and holding company's concentration of borrowed funds, their capacity to borrow from the FHLB, and the availability of other wholesale funds providers. Supervisory guidance states that banks and holding companies should periodically test the operational elements of the CFPs to ensure that there are no unexpected impediments or complications in accessing standby sources of liquidity during a contingent liquidity event. *See* Supervisory Guidance publications noted in the overview.

Principle 15: Operational risk

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Legal Framework Overview

Many banks and holding companies view operational risk as comprising any risk not categorized as credit or market risk and as being second in significance only to credit risk. This view has become more widely held in the wake of recent, highly visible breakdowns in internal controls and corporate governance that have exposed banks and holding companies to large losses. These facts combined with several key factors, including greater use of automated technology, proliferation of new and highly complex products; growth of e-banking transactions and related business applications; large scale acquisitions, mergers, and consolidations; and greater use of outsourcing arrangements have contributed to increased operational risk exposures at banks and holding companies. As a result, the U.S. federal banking agencies have increased their oversight of banks' and holding companies' management of operational risk, and have adopted/outlined proposed and final rules for the inclusion of an explicit operational-risk capital requirement.

The U.S. federal banking agencies issued new risk-based capital rules (72 *Fed. Reg*. 235 (December 7, 2007)), effective April 1, 2008, which generally parallels principles set forth in the BCBS's June 2006 - Basel II: International Convergence of Capital Measurement and Capital. The U.S. rule entitled "Risk-Based Capital Standards: Advanced Capital Adequacy Framework" adopts only the advanced approaches and is only required to be implemented by large and/or internationally active banks and holding companies. In addition to the credit and market risk requirements – the rule imposes a specific regulatory capital requirement for operational risk, as well as specific qualification requirements, including the development of operational-risk management processes, operational-risk data and assessment systems, and operational-risk quantification systems. These guidelines are implemented pursuant to the agencies' statutory authority to impose capital adequacy requirements. *See* 12 U.S.C. §§ 1831o and 3907. As of December 31, 2007, 12 organizations met the criteria under the rule's scope and are designated as "mandatory institutions."

The U.S. federal banking agencies also issued proposed risk-based capital rules (73 Fed. Reg. 146 (July 29, 2008)), which would provide an alternative to the advanced approaches for banks and holding companies not designated as "mandatory" under the final rule referred to above. While the proposed rule is referred to as the Standardized Framework, for operational risk, the proposed rule would require banks and holding companies to adopt the Basic Indicator Approach. In addition, banks and holding companies are encouraged to manage operational risk consistent with the principles outlined in the BCBS's "Sound Practices for the Management and Supervision of Operational Risk." In addition to the revised Advanced Approaches, proposed Standardized Approaches, and existing Basel I risk-based capital requirements, all U.S. banks and holding companies are subject to leverage capital requirements. Although these leverage capital requirements do not explicitly address operational risk, they provide an important backstop against operational and other risks.

Principle 15: Operational risk
The U.S. federal banking agencies have also issued extensive supervisory guidance on various aspects of operational risk management, including internal controls, information technology, outsourcing of financial services, payment systems, audit, business continuity planning, compliance, insurance, and fiduciary operations. In all cases, risk-management practices are expected to be commensurate with the size, complexity, and risk profile of the entity. The safety-and-soundness statutes, rules and guidelines are the principal legal bases for the imposition and enforcement of these operational-risk management standards. *See* 12 U.S.C. § 1831p-1 and 12 CFR 30, 208, 364, and 570. The federal banking agencies have also integrated principles set forth in the Basel Committee on Banking Supervision's *Sound practices for the management and supervision of operational risk*, February 2003; and *Outsourcing in financial services*, Joint Forum (February 2005) into its overall supervisory programs. The federal banking agencies also expect banks and holding companies to implement an appropriate risk-management program, again corresponding to the complexity of the bank and holding company's structure and products, to ensure compliance with all consumer protection laws and regulations. Additionally, the federal banking supervisors meet periodically to discuss operational risk issues through, for example, an interagency operational risk group.

EC 1	**Principle 15: Operational risk**
Criterion	The supervisor requires individual banks to have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes are adequate for the size and complexity of the bank's operations, and the supervisor confirms that they are periodically adjusted in the light of the bank's changing risk profile and external market developments.
Legal Framework	*See* Overview above.
Practices and Procedures	The federal banking agencies expect banks and holding companies to implement an appropriate risk-management program, corresponding to the complexity of the banking organization's structure and products, and to ensure compliance with all consumer protection laws and regulations. The agencies have identified operational risk as one of the risk categories inherent in banks' and holding companies' activities and confirm that banks and holding companies have risk-management policies and processes to identify, assess, mitigate, and monitor operational risk. The agencies use ongoing supervision techniques, including on-site and off-site examination procedures and

EC 1	Principle 15: Operational risk
	surveillance processes, to evaluate the adequacy of banks' and holding companies' operational risk-management policies and processes in the context of the size, nature, and complexity of operations and activities considering the external environmental and market factors in which banks and holding companies operate. The supervision process includes an identification and evaluation of the banks' and holding companies' critical and/or key operational risks and an evaluation of associated risk-management policies and processes, including banks' and holding companies' periodic re-evaluation of operational risk exposure in light of changes in their activities and risk profile and developments in external markets and the environment. Refer to Principle 7 for additional background on U.S. supervisors' expectations for the necessary elements of a sound risk-management program. Supervisory assessment of a bank's risk-management processes and practices are largely captured in the agencies' [Uniform Financial Institutions Rating System] (UFIRS) that evaluates each bank's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. The agencies have various internal risk-assessment systems that they use to evaluate the adequacy of a banking organization's risk-management processes. For example, OCC supervisors use a Risk Assessment System to evaluate the quantity of risk, the quality of risk management, the level of supervisory concern (measured as aggregate risk) and the direction of risk across various categories of risk, including transaction/operational risk. *See* the *Bank Supervision Process*, *Community Bank Supervision*, and *Large Bank Supervision* booklets of the OCC Comptroller's Handbook series. Similarly, the Federal Reserve and the OTS assign a formal supervisory rating to the adequacy of risk-management processes, including internal controls at supervised holding companies. *See* Federal Reserve SR letter 95-51 and OTS CEO Memorandum 266 and attachment. U.S. federal banking agencies adopted the new risk-based capital framework that is based on the advanced approaches from the New Basel Capital Accord in December 2007. As implemented, the advanced capital adequacy framework includes the U.S. version of the Advanced Measurements Approach (AMA) for operational risk. *See* Overview for additional information. The agencies have formal enforcement authority to address risk-management deficiencies at banks and holding companies and routinely exercise this authority when identified deficiencies materially threaten an institution's safe and sound operation. The following are examples of formal enforcement actions that serve as examples of U.S. supervisors' authority to direct adequate management of operational risks at banks and holding companies: North Valley Bank – Written Agreement dated March 15, 2007, requiring a written plan to strengthen and improve risk-management processes, including but limited to operational risk. www.federalreserve.gov/newsevents/press/enforcement/enf20070322a1.pdf First Security NB – Cease and Desist Order that mandates controls over new products and services, accurate and complete records, and improved MIS. www.occ.treas.gov/FTP/EAs/ea2008-150.pdf

EC 1	Principle 15: Operational risk
	Sunnyside Federal S & L Association of Irvington—Cease and Desist Order dated September 14, 2007, requiring establishment of committee of outside directors of board to monitor creation of, and compliance with, business plan, compliance management program, and other plans to ensure compliance with various laws. www.files.ots.treas.gov/enforcement/96199.pdf Home Federal Savings Bank—Temporary cease and desist order dated October 9, 2007, requiring establishment of committee of outside directors of board to monitor creation and maintenance of accurate books and records. http://files.ots.treas.gov/enforcement/96304.pdf

EC 2	Principle 15: Operational risk
Criterion	The supervisor requires that banks' strategies, policies and processes for the management of operational risk have been approved and are periodically reviewed by the Board. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.
Legal Framework	*See* Overview above.
Practices and Procedures	U.S. federal banking agencies evaluate the risk-management processes and programs of banks and holding companies, including an assessment of active board of directors' and senior management oversight, a key element of such programs. Boards have ultimate accountability for the level of risk taken by their banks and holding companies, and supervisors evaluate whether the board understands the nature of operational risks and take steps necessary to identify, measure, control, and monitor such risks. More specifically, U.S. federal banking agencies' examination procedures require verification that a board periodically reviews and approves significant operational risk management-related strategies, policies, and processes, and are among the routine responsibilities of the board in directing a bank's and/or holding company's activities. While the volume and content of such strategies, policies, and processes varies at each bank or holding company according to size and the nature of activities, the expectation for board review and approval of such policies and for a board's active oversight of management's execution/implementation of them is universal. With respect to the banks and holding companies that are required to, or chose to opt-in to, the advanced approach under Basel II, there is a requirement that the board must at least annually review the effectiveness of and approve the organization's advanced systems. Largely through on-site examinations, and secondarily through on- and off-site supervisory activities, supervisors identify a bank's

EC 2	Principle 15: Operational risk
	and/or holding company's operational risk-related strategies, policies, and processes and verify that they are current, reflect the organization's actual operating characteristics, and have been formally approved by the board. Additionally, supervisors evaluate the board oversight of management's effectiveness in implementing operational risk-management policies. This assessment is conducted in several ways: 1) Review of board and committee minutes; 2) Evaluation of the frequency, coverage, and quality of external and internal audit reports; and 3) Assessment of the frequency, nature, and integrity of applicable management information system that reflect effective policy/control implementation through reported residual risk levels (For more information, also *see* Principle 7, Principle 17, Principle 22, and EC 1 above). The consolidated supervision framework for large bank holding companies directs Federal Reserve participation in testing internal audit for a defined population of large bank holding companies and for combined U.S. operations of foreign banks every three years supplemented by annual reassessments. The following outstanding formal enforcement actions serve as an example of the authority to direct board approval and periodic review of operational risk-management policies and board oversight of effective implementation. Cache Valley Banking Company and Cache Valley Bank – Cease and Desist Order dated March 20, 2007, requiring development of a plan to strengthen board oversight, including a process to ensure timely board approval of new or revised policies and to monitor management's adherence to approved policies and procedures. www.federalreserve.gov/newsevents/press/enforcement/enf20070323a1.pdf Beach First National Bank – Formal Agreement dated September 30, 2008, requiring a review of current management and board supervision, conduct of strategy planning, and improvements of IT and MIS programs. www.occ.treas.gov/FTP/EAs/ea2008-142.pdf American Bank, Rockville, MD –Cease and Desist order dated September 4, 2008, requiring adoption of various policies and improvements in board oversight. http://files.ots.treas.gov/enforcement/97010.pdf

EC 3	Principle 15: Operational risk

EC 3	Principle 15: Operational risk
Criterion	The supervisor is satisfied that the approved strategy and significant policies and processes for operational risk are implemented effectively by management.
Legal Framework	*See* Overview above.
Practices and Procedures	U. S. federal banking supervisors review and evaluate the same information inputs available to the bank's and holding company's board. External and internal audit reports and selected management information system reports are reviewed and evaluated to verify that management has implemented the board approved operational risk-management strategies, policies and procedures effectively. Additionally, on a risk-focused basis and/or where warranted based on initial evaluation findings, on-site supervisors will perform select transaction testing to validate conformance with, and effectiveness of, operational risk management and control policies and processes. (For more information, also *see* Principle 7, Principle 17, and EC 1 and EC 2 above). The U.S. banking supervisors have also established uniform review procedures for use in all Basel II mandatory and potential opt in institutions. The procedures ensure even implementation and evaluation throughout the jurisdiction, and the information is collected, reviewed and summarized to address systemic or industry concerns. Additionally U.S. regulators are participating in, and serving as the central processor for, the 2008 LDCE (loss data collection exercise) sponsored by the Basel Committee. This effort, on a voluntary basis, will provide supervisors and institutions with a broad base of information to ensure consistent and even implementation of strategies and regulatory expectations are met. The following outstanding formal enforcement actions serve as examples of the authority to direct management's effective implementation of board approved policies and procedures. Bank of York – Cease and Desist Order dated August 14, 2006, requiring monitoring of effective policy implementation and enhancements to the internal audit program. www.federalreserve.gov/newsevents/press/enforcement/enf20060822a1.pdf\ First National Bank of Kansas – Cease and Desist Order that required the bank to revise its automated clearing house risk management system, including operational risk. www.occ.treas.gov/FTP/EAs/ea2008-093.pdf

EC 4	Principle 15: Operational risk
Criterion	The supervisor reviews the quality and comprehensiveness of the bank's business resumption and contingency plans to satisfy itself

EC 4	Principle 15: Operational risk
	that the bank is able to operate as a going concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.
Legal Framework	*See* Overview above.
Practices and Procedures	U.S. federal banking agencies have adopted examination procedures and perform risk-focused reviews of banks' and holding companies' business resumption and contingency plans during on-site examinations, with the scope/breadth of review contingent upon the risk profile of the organization. The risk profile is based on 1) the size and nature of the organization's current operations and activities, considering any significant changes since the previous regulatory review; 2) the scope/breadth and findings of previous regulatory reviews; and 3) any significant changes in the external or environmental factors that can materially impact business continuity risk. Additionally, under certain circumstances, the business resumption and contingency plans of banks and holding companies, individually by organization and/or horizontally across groups of banks and holding companies, are the subject of both on-site and off-site supervisory activities at the U.S. federal banking agencies. Various supervisory policies, standards, and/or guidance statements relevant to business resumption and contingency planning have been issued on an interagency basis. *See* March 2008 *FFIEC Business Continuity Planning Booklet*, as well as guidance published for responses to Hurricanes Katrina and Rita. Supervisory oversight of key financial firms and market utilities that support critical financial markets have dedicated supervisor teams to assess the adequacy of governance and risk management of critical business/service lines on an ongoing basis. These firms generally provide core clearing and settlement services that are the backbone of the U.S. financial and international financial systems. As such, U.S. federal supervisors have adopted guidelines that are outlined in the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. These guidelines outline recovery and resumption objectives for clearance and settlement activities that support critical financial markets with the specific goal of limiting systemic/disruption risk to the U.S. financial system. Supervisory programs have integrated these guidelines into their continuous monitoring program and periodic targeted control validation reviews, both of which leverage work already performed by, or conducted in concert with, other banking supervisors and functional regulators. A related principle in the consolidated supervision framework is that large holding companies should provide sufficient resiliency measures for the recovery and/or resumption of their most important business processes in the event of a business disruption. The Federal Reserve's supervisory approach focuses on the areas of the greatest systemic risk, i.e., clearing and settlement activities related to critical financial markets. The resulting supervision program establishes a mechanism to conduct ongoing evaluations of the adequacy of risk management over the resiliency and recovery of clearing and settlement activities related to critical financial markets as originally contemplated under SR letter 03-09, the *Interagency Paper on Sound Practices to Strengthen the Resilience of*

EC 4	Principle 15: Operational risk
	the U.S. Financial System. The supervisory program combines an examination team's continuous monitoring activities, an annual assessment of any material changes in a firm's related activities or characteristics, and periodic targeted control validation reviews. The OTS's approach is similar in its role as a consolidated supervisor. Also, the OCC and the FDIC expect banks under their jurisdiction to also provide for sufficient resiliency measures. The following outstanding formal enforcement action serves as an example of the authority to direct development and implementation of a business continuity plan: Vineyard Bank, N.A. – Cease and Desist Order dated July 22, 2008 requiring development of an enterprise-wide business continuity process. www.occ.treas.gov/FTP/EAs/ea2008-068.pdf

EC 5	Principle 15: Operational risk
Criterion	The supervisor determines that banks have established appropriate information technology policies and processes that address areas such as information security and system development, and have made investments in information technology commensurate with the size and complexity of operations.
Legal Framework	*See* Overview above. Pursuant to statute 15 U.S.C. § 6801(b), the U.S. federal banking agencies published the *Interagency Information Security Standards* in May 2001. This requires that banks and holding companies develop and implement a comprehensive written information security program that includes administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information. *See* 12 CFR 30, appendix B (OCC),
Practices and Procedures	U.S. federal banking agencies' supervisory procedures determine if banks and holding companies have appropriate systems in place to address information security and system development through on-site examinations considering the risk profile of the bank or holding company. The agencies have supervisors with specialized IT skill sets who can lead or assist in examinations of banks and holding companies that have complex IT or operating environments. Also, consumer compliance supervisors review banks' and holding companies' compliance with statutory consumer privacy provisions to ensure that controls are in place to protect sensitive customer information and that appropriate disclosures are made regarding banks' and holding companies' information sharing practices.

EC 5	Principle 15: Operational risk
	Various supervisory policies, standards, and/or guidance statements relevant to risk management of IT activities have been issued on an interagency basis, many through the FFIEC's IT Subcommittee (ITS), a standing subcommittee of the FFIEC Task Force on Supervision to address security and development. See www.ffiec.gov/PDF/annrpt06.pdf ,p. 20, for a description of roles and responsibilities. The FFIEC's *Information Security* booklet provides extensive guidance and examination procedures to evaluate IT security practices. The ITS develops and publishes IT-related risk-management policies and guidance statements based on industry/market trends or developments in the broader IT environment. This includes the *Information Security* booklet of the FFIEC's *IT Examination Handbook*, as well as other more targeted guidance such as *Interagency Guidance on Authentication in an Internet Banking Environment (October 2005)*, *Guidance on the Use of Free and Open Source Software (December 2004)*, *Internet "Phishing" Informational Brochure (October 2004)*, *Uniform Rating System for Information Technology (March 1999),* and *Interagency Supervisory Statement on Risk Management of Client/Server Systems (October 1996*). The following outstanding formal enforcement actions serve as examples of the authority to direct adequate risk management over information technology activities and environment: Sella Holding Banca, S.p.A and Sella Holding Banca, S.p.A. d/b/a Banca Sella, S.p.A. Miami Agency – Written Agreement dated April 12, 2006, requiring submission of an acceptable plan to improve management oversight of and strengthen the information technology function. www.federalreserve.gov/newsevents/press/enforcement/enf20060424d1.pdf Bank of America – Formal Agreement dated February 9, 2005 requiring controls over new products, services, or significant changes to existing customer relationships in the Wealth & Investment Management Group. www.occ.treas.gov/FTP/EAs/ea2005-10.pdf

EC 6	Principle 15: Operational risk
Criterion	The supervisor requires that appropriate reporting mechanisms are in place to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.
Legal	*See* Overview above.

EC 6	Principle 15: Operational risk
Framework	
Practices and Procedures	U.S. federal banking agencies rely upon a combination of their supervisory activities and required regulatory and public disclosures and reporting by banks and holding companies (public requirements stem from accounting and audit-related statutes and rules applicable to publicly held firms) to keep apprised of developments affecting operational risk at their supervised entities. The agencies also maintain on- and off-site supervisory monitoring and surveillance regimens; supervisory staff assigned to individual banks and holding companies monitor those firms' current and planned activities. At larger banks and holding companies, this may include supervisors with specialized skills in IT or operational risk issues. On-site and off-site supervisory staff also analyzes and reacts to developments regarding operational risk indicated by the firms' regulatory and public disclosures and reporting (see discussion below). Furthermore, regulations requiring a bank and holding company to file a formal, written application or notification with its primary federal banking agency regarding proposed mergers, acquisitions, changes in control, and/or expansions into certain new activities, provide each agency with indicators of events potentially affecting the organization's inherent operational risk profile. As an example, under the Bank Services Company Act, U.S. banks are required to provide regulatory notice upon entering into a third-party contract outsourcing the performance of certain functions or services. Such notices indicate developments in outsourcing risk and potentially in other categories of operational risk. Finally, the agencies maintain surveillance units that analyze the balance sheet, profit/loss, and supplemental information routinely submitted by all banks and holding companies through required quarterly financial reports. Performance trends in various financial indicators can directly or indirectly point to developments in a particular organization's operational risk profile. Supervisory analysis of a banking organization's operational risk and risk management also draws upon public disclosures of financial and managerial information and audit-related internal controls attestations required of publicly held banks and holding companies. The AMA to operational risk under the Basel II Capital directive (*see* EC 1 above) permits some flexibility in the use of specific tools for the quantification and management of operational risk. However, banks and holding companies are required to incorporate both scenario analysis and business environment and internal control factor analysis methodologies. Outside of the AMA framework, the agencies and the banking industry understand that a number of tools exist for the management of operational risk including, among others, scenario analysis; risk and control self assessments; scorecards; key risk indicators; risk assessment processes for information security risk under the Gramm-Leach-Bliley Act; and business continuity, internal audit, and internal control assessments under the Sarbanes-Oxley Act. The desired result sought by U.S. banking agencies is an accurate assessment of operational risk levels accompanied by appropriate risk-management controls or mitigants. How those results are arrived at, and the specific tools used, are typically left to the banks and holding companies in order that they might match specific tools to their circumstances. For banks and holding companies not required to implement the AMA for operational risk, the agencies have

EC 6	Principle 15: Operational risk
	proposed an additional capital adequacy framework that would implement the U.S. version of the standardized approach for credit risk and the Basic Indicator Approach (BIA) for operational risk contained in Basel II. This framework, as proposed would be optional for banks and holding companies not subject to the advanced approaches of Basel II.

EC 7	Principle 15: Operational risk
Criterion	The supervisor confirms that legal risk is incorporated into the operational risk management processes of the bank.
Legal Framework	*See* Overview above.
Practices and Procedures	Under the U.S. federal banking agencies' operational and managerial safety and soundness standards (12 CFR 30, appendix A), banks' an holing companies' internal controls and information systems must ensure compliance with applicable laws and regulations. Supervisors assess a bank's and/or holding companies' compliance with applicable laws and regulations as part of their supervision activities.

EC 8	Principle 15: Operational risk
Criterion	The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management program should cover: conducting appropriate due diligence for selecting potential service providers; structuring the outsourcing arrangement; managing and monitoring the risks associated with the outsourcing arrangement; ensuring an effective control environment; and establishing viable contingency planning. Outsourcing policies and processes should require the institution to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.
Legal Framework	*See* Overview above.

EC 8	Principle 15: Operational risk
Practices and Procedures	U.S. federal banking agencies strictly maintain that although banks and holding companies may outsource data processing and/or other business processes to outside parties, the banks' and holding companies' directorate and management remain responsible and accountable for the safe and sound performance and legitimacy/legality of the outsourced activity, including payment processing. Safety and soundness considerations include the security, integrity, and availability of any sensitive data or other assets transferred to the service provider. U.S. federal banking agencies' examination procedures ensure supervisors evaluate, through on-site exams, that banks and holding companies establish appropriate policies and processes to assess, manage, and monitor outsourced activities. Supervisors confirm that each firms' program includes conducting due diligence on potential service providers, structuring the outsourcing arrangement, assessing, managing, and monitoring of applicable risk, ensuring effective controls, and establishing and testing back-up plans. Interagency guidance on this topic has been issued through the FFIEC. While both *Guidance on the Risk Management of Outsourced Technology Services (November 2000)* and the *Outsourcing Technology Services Booklet (June 2004)* address regulatory risk-management expectations largely from the perspective of IT-related outsourcing, the same risk-management elements are applied in practice to any material outsourcing arrangement at banks and holding companies, whether technology or business process related. The *Interagency Information Security Standards (May 2001)* are applicable to customer information maintained by banks and holding companies themselves or maintained on their behalf by outsourced service providers. OTS Thrift Bulletin 82a provides additional guidance on third-party arrangements. U.S. federal banking agencies are active in additional aspects of the banking industry's use of service providers. Deriving authority and jurisdiction from the Bank Services Company Act, the agencies pool supervisory resources to perform IT-related risk management evaluations/examinations of data processing service providers with significant client bases comprised of supervised banks and holding companies. For large service providers whose performance is identified as having systemic implications, periodic evaluations are performed under the Multi-regional Data Processing Servicers (MDPS) Program administered by the FFIEC IT Subcommittee. Other data processing service providers with less significance, yet multiple client banks and holding companies are identified and evaluated under the Regional Technology Service Provider (Regional TSP) program administered by the agencies' regional or local offices.

AC 1	Principle 15: Operational risk
Criterion	The supervisor determines that the risk management policies and processes address the major aspects of operational risk, including an appropriate operational risk framework that is applied on a group-wide basis. The policies and processes should include additional risks prevalent in certain operationally intensive businesses, such as custody and correspondent banking, and should cover periods when operational risk could increase.

AC 1	Principle 15: Operational risk
Legal Framework	*See* Overview above.
Practices and Procedures	As discussed in the above responses to the ECs, U.S. federal banking agencies routinely ensure the existence, and evaluate the adequacy, of risk-management policies and processes across the major categories of operational risk applicable to all banks and holding companies. Additionally, on a risk-focused basis, an assessment of operational risk-management practices applied to significant or critical business lines can be scoped into planned supervisory activities. Further, as indicators of escalating operational risk surface at a specific bank, holding company, or more generally across the banking industry, the agencies' risk assessment and planned supervisory activities are adjusted accordingly. Regarding the existence and adequacy of an enterprise-wide risk-management framework overlaying all categories of operational risk across all of a supervised firm's business operations and activities, regulatory expectations are dependent upon the size, nature and complexity of a bank's or holding company's activities/operations. The requirements of the AMA for operations risk and capital adequacy under Basel II apply an enterprise-wide approach or framework to overall operational risk. The implementation by individual banks and holding companies in the United States, although limited, will serve to reinforce the prudence of enterprise-wide operational risk governance and management in the largest, most complex, and internationally active banks and holding companies.

Principle 16: Interest rate risk in the banking book

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Overview

The U.S. federal banking agencies have emphasized that banks and holding companies should carefully assess the risk to earnings and the economic value of their capital from adverse changes in interest rates. The "Joint Policy Statement on Interest Rate Risk[1]" provides guidance on this issue. The guidance stresses the importance of assessing interest rate risk to the economic value of a bank's or holding company's capital and, in particular, sound practice in selecting appropriate interest rate scenarios to be applied for capital adequacy purposes. Banks and holding companies are directed to establish limits on their interest rate risk exposures that are appropriate to the size, complexity and capital adequacy and that address the potential impact of changing interest rates on both reported earnings and economic value of equity. The agencies also refer to the BCBS's document "Principles for the management and supervision of interest rate risk, July 2004" for guidance.

The safety-and-soundness statute explicitly requires the U.S. federal banking agencies to prescribe standards for banks and holding companies relating to interest rate exposure. *See* 12 U.S.C. § 1831p-1(a)(1)(D). The interagency safety-and-soundness guidelines specify that a bank should (a) manage interest rate risk in a manner appropriate to the size and complexity of its assets and liabilities and (b) provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk. *See* 12 CFR 208, appendix D-1, § II(E); 12 CFR 30, appendix B, § II(E) (FRB) and 12 CFR 30, appendix A § II(E) (OCC). Interest rate risk management also is integral to ensuring compliance with regulatory capital standards imposed under 12 U.S.C. §§ 1831o and 3970 and the interagency capital guidelines, *see* 12 CFR 208, appendixes A, E, and F (FRB); and 12 CFR 3.10 and 12 CFR 3, appendix A (OCC).

As noted in Principle 7, the agencies adhere to the UFIRS and evaluate every bank against UFIRS guidelines during on-site examinations. UFIRS has a component to rate Sensitivity to market risk in the CAMELS ratings (S) that requires supervisors to evaluate the bank's exposure to, and management of, the interest rate risk in its banking book. Specifically, this component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a bank's earnings or economic capital. For most U.S. banks and holding companies, the primary source of market risk is the interest rate risk that arises from non-trading positions in their banking book. In some larger banks and holding companies, foreign operations can be a significant source of market risk. For some banks and holding companies, trading activities are a major source of market risk.

The Sensitivity to market risk evaluation is based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the bank's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices.

[1] *See* Federal Reserve SR letter 96-13; OCC Comptroller's Handbook, *Interest Rate Risk*; FDIC: FIL-52-96; Due to the high concentrations of mortgage securities and loans within the thrift industry, the OTS had, prior to the inception of the Interagency Statement, developed a separate policy and process for the measurement and control of interest rate risk, as partially described in Federal Register, 58 Fed. Reg, No. 167 (August 31, 1993). A more detailed discussion of OTS's supervisory approach to interest rate risk in the banking book can be found in Thrift Bulletin (TB) 13a, section 650 of the OTS Examination Handbook, *Interest Rate Risk Management.*

Principle 16: Interest rate risk in the banking book

- The ability of management to identify, measure, monitor, and control exposure to market risk given the size, complexity, and risk profile.
- The nature and complexity of interest rate risk exposure arising from non-trading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Interest rate risk is the current or prospective risk to both earnings and capital arising from adverse interest rate movements that affect the bank's and holding company's banking book. The main sources of interest rate risk in the banking book are repricing risk, yield curve risk, basis risk, and the option features embedded in many financial instruments.

As noted in EC 1 below, each agency has examination manuals and programs that supervisors use to assess the level and management of interest rate risk exposure.

EC 1	**Principle 16: Interest rate risk in the banking book**
Criterion	The supervisor determines that a bank's board approves, and periodically reviews, the interest rate risk strategy and policies and processes for the identification, measuring, monitoring and control of interest rate risk. The supervisor also determines that management ensures that the interest rate risk strategy, policies and processes are developed and implemented.
Legal Framework	Compliance with the interest rate exposure provisions of the interagency safety-and-soundness guidelines necessitates the development and adoption by the board of a strategy and policies and processes for identifying, measuring, monitoring, and controlling interest rate risk.
Practices and Procedures	As stated in the *Joint Agency Policy Statement on Interest Rate Risk*, the board is responsible for setting the banks' or holding company's "tolerance for interest rate risk, including approving relevant risk limits and other key policies, identifying lines of authority and responsibility for managing risk, and ensuring adequate resources are devoted to interest rate risk management" as well as monitoring "the bank's overall interest rate risk profile and ensuring that the level of interest rate risk is maintained at prudent levels." The policy statement also indicates that senior management is responsible for ensuring that interest rate risk is managed appropriately. In this regard, senior management should develop and implement policies and procedures; ensure adherence to board approved responsibilities for measuring, managing, and reporting interest rate risk exposures; oversee the implementation and maintenance of management information and other systems that identify, measure, monitor, and control the bank's and holding company's interest rate risk; and establish internal controls over the interest rate risk management process. U.S. federal banking supervisors confirm a bank's or holding company's compliance with this statement during on-site examinations. Due to the high concentrations of mortgage loans and securities that savings associations hold in their portfolios, OTS-regulated savings associations are particularly vulnerable to adverse movements in interest rates. Consequently, OTS's supervisory approach to interest rate risk in the banking book is somewhat different than that taken by the other U.S. federal banking agencies. In addition to its guidance to senior management and boards of directors on interest rate risk management, OTS also uses its Net Portfolio Value (NPV) Model to monitor the interest rate risk exposures of individual savings associations, as well as the industry as a whole, on a

EC 1	Principle 16: Interest rate risk in the banking book
	quarterly basis. The NPV Model is a comprehensive, off-site, supervisory interest rate risk model, which was initially developed in 1991, upgraded in 1993, and extensively modified in 2006 and 2007. As such, the NPV Model is a type of non-probabilistic, value-at-risk model, where the value-at-risk is the net economic value of a savings association's portfolio of assets, liabilities, and off-balance-sheet (OBS) contracts. OTS evaluates savings associations' interest rate risk by estimating the sensitivity of their portfolios to changes in market interest rates. In essence, OTS marks-to-market each savings association's balance sheet under several different interest rate scenarios to determine how the NPV of the savings association changes in response to changes in interest rates. OTS defines NPV as the present value of expected net cash flows from existing assets, less the present value of expected cash flows from existing liabilities, plus the present value of net expected cash flows from existing OBS contracts. The NPV Model is used to produce Interest Rate Risk Exposure Reports quarterly for OTS-regulated savings associations. Frequently, these reports are used as a management tool by small savings associations that do not have their own internal interest rate risk models. At the end of each quarter, savings associations report the outstanding balances of assets, liabilities, and OBS contracts they hold in their portfolios to OTS. These data, along with the maturities, coupon rates, and repricing frequencies for the various instruments, are reported on Schedule CMR of the *Thrift Financial Report*. The NPV Model uses these data as input. In assessing the strategy, policies, procedures and processes for the identification, measurement, monitoring, and control of interest rate risk, U.S. federal banking supervisors perform off-site risk assessments and on-site examinations. While each U.S. federal banking agency utilizes their own examination procedures and guidance for their supervised banks and holding companies[2], the guidance remains consistent across the agencies. For example, the agencies' procedures direct supervisors to obtain, review, and evaluate the interest rate risk and other relevant policies and procedures (written or unwritten); board and asset liability committee and other management meeting minutes; current strategic plan; and internal risk-management reports during the on-site examination. Examination procedures also call for supervisors to assess board and senior management oversight; evaluate the quality of interest rate risk management; evaluate the internal controls and internal audit function; and evaluate the exposure to interest rate risk from an earnings and economic-value perspective[3].

EC 2	Principle 16: Interest rate risk in the banking book

[2] *See* the Federal Reserve's *CBEM* - section 4090 and the *Trading and Capital Markets Activities Manual* - section 3010; *see* OCC's *Interest Rate Risk, Community Bank Supervision, and Large Bank Supervision* booklets of the Comptroller's Handbook series; *see* the FDIC's *Risk Management Manual of Examination Policies* - section 7.1; *see* the OTS *Examination Handbook* -section 600, "Sensitivity to Market Risk")

[3] Interagency guidance, including the OTS's TB 13a, notes that limits and measurements of interest rate risk should address the potential impact of changes in market interest rates on both a bank's and holding company's reported earnings and economic value of equity (EVE). From an earnings perspective, a bank and holding company should explore limits on net income as well as net interest income. A bank's and holding company's EVE limits should reflect the size and complexity of its underlying positions. For non-complex banks and holding companies, simple limits on permissible holdings or allowable repricing mismatches in intermediate- and long-term instruments may be adequate. At more complex banks and holding companies, more extensive limit structures may be necessary.

EC 2	Principle 16: Interest rate risk in the banking book
Criterion	The supervisor determines that banks have in place comprehensive and appropriate interest rate risk measurement systems and that any models and assumptions are validated on a regular basis. It confirms that banks' limits reflect the risk strategy of the institution and are understood by and regularly communicated to relevant staff. The supervisor also confirms that exceptions to established policies, processes and limits should receive the prompt attention of senior management, and the Board where necessary.
Practices and Procedures	The interest rate exposure provisions of the interagency safety-and-soundness guidelines require banks and holding companies to establish policies and procedures for assessing the level of interest rate risk and for reporting on interest rate risk to management and the board of directors and management. Banks and holding companies, as appropriate to their size and level of sophistication of operations, are required to establish comprehensive interest rate risk measurement systems and regularly validate any models and assumptions[4]. U.S. federal banking supervisors confirm that the board and senior management ensure that the level of interest rate risk is effectively managed and that appropriate policies and practices are established to control and limit risks. Also, supervisors review policies to ensure they include the delineations of clear lines of responsibility and authority for identifying the potential interest rate risk arising from existing or new products or activities; establishing and maintaining an interest rate risk measurement system; formulating and executing strategies to manage interest rate risk exposures; and authorizing policy exceptions. Also, supervisors confirm that the specific procedures and approvals are necessary for exceptions to policies, limits, and authorizations and that all interest rate risk policies are defined, periodically reviewed and revised as needed. In addition, U.S. federal banking agency guidance outlines the need for banks and holding companies to have a system for identifying and measuring interest rate risk; a system for monitoring and controlling interest rate risk exposures; and a system of internal controls, reviews, and audits to ensure the integrity of the overall risk-management process. The *Joint Agency Policy Statement on Interest Rate Risk* also requires an independent review of an interest rate model by a person(s) independent of the model function and savings associations are encouraged to have their risk-measurement systems reviewed by knowledgeable outside parties. In order to evaluate the bank's or holding company's risk-measurement systems and interest rate risk exposures, supervisors utilize examination procedures which are incorporated in the respective agencies guidance. The procedures direct supervisors to review and assess the data inputs and data integrity; to review and assess the model assumptions and methodology; and determine if there are appropriate controls and if the assumptions are regularly reviewed. The procedures also call for supervisors to evaluate the

[4] TB 13a provides guidelines for interest rate risk measurement systems at OTS-regulated institutions. According to these guidelines, unless otherwise directed by their OTS Regional Director, institutions below $1 billion in assets may usually rely on the quarterly NPV estimates produced by OTS and distributed in the Interest Rate Risk Exposure Report. If such an institution owns complex securities (*see* Glossary in TB 13a) whose recorded investment exceeds 5 percent of total assets, the institution should be able to measure, or have access to measures of, the economic value of those securities for hypothetical interest rate scenarios of plus and minus 100, 200, and 300 basis points from the actual term structure observed at quarter-end. In contrast, those institutions with more than $1 billion in assets should measure their own NPV and its interest rate sensitivity. These institutions are encouraged to have NPV measurement systems that produce financial instrument valuations that are based directly or indirectly on observed market prices, where feasible. *See* TB 13a for a detailed discussion of other desirable methodological features of NPV measurement systems that OTS examiners use in evaluating the quality of institutions' internal interest rate risk models.

EC 2	Principle 16: Interest rate risk in the banking book
	model's structure and capabilities to determine if the model is adequate to accurately assess the risk exposure of the banking organization; to support the bank's and holding company's risk-management process; and serve as a basis for internal limits and authorizations. The agencies also provide guidance to supervisors and bankers on key principles for model validation (*see* OCC Bulletin 2000-16) and have staffs with specialized skills in model development and validation that can assist supervisors at larger, more complex banks and holding companies. The OTS Thrift Bulletin 13a discusses desirable features of interest rate risk measurement systems. These include recommendations that financial instrument valuations should, where feasible, be based directly or indirectly on observed market prices; values are ascribed only to financial instruments currently in existence or for which contracts currently exist (i.e., future business is not included in NPV); values are based on granular information; zero-coupon (spot) rates of the appropriate maturities are used to discount cash flows; implied forward interest rates are used to model adjustable-rate product cash flows; cash flows are adjusted for reasonable non-interest costs that the savings association an SLHC will incur in servicing both assets and liabilities; valuations take account of embedded options; and valuation of deposits is based on savings association an SLHC-specific data regarding retention rates of existing accounts and the rates offered by the savings association on its deposits. Guidance also covers stress-testing results and market risk monitoring and reporting, with a requirement for savings associations to reconcile and explain differences between their internal model results and those of the OTS NPV Model.[5]

EC 3	Principle 16: Interest rate risk in the banking book
Criterion	The supervisor requires that banks periodically perform appropriate stress tests to measure their vulnerability to loss under adverse interest rate movements.
Practices and Procedures	U.S. federal banking agencies agree that the bank's or holding company's management should ensure that interest rate risk is measured over a probable range of potential interest-rate changes, including meaningful stress situations. The agencies stress that the scenarios used should be large enough to expose all of the meaningful sources of interest rate risk associated with a bank's and holding company's holdings. In developing appropriate scenarios, the agencies require that the bank's or holding company's management consider the current level and term structure of rates and possible changes to that environment, given the historical and expected future volatility of market rates. At a minimum, the agencies have stated that scenarios should include an instantaneous plus or minus 200 basis point parallel shift in market rates for a one year time horizon. The OCC encourages banks to assess the impact of both immediate and gradual changes in market rates as well as changes in the shape of the yield curve when evaluating their risk exposure.

[5] *See* section 650 of OTS *Examination Handbook* and TB 13a, appendix B, sections C, D, and E.

EC 3	Principle 16: Interest rate risk in the banking book
	The OTS requires savings associations to consider hypothetical interest rate scenarios of plus and minus 100, 200, and 300 basis points from the actual term structure observed at quarter-end. In addition, OTS encourages its savings associations, especially those with assets greater than $1 billion and/or using internal models, to conduct scenario analysis that considers variation in the slope of the yield curve. OTS also suggests that stress tests should include "worst-case" scenarios in addition to more probable interest rate scenarios. Possible stress scenarios recommended by OTS include abrupt changes in the general level of interest rates (i.e., parallel shifts in the yield curve); changes in the relationships among rates (i.e., basis risks); change in the slope of the yield curve; and changes in the liquidity of key financial markets or changes in the volatility of market rates. For instruments and/or positions that may be difficult to liquidate or offset during stressful situations, OTS requires that the board and senior management periodically review the design and results of stress testing and that the savings association conducts appropriate contingency planning.

AC 1	Principle 16: Interest rate risk in the banking book
Criterion	The supervisor has the power to obtain from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardised interest rate shock on the banking book.
Practices and Procedures	With the exception of the OTS, none of the U.S. federal banking agencies has a standard measure for interest rate risk. Instead, they utilize the bank's or holding company's internal measures of risk, require sound risk-management practices, and use surveillance screens to identify those banks and holding companies that appear to be taking excessive risk. The agencies' regulatory Call Reports include maturity and repricing information on each bank's investment, loan and deposit portfolios. Banks and holding companies must also report the current fair value of their investment portfolios. At the largest banks and holding companies, the agencies maintain on-site examination staffs who receive more detailed information on those banks' and holding companies' portfolios and risk exposures. During on-site examinations, supervisors review the bank's or holding company's internal interest rate risk exposure reports and also evaluate whether the interest rate risk measurement system, structure and capabilities are adequate to accurately assess the risk exposure, support the risk management process, and serve as a basis for internal limits and authorizations. The supervisory authority to review banks' internal interest rate risk measurement systems is included in section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) which addresses risk-based capital standards for interest rate risk. Interest rate risk exposure estimates, whether linked to earnings or economic value, use some form of forecasts or scenarios of possible changes in market interest rates. In conducting this analysis, supervisors confirm that a bank's or holding company's interest rate risk measurement systems assess all material IRR associated with its assets, liabilities, and off-balance-sheet positions over an appropriate range of interest rate scenarios; use generally accepted financial concepts and risk-measurement techniques; and have well documented assumptions and parameters. As noted previously, OTS has an off-site regulatory model that helps to assess the level of IRR in the industry and to identify savings associations that appear to have excessive levels of risk. To help supervisory staff interpret results from the model, OTS has developed a two-dimensional matrix that is used to quantify the level of IRR for each savings association. The matrix takes into account a savings association's pre-shock net portfolio value (i.e., pre-shock capital or net worth) and the degree to which that

AC 1	Principle 16: Interest rate risk in the banking book
	portfolio value is affected by an instantaneous, parallel shift in the yield curve of +/-200 bps. The matrix is designed in such a way that a savings association with a higher level of pre-shock capital can afford to take on a higher level of interest rate risk than one with a lower level of pre-shock capital. The matrix has four interest-rate-risk categories: "Minimal", "Moderate", "Significant", and "High." Supervisors are given the flexibility to use the results from the OTS NPV Model, or those from a savings association's internal model if such a model is deemed more appropriate.

AC 2	Principle 16: Interest rate risk in the banking book
Criterion	The supervisor assesses whether the internal capital measurement systems of banks adequately capture the interest rate risk in the banking book.
Practices and Procedures	The *Interagency Policy Statement on Interest Rate Risk* states that the adequacy and effectiveness of a bank's or holding company's interest rate risk management process and the level of its interest rate exposure are critical factors in an agency's evaluation of the bank's and holding company's capital adequacy. A bank or holding company with material weaknesses in its risk-management process or high levels of exposure relative to its capital will be directed by the appropriate agency to take corrective action. Depending on the facts and circumstances, such actions could include recommendations or directives to raise additional capital, strengthen management expertise, improve management information and measurement systems, reduce levels of exposure, or some combination thereof. *See* EC 1 for a further description of how the U.S. federal banking agencies evaluate compliance.

AC 3	Principle 16: Interest rate risk in the banking book
Criterion	The supervisor requires stress tests to be based on reasonable worst case scenarios and to capture all material sources of risk, including a breakdown of critical assumptions. Senior management is required to consider these results when establishing and reviewing a bank's policies, processes and limits for interest rate risk.
Practices and Procedures	U.S. federal banking agencies view stress testing as an important tool for banks and holding companies to identify, measure, monitor, and control their interest rate risk exposure and assess a bank's or holding company's stress test management during on-site examinations. While the formality of a bank's or holding company's stress testing regime will vary, based on its size and complexity, U.S. federal banking supervisors evaluate that the stress scenarios used should be large enough to expose all meaningful sources of IRR associated with a bank's or holding company's holdings. Supervisors also confirm that in developing stress scenarios, banks and holding companies consider a number of factors including the level and shape of the yield curve and incorporate sufficiently wide changes in market interest rates and/or yield curve shifts. In addition, banks and holding companies should employ assumptions about customer behavior and new business activity that are reasonable and consistent with each rate scenario that is evaluated. In particular, banks and holding companies should measure how the maturity, repricing, and cash flows of instruments with embedded options may change under the various stress scenarios. Supervisors confirm that these instruments

AC 3	Principle 16: Interest rate risk in the banking book
	include loans that can be prepaid without penalty prior to maturity or have limits on the coupon adjustments, and deposits with unspecified maturities or rights of early withdrawal. Stress tests should be designed to identify particular vulnerabilities of the bank and holding company under certain conditions. Supervisors confirm that senior management and the board periodically review stress test results in order to gain an understanding of the implications of various stress scenarios including the reasonableness and sensitivity to key assumptions. Also, supervisors review that the stress test results be used as a mechanism to facilitate the review of the bank's or holding company's risk tolerances and limits and provide the basis needed to implement strategies to mitigate the identified risk exposure and realign the risk tolerances.

AC 4	Principle 16: Interest rate risk in the banking book
Criterion	The supervisor requires banks to assign responsibility for interest rate risk management to individuals independent of and with reporting lines separate from those responsible for trading and/or other risk-taking activities. In the absence of an independent risk management function that covers interest rate risk, the supervisor requires the bank to ensure that there is a mechanism in place to mitigate a possible conflict of interest for managers with both risk management and risk-taking responsibilities.
Practices and Procedures	U.S. federal banking agencies believe that effective oversight by senior management and the board is critical to the internal control process and evaluate this oversight during on-site examinations. U.S. federal banking supervisors confirm that senior management and the board establish clear lines of authority, responsibilities, and risk limits, and ensure that adequate resources are provided to support the risk monitoring, audit, and control functions. For example, supervisors confirm that the persons or units responsible for risk monitoring and control functions are independent from the persons or units that create the risk exposures. The persons or units may be part of a more general operations, audit, compliance, risk management, or treasury unit. If the risk monitoring and control functions are part of a treasury unit that also has the responsibility and authority to execute investment or hedging strategies to manage the bank's or holding company's risk exposure, supervisors confirm that the bank or holding company has a strong internal audit and control function and sufficient safeguards in place.

Principle 17: Internal control and audit

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Overview

The effectiveness of internal controls, information systems, and audits is essential to a bank's and holding company's ability to comply with prudential and other legal requirements. The safety-and-soundness provision of the FDI Act explicitly requires the U.S. federal banking agencies to prescribe standards relating to internal controls, information systems, and audits. Refer to section 39 of the FDI Act, codified as 12 U.S.C. § 1831p-1(a)(1)(A). Furthermore, section 112 of the FDIC Improvement Act (FDICIA) added section 36 of the FDI Act to provide greater specificity to the requirements of section 39, and these must conform with statutory requirements concerning (a) the submission of annual reports; (b) the submission of financial statements with appropriate attestations by management regarding the effectiveness of internal controls and legal compliance, among other matters; (c) an evaluation and attestation regarding the effectiveness of internal controls by an independent public accountant meeting certain qualification standards; (d) an annual independent audit of the bank's and holding company's financial statements, prepared by an independent public accountant meeting certain qualification standards, in accordance with generally accepted accounting and auditing principles; (e) the establishment and independence of, and reporting to, an internal audit committee by larger banks and holding companies; and (f) the sharing of information with external auditors and supervisors. *See* 12 U.S.C. § 1831m. In general, smaller banks and holding companies s (i.e., those with total assets of $150 million or less) are exempt from these specific requirements but still must adhere to the general requirements of the safety-and-soundness provision regarding the establishment of internal controls, information systems, and audits. With respect to audited financial statements, section 36 of the FDI Act currently requires audited financial statements for banks and holding companies with $500 million or more in assets. In addition, at those with greater than $1 billion in assets management must sign off on the adequacy of internal controls over financial reporting.

The interagency safety-and-soundness guidelines implement the foregoing requirements. *See*12 CFR 208, appendix D-1, § II(A) and (B); 12 CFR 30, appendix A, § II(A) and (B). They specify that a bank and holding company should have internal controls and information systems that are appropriate to the size of the bank and holding company and the nature, scope, and risk of its activities and that provide for (a) an organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies; (b) effective risk assessment; (c) timely and accurate financial, operational and regulatory reports; (d) adequate procedures to safeguard and manage assets; and (e) compliance with applicable laws and regulations. A bank and holding company also should have an internal audit system that is appropriate to the size of the bank and holding company and the nature and scope of its activities and that provides for (a) adequate monitoring of the system of internal controls through an internal audit function (or, in the case of smaller or noncomplex banks and holding companies, a system of independent reviews of key internal controls); (b) independence and objectivity; (c) qualified persons; (d) adequate testing and review of information systems; (e) adequate documentation of tests and

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findings and any corrective actions; (f) verification and review of management actions to address material weaknesses; and (g) review by the bank's and holding company's audit committee or board of directors of the effectiveness of the internal audit systems. The agencies have issued supervisory guidance elaborating on these requirements. *See* "Interagency Policy Statement on the Internal Audit Function and its Outsourcing" (March 17, 2003)[1]. These policies align with BCBS's documents *Framework for internal control systems in banking organisations*, September 1998; *Internal audit in banks and the supervisor's relationship with auditors*, August 2001; and *Compliance and the compliance function in banks*, April 2005.

The OTS requires an independent audit for safety and soundness purposes of any SLHC that controls a savings association subsidiary with aggregate consolidated assets of $500 million or more[2] and of any savings association with a composite CAMELS rating of 3, 4, or 5. *See* 12 CFR 562.4(b). For safety and soundness purposes, OTS may also require, at any time, an independent audit of the financial statements of, or the application of procedures agreed upon by the OTS to a savings association, SLHC, or affiliate. *See* 12 CFR 562.4(a).

Additional audit requirements are set forth for national banks and federal savings associations acting in a fiduciary capacity. *See* 12 CFR 9.9 (national banks); 12 CFR 550.440-480 (federal savings associations).

As discussed under Principle 3, ECs 3 and 9, the effectiveness of internal controls, information systems, and audits is evaluated at the time of charter grantings of banks and holding companies and as part of the supervisory process[3]. If an agency determines that a bank or holding company fails to meet any safety or soundness standard established under the interagency guidelines, the agency may require the bank and holding company to submit an acceptable plan to achieve compliance. In the event that a bank or holding company fails to submit an acceptable plan within the time allowed or fails in any material respect to implement an accepted plan, the agency must order the bank or holding company to correct the deficiency. The agency may, and in some cases must, take other supervisory actions until the deficiency is corrected. *See* 12 U.S.C. § 1831p-1(e).

Since the enactment in 2002 of the Sarbanes-Oxley Act (the Act),[4] the federal securities laws have established internal control and audit requirements for internal controls over financial reporting for companies, including banks, savings associations, and their holding companies, that have securities registered under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c *et seq.*, ("public companies").[5] Section 301 of the Act, 15 U.S.C. § 78j-1, requires that all members of the audit committee of a public company must be independent and also subjects them to other requirements. The audit committee must establish procedures to handle complaints regarding accounting matters that are received by the public company, including from its

[1] *See* Federal Reserve SR letter 03-5; OCC Bulletin 2003-12; FDIC FIL-21-2003; and OTS Thrift Bulletin 81.
[2] SLHC report H-(b)(11) requires audited financial statements.
[3] Each agency's examination manual includes procedures to evaluate internal controls and audit. *See*, for example, OCC Comptroller's Handbook series and the FFIEC IT Handbook.
[4] Pub. L. No. 107-204, 116 Stat. 745 (2002).
[5] As a general matter, the U.S. federal banking supervisors apply the SEC's regulations implementing the Sarbanes-Oxley Act to banks that are public companies and enforce the Act with respect to banks. *See* 15 U.S.C. § 78*l*(i). (The SEC has enforcement authority with respect to holding companies.)

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employees, or the company's securities may be delisted from securities exchanges. *Id.* Section 302 of the Act, 15 U.S.C. § 7262(a), requires the principal executive and financial officers of a public company to make certain representations about the veracity and accuracy of annual and quarterly reports. Section 404 of the Sarbanes-Oxley Act, 15 U.S.C. § 7262(b), requires an auditor of a public company annually to render an opinion on the effectiveness of the company's internal controls over financial reporting. Pursuant to section 406 of the Act, 15 U.S.C. § 7264, a public company must disclose in its periodic reports if it has adopted a code of ethics for senior financial officers and, if not, why not. In addition to creating a new registration requirement for auditors of public companies, the Act established requirements designed to further the independence of auditors from the public companies that they audit. A registered auditor cannot perform certain specific nonaudit services for a public company. Also, a registered auditor cannot provide services for a public company if the lead audit partner has performed such services in each of the last five years. In addition, the registered auditor must report certain information to the audit committee concerning the company's accounting policies and practices. Finally, a registered auditor cannot perform audit services for a public company if the auditor employed certain persons in the company's management during the previous year. 15 U.S.C. § 78j-1. Through FDIC guidelines, these independence requirements may be applied to an independent public accountant who audits a bank that is required under the banking laws to have an annual independent audit, or to the auditor of its holding company if the bank satisfies the requirement through an independent audit at the holding company level. *See* 12 CFR Part 363, appendix A, ¶ 14. The "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (March 17, 2003) encouraged banks and holding companies that are neither subject to Section 36 of the FDI Act nor the Sarbanes-Oxley Act auditor independence requirements not to use their external auditor to perform internal audit services.[6]

EC 1	Principle 17: Internal control and audit
Criterion	Laws, regulations or the supervisor establish the responsibilities of the Board and senior management with respect to corporate governance to ensure that there is effective control over a bank's entire business.
Legal Framework	Together, the authorities cited in the overview to this principle and under risk management and risk-specific principles (7-9 and 12-16) provide for the establishment of a general corporate governance framework for banks and holding companies. Although the

[6] *See* Federal Reserve SR letter 03-5; OCC Bulletin 2003-12; FDIC FIL-21-2003; and OTS Thrift Bulletin 81.

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	specifics of implementation largely are left to the individual organizations to decide, at a minimum, the framework requires banks and holding companies to have clearly established responsibilities for board members and senior management with respect to corporate governance to ensure that there is effective control over a bank's and holding company's entire business.
Practices and Procedures	U.S. federal banking agencies establish expectations of boards of directors and senior management through law noted above and through various interagency statements, including those referred to below. The level of technical knowledge required of directors may vary depending on the size and complexity of the bank and holding company. Specifically, boards of directors and officers of banks and holding companies are obligated to discharge the duties owed to their bank and holding company and to the shareholders and creditors of their organizations, and to comply with federal and state statutes, rules and regulations. These duties include the duties of loyalty and care. Directors have ultimate responsibility for the level of risk taken by their bank or holding company. This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies; and for making business decisions on the basis of fully informed and meaningful deliberation. Directors and senior management oversight of the enterprise-wide compliance program, including approval of risk-management policies and monitoring of internal processes, is essential. *See* "Interagency Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations" (May 2003)[7], "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing" (April 2003)[8], "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities" (January 2007)[9], FDIC "Statement of Policy Concerning the Responsibilities of Bank Directors and Officers." (October 2005). There are also separate requirements for boards of directors and audit committees of banks under the FDI Act and the FDIC's implementing regulation and guidance. FDIC insured banks with assets of $1 billion or more, as of the beginning of their fiscal year, are required to opine on their Internal Controls Over Financial Reporting (ICOFR) and have an audit committee comprised of outside directors who are independent of management of the bank. The audit committee of banks with assets of more than $3 billion, measured as of the beginning of each fiscal year, must include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the bank. If a large bank is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this rule, the holding company audit committee shall not include any members who are large customers of the subsidiary bank.[10] In addition, supervisors review documentation that banks and holding companies produce for internal control reviews under section 404 of Sarbanes-Oxley to determine whether there are any material weaknesses or significant deficiencies that should be followed up during the course of

[7] *See* Federal Reserve SR letter 03-8; OCC Bulletin 2003-21; FDIC FIL-17-2003; and OTS CEO Memorandum 174.
[8] *See* Federal Reserve SR letter 03-5; OCC Bulletin 2003-12; FDIC FIL-21-2003; and OTS Thrift Bulletin 81.
[9] *See* Federal Reserve SR letter 07-5; OCC Bulletin 2007-1; FDIC p. 5369 "Pocket Guide Directors" (1988)
[10] *See* FDIC FIL-119-2005

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	examination work. The following formal enforcement actions serve as examples of the banking agencies' authority to direct, with respect to corporate governance, effective control over a bank's and holding company's entire business. • Southern Bank of Commerce – Written Agreement dated December 21, 2007, requiring a written board action plan to improve the bank's condition and maintain effective control over, and supervision of, the bank's senior management and major operations and activities. /www.federalreserve.gov/newsevents/press/enforcement/20080108a.htm • Commerce Bank/Harrisbury, N.A. – Formal Agreement dated January 29, 2007, requiring an independent management and board supervisory study focusing in risk management, internal audit, consumer and BSA compliance. http://www.occ.treas.gov/FTP/EAs/ea2007-008.pdf

EC 2	Principle 17: Internal control and audit
Criterion	The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the Board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments. More specifically, these controls address: • Organizational structure: definitions of duties and responsibilities, including clear delegation of authority (for example, clear loan approval limits), decision-making policies and processes, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance). • Accounting policies and processes: reconciliation of accounts, control lists, information for management. • Checks and balances (or "four eyes principle"): segregation of duties, cross-checking, dual control of assets, double signatures. • Safeguarding assets and investments: including physical control.

EC 2	Principle 17: Internal control and audit
Legal Framework	As noted in the overview to this principle in EC 1 above, the U.S. federal banking agencies assess adequacy of a bank's and holding company's corporate governance framework at granting charters and as part of the supervisory process.
Practices and Procedures	U.S. federal banking agencies evaluate the adequacy of bank's and holding company's internal controls during on-site examinations, on- and off-site periodic monitoring and supervisory activities, and through various surveillance activities. In conducting these activities, supervisors determine that banks and holding companies have in place internal controls that are adequate for the nature and scale of their business. When evaluating the adequacy of a bank's and holding company's internal controls and audit procedures, supervisors consider whether • The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the bank's and holding company's activities. • The organizational structure of the bank and holding company establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits. • Reporting lines for the control areas are independent from the business lines, and there is adequate separation of duties throughout—such as duties relating to accounting, trading, custodial, and back-office activities. • Official organizational structures reflect actual operating practices. • Financial, operational, and regulatory reports are reliable, accurate, and timely, and, when applicable, exceptions are noted and promptly investigated. • Adequate procedures exist for ensuring compliance with applicable laws and regulations. • Internal audit or other control-review practices provide for independence and objectivity. • Internal controls and information systems are adequately tested and reviewed. The coverage of, procedures for, and findings and responses to audits and review tests are adequately documented. Identified material weaknesses are given appropriate and timely high-level attention, and management's actions to address material weaknesses are timely, and objectively verified and reviewed. • The bank's and holding company's audit committee or the board of directors reviews the effectiveness of internal audits and other control-review activities. Supervisors will also assess the risks inherent in the bank and/or holding company, and the risk mitigants and controls as part of the ongoing examination processes. *See* Amended "Interagency Guidance on the Internal Audit Function and its Outsourcing," pp. 2 - 3; Federal Reserve CBEM, section 1010, and SR letter 95-51; OCC *Internal Control*, *Internal and External Audit*, and *Bank Supervision Process* booklets of the OCC's Handbook series; FDIC *Risk Management Manual of Examination Policies,* section 4.2; and OTS *Examination Handbook.* U.S. federal banking agencies assess a bank's and holding company's compliance with the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing (*see* EC 1). Also, supervisors determine the quality and reliability of the bank's and

EC 2	Principle 17: Internal control and audit
	holding company's policies, procedures, and processes with respect to internal control functions and reach an overall assessment of the internal control system. During targeted examinations of specific product areas within the bank and holding company or as part of an annual review, supervisors evaluate the adequacy of internal control. When supervisors determine that the work performed by internal audit is effective, they will leverage off that work to evaluate the effectiveness of internal control. Section 404 (b) of the Sarbanes-Oxley Act, 15 U.S.C. § 7262(b), requires auditors of public companies to annually render an opinion on the effectiveness of the entity's internal controls over financial reporting. Under section 36 of the FDI Act, 12 U.S.C. § 1831m(b) & (c), management of nonpublic banks with $1 billion or more in total assets must annually assess the effectiveness of internal control over financial reporting as of year-end and have the bank's and holding company's independent auditor render an opinion on management's assertion concerning internal control. *See* 12 CFR 363.2(b), 363.3(b), & appendix A (FDIC's implementing regulation). Supervisors review these reports as well as the list of weaknesses or deficiencies from auditor's opinions under Sarbanes-Oxley to determine where control weaknesses exist and whether management is addressing these deficiencies in a timely manner. The following formal enforcement actions serve as examples of the agencies' authority to direct the implementation of adequate internal controls: • The Bank of New York, Written Agreement dated April 21, 2006, requiring an assessment of the effectiveness of the bank's control infrastructure, governance, organizational structure, and business line accountability. www.federalreserve.gov/newsevents/press/enforcement/20060424a.htm • Asian Financial Corporation and Asian Bank, Cease and Desist Order dated March 3, 2006, requiring submission of written policies and procedures designed to strengthen and maintain the bank's internal controls. www.federalreserve.gov/newsevents/press/enforcement/20060308a.htm • Commerce Bank, N.A., Cease and Desist Order dated June 28, 2007, requiring a plan to address deficiencies in management and board structure. www.occ.treas.gov/FTP/EAs/ea2007-065.pdf

EC 3	Principle 17: Internal control and audit
Criterion	Laws, regulations or the supervisor place the responsibility for the control environment on the Board and senior management of the bank. The supervisor requires that the Board and senior management understand the underlying risks in their business and are committed to a strong control environment.
Legal	Several statutory and regulatory provisions, including those governing safety and soundness, external audits and management

EC 3	Principle 17: Internal control and audit
Framework	certification of financial statements, capital adequacy, and remedial powers of the agencies, make clear that the board of directors and management ultimately are responsible for the control environment of the bank and/or holding company. In addition, licensing and supervisory standards require that board and senior management understand the underlying risks in their business and are committed to a strong control environment.
Practices and Procedures	U.S. federal banking agencies also place responsibility for the control environment through supervisory guidance. This guidance indicates that the effective functioning of the internal control process, including the control environment, risk assessment, control activities, information and communication, and monitoring activities is the responsibility of the bank's or holding company's board of directors, management, and other personnel. Supervisory guidance also indicates that an effective control environment requires a commitment by the board of directors and senior management to strong controls, and that the board of directors and management are responsible for establishing and maintaining effective internal control that meets statutory and regulatory requirements and responds to changes in the organization's environment and conditions. *See* FDIC *Risk Management Manual of Examination Policies,* section 4.2; OCC *Internal Control*, and *Duties and Responsibilities of Directors* booklets of the Comptroller's Handbook (Safety and Soundness series) and "The Director's Book – The Role of a National Bank Director" (at www.occ.gov/director.pdf); Federal Reserve CBEM, section 1010, and CA letter 06-8; and OTS *Examination Handbook*, section 310.

EC 4	Principle 17: Internal control and audit
Criterion	The supervisor has the power to require changes in the composition of the Board and senior management to address any prudential concerns related to the satisfaction of these criteria.
Legal Framework	As part of their remedial powers, U.S. federal banking agencies may limit the powers of institution-affiliated parties (IAP)(including directors and management) when an unsafe or unsound violation or practice exists. *See* 12 U.S.C. § 1818(b). The agencies also have the power, under certain well-defined circumstances, to prohibit an IAP from participating in the affairs of a bank or holding company. *See* 12 U.S.C. § 1818(e). In some instances, this prohibition may extend industry-wide. Id. § 1818(e)(7). In general, supervisors try to address deficiencies in the composition of the board or management by less formal means and as part of a broader effort to resolve prudential concerns.

EC 5	Principle 17: Internal control and audit
Criterion	The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.
Legal Framework	As noted in the overview to this principle, the U.S. federal banking agencies assess the adequacy of a bank's and holding company's corporate governance framework, including the competence and qualifications of its employees, at licensing and as part of the supervisory process.
Practices and Procedures	As part of on-site examinations, on- and off-site periodic monitoring and supervisory activities, and various surveillance activities, supervisors evaluate a bank's and holding company's internal control functions when assessing the control functions and processes of the bank and holding company as a whole and for specific activities and operations. Supervisors coordinate the review of internal control with the reviews of other areas of the bank and holding company (e.g., credit, capital markets, compliance, and information systems) as a cross-check of the bank's and holding company's compliance and process integrity. Supervisors also perform periodic reviews of control monitoring functions such as internal audit. If internal audit is effective, supervisors leverage their work as part of risk-focused examinations. Supervisors regularly conduct targeted reviews of high risk areas such as trading to determine whether effective controls, including segregation of duties, are in place. Supervisory guidance cautions supervisors to be alert for indications that adverse circumstances may exist (such as inappropriate balance of skills and resources between operational and back office functions) when reviewing internal controls. Supervisors evaluate the competency and skills of personnel assigned to various control functions and the adequacy of resources the bank and holding company has available to effectively meet its internal control objectives. *See* OCC Comptroller's Handbook series; Federal Reserve CBEM, section 1010; FDIC *Risk Management Manual of Examination Policies,* sections 4.2.; and OTS *Examination Handbook*, section 340.

EC 6	Principle 17: Internal control and audit
Criterion	The supervisor determines that banks have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the bank. The compliance function must be independent of the business activities of the bank. The supervisor determines that the Board exercises oversight of the management of the compliance function.
Legal Framework	As noted in the overview to this principle in EC 1 above, the interagency safety-and-soundness guidelines encompass compliance with applicable laws and regulations, including the agencies' authority to assess the adequacy of a bank's and holding company's compliance function. In addition to these general guidelines, under the agencies' Bank Secrecy Act (BSA) regulations, every bank must establish a BSA compliance program. (*See* 12 CFR 21.21)
Practices and Procedures	U.S. federal banking agencies' guidance and examination procedures direct supervisors to determine whether the bank and holding company have an effective compliance function. Supervisors confirm that the compliance function is independent of the bank's and

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	holding company's business activities and has controls commensurate with the bank's and holding company's size and activities. The guidance also indicates that the bank's and holding company's board of directors is ultimately responsible for developing and administering a compliance management system that ensures compliance with laws and regulations. Supervisors confirm that the board of directors and management establish and maintain an effective compliance management system including • demonstrating clear and unequivocal expectations about compliance; • adopting clear policy statements; • appointing a compliance officer with authority and accountability; • allocating resources to compliance functions commensurate with the level and complexity of the bank's and holding company's operations (e.g., sufficient to address compliance in specialty areas such as leverage leasing, insurance and private banking); • conducting periodic compliance audits; • ensuring that business lines have appropriate personnel with compliance expertise; and • providing for recurrent reports by the compliance officer. *See* FDIC [*Compliance Handbook and Risk Management Manual of Examination Policies,* section 4.2]; Federal Reserve [Consumer Compliance Handbook, CBEM sections 1000 and 2115.1, and CA letter 06-8]; OCC [*Compliance Management System* booklet of the Comptroller's Compliance Handbook series and *Internal Control* booklet]; and OTS [*Examination Handbook*, section 300]. The following serve as an example of the agencies' authority to direct the implementation of an adequate compliance function: • The Bank of New York – Written Agreement dated April 21, 2006, requiring an assessment of the duties, qualifications, and training of the bank's senior management responsible for implementing and overseeing the compliance function. www.federalreserve.gov/newsevents/press/enforcement/20060424a.htm • Old National Bank – Civil Money Penalty issued for flood insurance related violations. www.occ.treas.gov/FTP/EAs/ea2008-111.pdf

EC 7	Principle 17: Internal control and audit
Criterion	The supervisor determines that banks have an independent, permanent and effective internal audit function charged with (i) ensuring that policies and processes are complied with and (ii) reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the bank's business.

EC 7	Principle 17: Internal control and audit
Legal Framework	As noted in the overview to this principle in EC 1 above, the interagency safety-and-soundness guidelines, among other authorities, contemplate that most banks and holding companies will establish a permanent internal audit unit responsible for (a) ensuring compliance with policies and procedures and (b) assessing the continued adequacy of the policies and procedures.
Practices and Procedures	As noted in the "Interagency Guidance on Internal Audit and its Outsourcing," each bank's and holding company's audit committee and management must consider the type of internal audit oversight that is necessary to ensure that internal controls are effective. While the benefits of a full-time audit function will largely outweigh the costs at a large bank or holding company, the cost may not outweigh the benefits at smaller ones. Small banks and holding companies should still have a comprehensive review of significant internal controls by an independent party. Supervisors determine the adequacy of the internal audit function through their ongoing supervisory activities. Current guidance suggests annual evaluation of changes to Internal Audit through periodic monitoring and a full scope review of Internal Audit every three years, particularly at large complex banks and holding companies. Supervisors assess the quality and scope of a bank's and holding company's internal audit function, regardless of whether it is performed by the bank's and holding company's employees or by an outsourcing vendor. Specifically, supervisors consider whether • The internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the bank's and holding company's activities; • The internal audit activities have been adjusted for significant changes in the bank's and holding company's environment, structure, activities, risk exposures, or systems; • The internal audit activities are consistent with the long-range goals and strategic direction of the bank and holding company and are responsive to its internal control needs; • The internal audit manager's impartiality and independence is promoted by having him or her directly report audit findings to the audit committee; • The internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired; • The bank and holding company have promptly responded to significant identified internal control weaknesses; • The internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and results of audits are promptly communicated to senior management and members of the audit committee and board of directors; • Workpapers adequately document the internal audit work performed and support the audit reports; • Management and the board of directors use reasonable standards, such as the Institute of Internal Auditor's (IIA) Standards for the Professional Practice of Internal Auditing, when assessing the performance of internal audit; and • The audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

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	Supervisors also assess the competence of the bank's and holding company's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. *See* Federal Reserve [SR letter 03-5, pp. 2, 15; section 1010 of the CBEM; and section 2060 of the BHC Supervision Manual]; OCC [*Internal Audit* and *External Audit* booklet of the Comptroller's Handbook – Safety & Soundness, Objective 6]; FDIC [*Risk Management Manual of Examinations Policies* section 4.2]; and OTS [*Examination Handbook,* section 355]. The following outstanding formal enforcement actions serve as examples of the agencies' authority to direct the implementation of an adequate internal function. • Bank of New York – Cease and Desist Order dated August 14, 2006, requiring submission of an acceptable written internal audit program. • Asian Financial Corporation and Asian Bank – Cease and Desist Order dated March 3, 2006, requiring submission of acceptable written internal audit policies and procedures. www.federalreserve.gov/newsevents/press/enforcement/20060308a.htm

EC 8	Principle 17: Internal control and audit
Criterion	The supervisor determines that the internal audit function: • has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; • has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations; • has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties; • employs a methodology that identifies the material risks run by the bank; • prepares an audit plan based on its own risk assessment and allocates its resources accordingly; and • has the authority to assess any outsourced functions.
Legal Framework	As noted in the overview to this principle in EC 1 above, the supervisory assessment of the adequacy of a bank's and holding company's internal audit function, including the competence and qualifications of its employees, is encompassed in the interagency safety-and-soundness guidelines and is determined as part of the supervisory process.

EC 8	Principle 17: Internal control and audit
Practices and Procedures	In addition to supervisory guidance, U.S. federal banking supervisors also use industry standards (e.g., those of the Institute of Internal Auditors (IIA)) to assess the adequacy of their work against these standards. The scope of periodic reviews includes audit independence and competency, the role of the Board and Audit Committee, the identification of the audit universe, audit's planning and risk assessment methodology, audit's plans, audit work including work papers and sampling methodology, audit reports and ratings, follow-up of audit issues, and audit's interaction with management. *See* response to EC 7. In addition, the "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (*see* EC 1) instructs supervisors to perform additional steps when reviewing outsourcing arrangements. Supervisors are required to determine whether: • The arrangement maintains or improves the quality of the internal audit function and the bank's and holding company's internal control; • Key employees of the bank and holding company and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed; • The scope of the outsourced work is revised appropriately when the bank's and holding company's environment, structure, activities, risk exposures, or systems change significantly; • The directors have ensured that the outsourced internal audit activities are effectively managed by the bank or holding company; • The arrangement with the outsourcing vendor satisfies the independence standards described in this policy statement and thereby preserves the independence of the internal audit function, whether or not the vendor is also the bank's and holding company's independent public accountant; and • The bank and holding company has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

AC 1	Principle 17: Internal control and audit
Criterion	In those countries with a unicameral Board structure (as opposed to a bicameral structure with a Supervisory Board and a Management Board), the supervisor requires the Board to include a number of experienced non-executive directors.
Legal Framework	For banks and holding companies with total assets of $1 billion or more, the audit committee must be comprised entirely of outside, non-executive directors. For banks and holding companies with total assets of $500 million or more but less than $1 billion, the majority of audit committee members must be outside, non-executive directors, subject to case-by-case exceptions granted by supervisors. *See* 12 U.S.C. § 1831m(g); and 12 CFR 363.5. For banks and holding companies with total assets of more than $3

AC 1	Principle 17: Internal control and audit
	billion, the audit committee members must (a) have banking or related financial management expertise; (b) have access to the committee's own outside counsel; and (c) not be a large customer of the bank or holding company. Id. For public companies, the Sarbanes-Oxley Act requires each member of the audit committee to be independent of the issuer. *See* 15 U.S.C. § 78j-1. The Sarbanes-Oxley Act also requires public companies to disclose in their periodic reports whether there is at least one financial expert on the audit committee and, if not, why not. *See* 15 U.S.C. § 7265.
Practices and Procedures	For public companies, the Sarbanes-Oxley Act requires each member of the audit committee to be independent of the issuer. Banks and holding companies subject to section 36 of the FDI Act and part 363 of the FDIC's regulations are required to maintain independent audit committees. This committee is to be established consisting of outside directors who are independent of management. The independent audit committee's duties include reviewing with management and the independent public accountant the basis for the all financial reports issued. The U.S. federal banking agencies may, by order or regulation, permit the independent audit committee of a bank and a holding company to be made up of less than all, but no less than a majority of, outside directors. Further, SEC rules require each member of the audit committee to be financially literate; as such qualification is interpreted by the bank's and holding company's board of directors in its business judgment. FDIC rules require audit committee members of any bank and holding company that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, to include members with banking or related financial management expertise.

AC 2	Principle 17: Internal control and audit
Criterion	The supervisor requires the internal audit function to report to an audit committee, or an equivalent structure.
Legal Framework	For public companies, Sarbanes-Oxley Act of 2002 defines the scope of the audit committee's duties to include overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer (which implicitly includes internal audit). *See* 15 U.S.C. §7201.
Practices and Procedures	U.S. federal banking agencies assess compliance against "The Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" which requires the internal audit function to be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee, using objective criteria it has established, is required to oversee the internal audit function and evaluate its performance. (*See* Federal Reserve SR letter 03-5, p. 3; OCC Bulletin 2003-12; FDIC FIL-21-2003; and OTS *Examination Handbook* section 355.) In addition, supervisors evaluate internal audit functions against IIA standards which recommend a reporting line to the Audit Committee. Supervisors confirm the internal audit function reporting line during on-site examinations by review of the organization chart as well as review of audit committee meeting minutes and through discussions with the internal auditor.

AC 3	Principle 17: Internal control and audit
Criterion	In those countries with a unicameral Board structure, the supervisor requires the audit committee to include experienced non-executive directors.
Legal Framework	For banks and holding companies with total assets of $1 billion or more, the audit committee must be comprised entirely of outside, non-executive directors. For banks and holding companies with total assets of $500 million or more but less than $1 billion, the majority of audit committee members must be outside, non-executive directors, subject to case-by-case exceptions granted by supervisors. *See* 12 U.S.C. § 1831m(g); 12 CFR 363.5. For banks and holding companies with total assets of more than $3 billion, the audit committee members must (a) have banking or related financial management expertise; (b) have access to the committee's own outside counsel; and (c) not be a large customer of the bank or holding company. Id. For public companies, the Sarbanes-Oxley Act requires each member of the audit committee to be independent of the issuer, subject to case-by-case exemptions granted by the SEC. *See* 15 U.S.C. § 78j-1. The Sarbanes-Oxley Act also requires public companies to disclose in their periodic reports whether there is at least one financial expert on the audit committee and, if not, why not. *See* 15 U.S.C. § 7265.
Practices and Procedures	For public companies, the Sarbanes-Oxley Act requires each member of the audit committee to be independent of the issuer, subject to case-by-case exemptions granted by the SEC. The Sarbanes-Oxley Act also requires public companies to disclose in their periodic reports whether there is at least one financial expert on the audit committee and, if not, why not. *See* 15 U.S.C. § 7265. Banks subject to section 36 of the FDI Act and part 363 of the FDIC's regulations are required to maintain independent audit committees. For banks and holding companies with total assets of $1 billion or more, this committee is to be established consisting entirely of outside directors who are independent of management. For those with total assets of $500 million or more but less than $1 billion, the majority of audit committee members must be outside directors who are independent of management, subject to case-by-case exceptions granted by supervisors. The independent audit committee's duties include reviewing with management and the independent public accountant the basis for the all financial reports issued by the bank or holding company. Also, *see* response to AC 1 for additional requirements.
AC 4	**Principle 17: Internal control and audit**
Criterion	Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of senior management.
Legal Framework	Certain laws and regulations require the bank and holding company to notify the supervisor when they become aware of material information that may indicate that a board member or member of senior management is unfit for service. For example, suspicious activity reports are required to be filed for any instances of known or suspected illegal or suspicious activity including the actions of board members and senior management. [*See* 31 U.S.C. § 5318(g); 12 CFR 208.62, 12 CFR 211.24(f), and 12 CFR 225.4(f) (Federal Reserve); 12 CFR 353 (FDIC); 12 CFR 21.11 (OCC); and 12 CFR 563.180 (OTS)].
Practices and Procedures	U.S. federal banking agencies expect that notification would be given of any circumstance involving a board or management member that has the potential to impact the safety or soundness of the bank or holding company.

Principle 18: Abuse of financial services

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Overview

Various statutes and regulations require the U.S. federal banking agencies to issue regulations and conduct periodic examinations to evaluate compliance by banks and holding companies with anti-money-laundering (AML) and suspicious activity reporting laws and regulations, and the agencies have authority to take enforcement actions, including cease and desist orders and civil money penalties. The agencies also ensure that the institutions they supervise have adequate policies and procedures in place and comply with applicable laws and regulations to prevent misuse of banks and holding companies for criminal purposes, including fraud, money laundering, and terrorist financing. For example, under 12 U.S.C. § 1818(s), the agencies are required to and have prescribed regulations requiring banks that they supervise to establish and maintain procedures reasonably designed to assure and monitor an institution's compliance with the requirements of the Bank Secrecy Act (BSA), 31 U.S.C. §5311 *et seq.*, 12 U.S.C. §1829b, and §1951 – 1959, an AML and counter terrorist financing (CFT) statute. The agencies and the Department of the Treasury (Treasury), through the Financial Crimes Enforcement Network (FinCEN), have also issued regulations requiring financial institutions to establish and implement risk-based procedures for verifying the identity of each customer. *See* 12 CFR 21.21(b)(2) (OCC); 208.63(b)(2), 211.5(m)(2), 211.24(j)(2) (Federal Reserve); 326.8(b)(2) (FDIC); 563.177(b)(2) (OTS) 31 CFR 103.121 (FinCEN). Each of the agencies has issued regulations that set forth the requirements for banks under its supervision to establish and maintain procedures to ensure and monitor their compliance with the BSA (the "BSA/AML Compliance Program"). *See* 12 CFR 208.63, 211.24(j)(1), 211.5(m)(1) (Federal Reserve); 326.8 (FDIC); 21.21 (OCC); and 563.177 (OTS). The cornerstone of a strong BSA/AML Compliance Program is the adoption and implementation of comprehensive customer due diligence (know-your-customer) policies, procedures, and processes for all customers. Under statutory and regulatory authority and using an interagency BSA/AML examination manual and an interagency statement on enforcement, the agencies examine banks and holding companies for BSA/AML compliance and take enforcement actions to address non-compliance. *See* 12 U.S.C. § 1818(s)(2); *Federal Financial Institutions Examination Council (FFIEC) Bank Secrecy Act /Anti-Money Laundering Examination Manual*; and "Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements" (August 1, 2007). The agencies have traditionally supported the Basel Committee's efforts to provide guidance through the issuance of documents such as the *Prevention of criminal use of the banking system for the purpose of money-laundering*, December 1988; *Customer due diligence for banks*, October 2001; *Shell banks and booking offices*, January 2003; *Consolidated KYC risk management*, October 2004; *FATF 40 + IX*, 2003 and *FATF AML/CFT Methodology*, 2004, as updated; and *Due diligence and transparency regarding cover payment messages related to cross-border wire transfers*, May 2009.

The agencies and Treasury have also issued regulations requiring banks and holding companies to file suspicious activity reports (SARs) to report known or suspected criminal violations or suspicious transactions with the agencies, federal law enforcement authorities, and FinCEN. *See* 12 CFR 21.11 (OCC); 208.62, 211.5(k), 211.24(f), 225.4(f) (Federal Reserve); 353 (FDIC); 563.180(d) (OTS); 31 CFR 103.18 (FinCEN), and SAR form (TD F 90-22.47). BHCs (12 CFR 225.4(f)) and certain SLHCs and their nondepository subsidiaries are required to file SARs pursuant to Treasury regulations (e.g., insurance companies, 31 CFR 103.16, and broker/dealers, 31 CFR 103.19). In addition, SLHCs, if not required, are strongly encouraged to file SARs in appropriate circumstances. Effective customer due diligence policies, procedures, and processes provide the critical framework that enables banks and holding companies to comply with regulatory requirements and to report suspicious activity.

The agencies and Treasury may take enforcement actions against banks and holding companies to address significant failures to comply with suspicious

Principle 18: Abuse of financial services
activity reporting and other recordkeeping and reporting requirements, and in cases where noncompliance indicates possible criminal activity, matters may be referred to the U.S. Department of Justice (DOJ). The agencies also supervise to ensure compliance with U.S. economic and trade sanctions, administered by the Treasury Department's Office of Foreign Assets Control (OFAC). *See* 31 CFR 500 *et seq*. OFAC has civil monetary penalty authority, and OFAC violations may result in criminal sanctions imposed by the DOJ. Other agencies have enforcement authority with respect to certain conduct that results in abuse of financial services. For example, the Federal Trade Commission (FTC) may take action against non-depository organizations involved in fraud that harms consumers. The Commerce Department administers and enforces certain export restrictions and violations of such restrictions may result in penalties. Finally, any conduct by a banking organization that rises to the level of a criminal offense (i.e., actual participation in fraud, money laundering, or other misconduct) can result in criminal prosecution.

EC 1	Principle 18: Abuse of financial services
Criterion	Laws or regulations clarify the duties, responsibilities and powers of the banking supervisor and other competent authorities, if any, related to the supervision of banks' internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
Legal Framework	The agencies must review each supervised bank's BSA/AML Compliance Program at each examination. *See* 12 U.S.C. § 1818(s)(2)(A). The agencies have authority to enforce all banking rules and regulations, including compliance with the BSA, and certain enforcement obligations apply with respect to BSA/AML Compliance Program violations. *See* 12 U.S.C. § 1818(s)(3). State banking supervisors also have enforcement authority for state-chartered banking institutions. The federal and state banking supervisors may require banks to undertake remedial actions and may assess civil money penalties and issue cease and desist orders. FinCEN and the DOJ have authority to assess civil and criminal penalties, respectively, for BSA violations[1]. *See* 31 U.S.C. §5322.
Practices and Procedures	The agencies have clear statutory authority to regulate banks and holding companies, examine them for compliance with laws and regulations relating to the prevention of criminal misuse, and enforce those requirements through civil enforcement actions. *See e.g.* 12 U.S.C. §§ 1818(s)(2) and (s)(3); 1818(i). These provisions are vigorously enforced by the federal banking agencies and over the years a number of banks and holding companies have been assessed significant penalties for BSA/AML compliance failures. *See e.g.* OCC EA 2008-29 (United Bank for Africa $15 million penalty); OCC EA 2007-110 (Union Bank of California $10 million penalty); OCC EA 2004-44 (Riggs Bank, N.A $25 million penalty); OTS ATL 2006-01 (BankAtlantic, Fort Lauderdale, FL $10 million penalty); FRB 05-035-CMP-FB (ABN AMRO Bank N.V. and ABN AMRO Bank N.V. New York and Chicago Branches, $40 million penalty). In addition to the agencies, certain other federal and state government agencies play critical roles in

[1] Besides banks, other types of holding company subsidiaries may be "financial institutions," which are subject to BSA laws. *See* 31 U.S.C. § 5312(a)(2)). The agencies have implemented examination procedures for enterprise-wide compliance programs, which they encourage more complex holding companies to adopt. *See* the Manual, at 149-64.

EC 1	Principle 18: Abuse of financial services
	safeguarding the U.S. financial sector from criminal activities as noted in the overview.

EC 2	Principle 18: Abuse of financial services
Criterion	The supervisor must be satisfied that banks have in place adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.
Legal Framework	The agencies and Treasury have issued regulations requiring banks to establish and maintain BSA/AML Compliance Programs that, at a minimum, include the following elements: internal controls to assure BSA compliance; independent testing of compliance; an individual responsible for coordinating and monitoring day-to-day compliance; and training for appropriate personnel. *See* 31 U.S.C. § 5318(h)(1) (statutory requirement); 12 CFR 21.21 (OCC); 208.63, 211.5, 211.24 (Federal Reserve); 326.8 (FDIC); and 563.177 (OTS). The agencies and Treasury have issued separate regulations requiring banks to establish a customer identification program (CIP). [*See* 31 U.S.C. §5318(l) (statutory requirement); 12 CFR 208.63(b)(2) (Federal Reserve); 12 CFR 326.8(b)(2) (FDIC);); 12 CFR 21.21(b)(2)(OCC); 12 CFR 563.177(b)(2) (OTS), as well as cites in the overview; and 31 CFR 103.121 (Treasury/FinCEN).] The agencies and Treasury have issued regulations requiring banks and holding companies to file a suspicious activity report with FinCEN within 30 days of the initial detection of certain facts (within 60 days if attempting to identify a subject). *See* 31 CFR 103.18(b) (Treasury/FinCEN); 12 CFR 21.11(d) (OCC); id. at 208.62(d) (Federal Reserve); id. at 353.3(b)(1) (FDIC); *id.* at 563.180(d)(5) (OTS); *see also* 31 U.S.C. § 5318(g) (statutory requirement). The Bank Protection Act, 12 U.S.C. § 1882, requires the agencies to promulgate rules applicable to banks with respect to the installation, maintenance, and operation of security devices and procedures to discourage robberies, burglaries, and larcenies and to assist in the identification and apprehension of persons who commit such acts. *See e.g*. 12 CFR 21, subpart A (Minimum Security Devices and Procedures (OCC); 12 CFR 326 (FDIC); 12 CFR 208.61 (Federal Reserve); and 12 CFR 568 (OTS). The *Interagency Guidelines Establishing Information Security Standards* 12 CFR 30, appendix B (OCC); 12 CFR 364 appendix B (FDIC); and 12 CFR appendix D-2 (Federal Reserve) and 12 CFR 225, appendix F (Federal Reserve); and 12 CFR 570, appendix B (OTS)set standards for banks to develop and implement safeguards for the security, confidentiality, and integrity of customer information, including protecting against unauthorized access, and advise banks to perform background checks for employees with responsibilities for, or access to, customer information.
Practices and Procedures	Examinations of banks and holding companies are conducted by federal and state supervisors using a consistent, risk-based approach set forth in the *FFIEC BSA/AML Examination Manual* (Manual). The agencies released the Manual publicly to fully inform banks of examination criteria and disseminate uniform guidance on supervisory expectations. The agencies design, conduct, and facilitate training for the banking industry to introduce and reinforce regulations and procedures contained in the Manual. The agencies have issued a policy statement clarifying the practice for taking enforcement actions relating to BSA/AML compliance problems. This statement can be found in Appendix R of the Manual. The federal and state supervisors also assess more broadly whether the bank and holding company hve adequate policies and processes in place to promote high ethical and professional standards to prevent the bank from being used, intentionally or unintentionally, for criminal activities.

EC 2	Principle 18: Abuse of financial services
	As part of the examination of the BSA/AML Compliance Program, U.S. federal banking supervisors evaluate whether a bank has the appropriate policies, procedures, and processes in place to monitor, identify, and report unusual activity, concentrating on high-risk products, services, customers and geographic locations. Supervisors also confirm that an institution's board meets the regulatory mandate of formally approving the written BSA/AML program. *See, e.g.,* 12 U.S.C. § 1818(s); 12 CFR 21.21(b) (OCC); 12 CFR 326.8 (FDIC); 12 CFR 208.63 (Federal Reserve); and 12 CFR 563.177 (OTS)..

EC 3	Principle 18: Abuse of financial services
Criterion	In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when they are material to the safety, soundness or reputation of the bank.
Legal Framework	The agencies and Treasury have issued regulations requiring banks and holding companies to file a SAR with FinCEN within 30 days of the initial detection of certain facts (within 60 days if attempting to identify a subject). *See* 31 CFR 103.18(b) (Treasury/FinCEN); 12 CFR 21.11(d) (OCC); id. at 208.62(d) (Federal Reserve); id. at 353.3(b)(1) (FDIC); id. at 563.180(d)(5) (OTS); *see also* 31 U.S.C. § 5318(g) (statutory requirement). Specifically, a bank, bank holding company, bank holding company's non-bank subsidiary, and certain SLHCs and non-bank subsidiaries of SLHCs are under an obligation to file a SAR whenever it detects any known or suspected federal criminal violation, or pattern of criminal violations, committed or attempted against the bank or involving a transaction or transactions conducted through the bank, where the filer believes that it was either an actual or potential victim of a criminal violation, or series of criminal violations, or that the filer was used to facilitate a criminal transaction, and (1) an insider was involved; or (2) over $5,000 was involved, and the filer can identify a suspect; or (3) over $25,000 was involved, but the bank cannot identify a suspect; or alternatively, that the transaction involves $5,000 or more and involves potential money laundering or violations of the Bank Secrecy Act. *See* 12 CFR 21.11(c) (OCC); id. at 208.62(c) (Federal Reserve); id. at 353.3(a) (FDIC); and id. at 563.180(d)(3) (OTS). In cases involving violations requiring immediate attention, such as when a reportable transaction is ongoing, the filing institution, whether a bank or holding company, must immediately notify law enforcement and the agency in addition to filing a SAR. *See* 12 CFR 21.11(d) (OCC); id. at 208.62(d) (Federal Reserve); id. at 353.3(b)(2) (FDIC); id. at 563.180(d)(5) (OTS). Also, whenever a bank files a SAR it must promptly notify the board of directors or board committee. *See* 12 CFR 21.11(h) (OCC); id. at 208.62(h) (Federal Reserve); id. at 353.3(f) (FDIC); and id. at 563.180(d)(9) (OTS). Banks and holding companies are required at all times to conduct their business and exercise their powers with due regard to safety and soundness. *See, e.g.,* 12 CFR 208.3(d)(1) (addressing conditions of membership in the Federal Reserve); 12 CFR 30 (safety and soundness standards for national banks)) and 12 CFR 353.3(b)(2) for FDIC. As part of this obligation, the agencies expect banks to report directly to them any suspicious activities and incidents of fraud which might be material to the safety, soundness, or reputation of the institution. The Bank Protection Act, 12 U.S.C. § 1882, requires the agencies to promulgate rules applicable to banks with respect to the

EC 3	Principle 18: Abuse of financial services
	installation, maintenance, and operation of security devices and procedures to discourage robberies, burglaries, and larcenies and to assist in the identification and apprehension of persons who commit such acts. *See, e.g.*, 12 CFR 21, subpart A (Minimum Security Devices and Procedures) (OCC); 12 CFR 326 (FDIC); 12 CFR 208.61 (Federal Reserve); and 12 CFR 568 (OTS).
Practices and Procedures	All SARs filed pursuant to the agencies' and Treasury's rules are centrally filed with FinCEN and the agencies have direct, on-line access to such reports . As part of the supervision process, the agencies assess the procedures and controls used by the reporting organization to identify, monitor, and report violations and suspicious activities. The agencies and law enforcement also provide guidance, notices, and alerts to the banking industry on criminal activity and terrorist finance trends. *See, e.g*., OCC Alerts, FDIC's Financial Institution Letters and Special Alerts and FinCEN's Secure Information Sharing System. SARs, CTRs, and CTR exemptions can be downloaded from or obtained directly online from a controlled BSA-reporting database (Web CBRS) maintained by FinCEN. Each agency has staff authorized to obtain this data from the BSA-reporting database that supervisors can use to help scope and plan their examination activities. FinCEN also publishes the "SAR Activity Review, Trends, Tips and Issues" twice a year to provide information and guidance to SAR filers. They also issue the "SAR Activity Review, By the Numbers" twice a year to provide numerical data and information concerning the number and types of SAR filings. In general, material issues affecting the safety, soundness, or reputation of a supervised institution, whether or not reflected on a SAR, are monitored by the U.S. federal banking supervisory staff. As a part of its examination scoping responsibilities, the agencies review BSA data (including SARs) to identify BSA/AML and fraud risks and document the examination plan based upon these risks and other risks to the institution. This scoping process includes determining the examination staffing needs and technical expertise, and selecting examination procedures to be completed. *See* Manual p. 11. Additionally, the agencies review SARs that report known or suspected criminal activities by current and former officers, directors, employees, and other institution-affiliated parties (IAPs) to ensure that appropriate enforcement actions are brought against IAPs. *See*, Federal Reserve *SR letter 03-20*, "Suspicious Activity Reports and Enforcement Actions against Individuals." In addition, the OCC's Fast Track Enforcement Program is designed to ensure that bank insiders who have engaged in criminal acts in banks, but who are not being criminally prosecuted, are prohibited from working in the banking industry. SAR data is reviewed to identify IAPs that have engaged in suspicious or illegal conduct. *See* OCC PPM 5310-8 (Rev). The OTS reviews SARs to identify IAPs engaged in suspicious or illegal conduct and has details on enforcement actions in section 080 of the *Examination Handbook*. The FDIC describes among other SAR review process, its internal review procedure of IAP SARs in the Winter 2007 Supervisory Insights Journal.

EC 4	Principle 18: Abuse of financial services
Criterion	The supervisor is satisfied that banks establish "know-your-customer" (KYC) policies and processes which are well documented and communicated to all relevant staff. Such policies and processes must also be integrated into the bank's overall risk management. The

EC 4	Principle 18: Abuse of financial services
	KYC management program, on a group-wide basis, has as its essential elements: • a customer acceptance policy that identifies business relationships that the bank will not accept; • a customer identification, verification and due diligence program; this encompasses verification of beneficial ownership and includes risk-based reviews to ensure that records are updated and relevant; • policies and processes to monitor and recognize unusual or potentially suspicious transactions, particularly of high-risk accounts; • escalation to the senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk; and • clear rules on what records must be kept on consumer identification and individual transactions and their retention period. Such records should have at least a five year retention period.
Legal Framework	Pursuant to statute, 31 U.S.C. 5318(l), the agencies and Treasury have issued regulations requiring various account opening procedures, including verifying the identity of any person seeking to open an account, to the extent reasonable and practicable and maintaining records of the information used to verify the person's identity, including name, address, and other identifying information. The Customer Identification Program (CIP) also must include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer; this provision is implemented by regulation 31 CFR 103.121. In addition, for certain non-U.S. accounts and transactions, banks must identify beneficial owners (*see* section 312 of the USA Patriot Act, 31 U.S.C. 5318(i), and 31 CFR 103.178). The BSA regulations generally require that the banks properly safeguard and maintain copies of records and reports for a period of five years following the completion of the transaction. *See* 31 CFR 103, subpart C.
Practices and Procedures	Banking supervisors determine whether the internal controls in a bank's BSA/AML Compliance Program include prudent account opening procedures and ongoing monitoring systems, including a customer acceptance policy identifying business relationships the bank will not accept, if any. Supervisors evaluate whether the bank's CIP enables the bank to form a reasonable belief of the customer's true identity at account opening and whether the bank has measures in place to ensure account profiles are current, so that monitoring can be risk-based. Where appropriate, supervisors also review accounts to determine whether a bank has identified individuals that are politically exposed persons (PEPs) and whether management is involved in decisions to accept PEP accounts or maintain existing accounts whose holders are determined to be PEPs, and to ensure the bank conducts ongoing risk-based monitoring of PEP accounts. *See* the Manual, *see also*, 31 U.S.C. § 5318(i)(3)(b) and 31 CFR 103.178(c). The U.S. federal banking agencies and FinCEN have issued detailed "frequently asked questions" (FAQs) relating to CIP requirements that can be found on FinCEN's website. *See* "Interagency Interpretive Guidance on Customer Identification Program Requirements" under section 326 of the USA Patriot Act (April 28, 2005). All banks are required to have a BSA compliance program (31 U.S.C. § 5318(h)) and maintain bank records relating to AML programs (31 U.S.C. § 5318(k)). The cornerstone of a strong BSA/AML program is the adoption of comprehensive customer due diligence (CDD) policies, procedures, and processes for all customers, particularly those that present a high risk for money laundering and terrorist financing. Effective CDD policies and procedures provide the critical framework that enables banks to comply with regulatory requirements and to report suspicious activity. *See* Manual p. 56. The agencies have enforced supervisory

EC 4	Principle 18: Abuse of financial services
	guidance that directs banks to establish CDD policies, procedures and processes, which are integrated into the bank's overall risk management strategy. The agencies have identified failures of such during examinations evidenced by recent public enforcement actions. Details of the enforcement actions may be found on each agency's website. Below are some examples: OCC Cease and Desist Order and Civil Money Penalty, Eastern National Bank (EA 2008-129 and EA 2008-38) www.occ.treas.gov/FTP/EAs/ea2008-152.pdf Federal Reserve Cease and Desist Order and Civil Money Penalty, FRB 07-17-B-EC, American Express Bank International (2007). FDIC Cease and Desist Order, First Regional Bank (2008). www.fdic.gov/bank/individual/enforcement/2008-03-03.pdf OTS Cease and Desist Order, First Federal Savings of Middletown, NY (2008) http://files.ots.treas.gov/enforcement/97023.pdf

EC 5	Principle 18: Abuse of financial services
Criterion	The supervisor is satisfied that banks have enhanced due diligence policies and processes regarding correspondent banking. Such policies and processes encompass: • gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and • not establishing or continuing correspondent relationships with foreign banks that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.
Legal Framework	31 U.S.C. § 5318(i) and its implementing regulation at 31 CFR 103.176, require banks to establish risk-based due diligence policies and procedures reasonably designed to detect and report money laundering through correspondent accounts established, maintained, administered, or managed in the United States for a foreign financial institution. In addition, banks must perform enhanced due diligence for foreign correspondent banks operating under certain high-risk banking licenses. Enhanced due diligence includes obtaining ownership information about certain correspondents, conducting additional scrutiny of the transactions routed through these accounts, and ascertaining whether the foreign correspondent provides correspondent accounts to other foreign banks.

EC 5	Principle 18: Abuse of financial services
	31 U.S.C. § 5318(j) and its implementing regulation at 31 CFR 103.177 prohibit U.S. banks from providing correspondent accounts to foreign shell banks and require U.S. banks to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide financial services to foreign shell banks. U.S. banks are required to obtain certifications to that effect from their foreign bank customers and to periodically obtain re-certification.
Practices and Procedures	U.S. federal and state banking agencies generally view BSA/AML risks in domestic correspondent banking as low compared to other types of financial services, but U.S. federal and state banking supervisors nevertheless evaluate, for U.S. banks that offer correspondent bank services to domestic respondent banks, the policies, procedures, and processes to manage the BSA/AML risks involved in these correspondent relationships and to detect and report suspicious activities. (*See* the Manual). The agencies supervise banks to ensure compliance with foreign correspondent banking requirements, in accordance with the procedures and expectations set forth in the Manual. The agencies confirm that banks are meeting their legal obligation to include procedures for a periodic review of each correspondent account to determine consistency with the information obtained about the type, purpose, and anticipated activity of the account as required under 31 U.S.C. § 5318(i). Supervisors are provided a list of factors that may be used to help identify potential risk characteristics of a foreign correspondent customer in the Manual. The agencies enforce requirements that banks establish due diligence and enhanced due diligence policies and processes regarding correspondent banking. The agencies have cited failures of such rules as a cause of concern during examinations as evidenced by recent public enforcement actions, found on each agency's website, some of which are described below. OCC Cease and Desist Order, Union Bank of California, www.occ.treas.gov/FTP/EAs/ea2007-110.pdf Federal Reserve Written Agreement, FRB 06-030-WA/RB-FB, FRB 06-030-WA/RB-FBR, Intesa Sanpaolo S.p.A. and Intesa Sanpaolo S.p.A. New York Branch (2007). FDIC Order to Case and Desist and Order to Pay, Israel Discount Bank of New York (2005) and Israel Discount Bank of New York (Civil Money Penalties 2006) OTS Cease and Desist Order, Downey Sav. & L. Association (2007) http://files.ots.treas.gov/enforcement/96186.pdf

EC 6	Principle 18: Abuse of financial services
Criterion	The supervisor periodically confirms that banks have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering.
Legal	Under 12 U.S.C. § 1818(s), each examination by a federal banking agency is required to include an examination of the institution's

EC 6	Principle 18: Abuse of financial services
Framework	BSA Compliance Program. Under 12 U.S.C. § 248 (Federal Reserve); 481 (OCC); 1464(d) (OTS); 1820 (FDIC), agency supervisors have complete access to a supervised bank's books and records during an examination (see also PPM 5310-10 for examiner guidance (OCC)). In some circumstances, supervisors may also review the books and records of bank affiliates and subsidiaries. In addition, supervisors have access to the books and records of bank service companies, and to the books and records of independent servicers that pertain to the services that are subject to the Bank Service Company Act, 12 U.S.C. § 1867. The federal and state banking agencies' supervision process includes both on-site examinations and off-site surveillance and monitoring. In general, on-site examinations must occur once every 12 to 18 months (e.g., 12 CFR 208.64 (Federal Reserve), 12 CFR 4.6 and 4.7 (OCC)) 12 CFR 337.12 (FDIC)). Institutions that the agencies believe possess significant compliance risks may be examined more frequently. For larger more complex banking organizations, the agencies maintain resident on-site supervisors who perform continuous monitoring to assess any deterioration in the control infrastructure and annually assess the organization's condition and risk assessment. The agencies are responsible for examining banks and holding companies within their respective jurisdictions for safety and soundness and compliance with applicable laws. In addition, federal law requires that each agency's examination of a bank includes a review of the BSA Compliance Program and that its reports of examination describe any problem with the BSA Compliance Program. *See* 12 U.S.C. § 1818(s).
Practices and Procedures	A key component of the BSA/AML on-site examination is to ensure that the bank maintains an effective BSA/AML Compliance Program for its business activities. Prior to the examination, banking supervisors routinely conduct an off-site review of the FinCEN databases of bank SARs and CTRs to determine if a bank that is about to be examined has filed such reports, that they appear complete and timely, and for areas of examination interest. The agencies assess a bank's compliance with BSA/AML and OFAC obligations using the core examination procedures detailed in the Manual during each examination. The agencies also alert the industry of fraud schemes through bulletins and industry conferences.

EC 7	Principle 18: Abuse of financial services
Criterion	The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its obligations related to criminal activities.
Legal Framework	In appropriate circumstances, an agency may take formal or informal enforcement actions to address violations of BSA/AML requirements (including those related to BSA Compliance Programs and SAR and CTR regulatory obligations), OFAC deficiencies, and unsafe and unsound practices or breaches of fiduciary duty involving failure to comply with obligations related to criminal activity. In certain circumstances, 12 U.S.C. § 1818(s)(3), requires an agency to issue a cease and desist order to address a violation of the BSA Compliance Program requirement for banks. *See* 12 U.S.C. § 1818. Actions also may be taken to enforce compliance with the requirements of the Bank Protection Act. 12 U.S.C. § 1882. FinCEN also has the authority to assess penalties against banks and holding companies for violations of the BSA. *See* 31 U.S.C. § 5321 and 31 CFR 103.57. The DOJ has the authority to bring criminal cases against banks and holding companies for violations of criminal statutes, including certain provisions of the BSA. 31 U.S.C. § 5322; 18 U.S.C. §§ 1956 and 1957. Any bank convicted of violating the criminal money laundering statutes must undergo a hearing to have its deposit insurance revoked, and for convictions of civil

EC 7	Principle 18: Abuse of financial services
	statutes a hearing may be conducted. *See* 12 U.S.C. § 1818(w).
Practices and Procedures	In general, BSA/AML deficiencies that give rise to supervisory enforcement actions relate to compliance with the four-part BSA/AML Compliance Program rule, CIP rule, and with SAR filing requirements. In the event that BSA/AML deficiencies are significant, repeated, unresolved by the bank's management, or otherwise of serious concern, the appropriate agency may exercise its enforcement authority by taking a formal action against a bank subject to its supervision. Depending on the degree of noncompliance, an agency can issue written orders that impose remedial actions; impose civil money penalties; reprimand individuals or bar them from employment within the industry; restrict or suspend the specific activities of the organization; revoke the license of the organization; or refer the matter to the DOJ for possible criminal penalties. The provisions of each enforcement action are tailored to address the particular violations and weaknesses identified by the supervisors. In order to promote a consistent approach for enforcement of BSA/AML Compliance Program requirements and to make those standards more transparent to the industry, the agencies issued an interagency statement in August 2007 to clarify the circumstances in which an agency will issue a cease and desist order to address noncompliance with certain BSA/AML requirements. This statement can be found in Appendix R of the Manual. The agencies are authorized to take formal administrative action against an IAP of any banking organization and are able to take informal actions with respect to less serious deficiencies or more technical violations of the BSA/AML requirements. *See* 12 U.S.C. § 1813(u) and 1818, *see also*, Principle 23, EC 3 and EC 6.

EC 8	Principle 18: Abuse of financial services
Criterion	The supervisor must be satisfied that banks have: • requirements for internal audit and/or external experts to independently evaluate the relevant risk management policies, processes and controls. The supervisor must have access to their reports; • established policies and processes to designate compliance officers at the management level, and appointed a relevant dedicated officer to whom potential abuses of the bank's financial services (including suspicious transactions) shall be reported; • adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; and • ongoing training programs for their staff on KYC and methods to detect criminal and suspicious activities.
Legal Framework	Banks must have adequate BSA/AML Compliance Programs in place that include independent testing of the bank's compliance; the designation of an individual responsible for coordinating and monitoring day-to-day compliance; and ongoing training programs. 12 U.S.C. § 1818(s), *see also* the response to Principle 18, EC 2. The agencies have issued "Interagency Guidelines Establishing Standards for Safeguarding Customer Information" that advises banks to perform background checks for employees with responsibilities for, or access to, customer information. *See* 12 CFR 208, appendix D-2 and 12 CFR 225, appendix F (Federal Reserve); 12 CFR 364, appendix B (FDIC); 12 CFR 30, appendix B, (§ III-C-1-e) (OCC); and 12 CFR 570, appendix B (OTS).

EC 8	Principle 18: Abuse of financial services
Practices and Procedures	The expectations of, and examination procedures utilized by, banking supervisors regarding the BSA/AML Compliance Program requirements are covered extensively in the Manual. Supervisors assess the adequacy of the bank's BSA/AML Compliance Program and determine whether the bank has developed, administered, and maintained an effective program including independent testing; the designation of an individual responsible for coordinating and monitoring day-to-day compliance; and ongoing training programs for staff on customer due diligence and methods to detect suspicious activities. If one or more of the components of the BSA/AML Compliance Program are considered inadequate, the agencies may take informal or formal supervisory actions to require the bank to correct the deficiencies to strengthen the bank's compliance program. (*See* the response to Principle 18, EC 7). The agencies strongly encourage banks to use reasonable employment screening processes to minimize the risk of fraud, embezzlement, money laundering, and other crimes. The agencies consider that a reasonable policy might include checking references, performing credit and/or background checks, Internet searches, and performing criminal background checks, including an FBI fingerprint check, for prospective employees. (*See* the response to Principle 23, EC 6 for a description of enforcement actions against individuals). Further, the FDIC issued a FIL -46-2005, "Pre-employment Background Screening", that provided guidance on such a policy. *See also*, *FFIEC Information Technology Examination Handbook*, Operations, Personnel Controls. The agencies also issue guidance to the industry concerning best practices in this area. *See e.g*., Comptroller's Handbook for *Asset Management* – Conflicts of Interest; FFIEC, The Detection, Investigation and Prevention of Insider Loan Fraud: A White Paper, May, 2003; OCC *The Directors Book* – The Role of a National Bank Director, March 1997.

EC 9	Principle 18: Abuse of financial services
Criterion	The supervisor determines that banks have clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor also confirms that banks have adequate management information systems to provide managers and the dedicated officers with timely information on such activities.
Legal Framework	In addition to the SAR requirements, the audit committees of publicly held banks and holding companies that are subject to section 301 of Sarbanes-Oxley must establish procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. 15 U.S.C. § 78j-1(m)(4). The Bank Protection Act, 12 U.S.C. § 1882, requires the agencies to promulgate rules applicable to banks with respect to the installation, maintenance, and operation of security devices and procedures to discourage robberies, burglaries, and larcenies and to assist in the identification and apprehension of persons who commit such acts. *See e.g*. 12 CFR 21, subpart A (Minimum Security Devices and Procedures) (OCC); 12 CFR 326 (FDIC); and 12 CFR 568 (OTS). Also, whenever a bank files a SAR, it must promptly notify the board of directors or board committee. 12 CFR 21.11(h) (OCC); id. at 208.62(h) (Federal Reserve); id. at 353.3(f) (FDIC); and id. at 563.180(d)(9) (OTS).

EC 9	Principle 18: Abuse of financial services
Practices and Procedures	The agencies assess a bank's and holding company's policies, procedures, and processes, including internal controls and day-to-day supervision, for monitoring and identifying unusual activity and for referring unusual activity from all business lines to the personnel or department responsible for evaluating unusual activity. Banking supervisors evaluate the effectiveness of the monitoring systems by considering the bank's overall risk profile, the volume of transactions, and the adequacy of staffing assigned to the identification, research, and reporting of suspicious activities. Additionally, the agencies evaluate the escalation process from the point of initial detection to disposition of the investigation to determine whether management's documented decisions to file or not file a SAR are reasonable and whether SARs are filed in a timely manner. Finally, the agencies review management information systems to ensure that they inform the board (or board committee) and senior management of suspicious activities, compliance deficiencies, and corrective action. (*See* Manual).

EC 10	Principle 18: Abuse of financial services
Criterion	Laws and regulations ensure that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.
Legal Framework	The BSA and the agencies' SAR regulations provide protection to financial institutions and their employees from civil liability for filing a SAR or for making disclosures in a SAR. The agencies and FinCEN have issued an interagency advisory on the scope of this "safe harbor," as judicially interpreted on May 24, 2004. See SR letter 04-8 (May 24, 2004); OCC Bulletin 2004-24; and FDIC FIL-67-2004. U.S. federal law (31 U.S.C. § 5318(g)(3)) provides protection from civil liability for all reports of suspicious transactions made to appropriate authorities, including supporting documentation, regardless of whether such reports are filed pursuant to the SAR instructions. Specifically, the law provides that a bank and holding company and its directors, officers, employees, and agents that make a disclosure of any possible violation of law or regulation, including a disclosure in connection with the preparation of SARs, "shall not be liable to any person under any law or regulation of the U.S., any constitution, law, or regulation of any state or political subdivision of any state, or under any contract or other legally enforceable agreement (including any arbitration agreement), for such disclosure or for any failure to provide notice of such disclosure to the person who is the subject of such disclosure or any other person identified in the disclosure." Section 351 of the USA Patriot Act, amended 31 U.S.C. § 5318(g)(3) to expand the immunity to charges of breach of contract and included directors, officers, employees, and agents of the bank or holding company who participate in preparing and reporting of SARs under safe harbor protections. The safe harbor applies to SARs filed within the required reporting thresholds as well as to SARs filed voluntarily on any activity below the threshold. Each agency has applicable regulations which specifically include a safe harbor provision for banking in the filing of SARs. *See* 12 CFR 353.3(h) (FDIC); 12 CFR 21.11(l) (OCC); 12 CFR 563.180(d)(13) (OTS); and 12 CFR 208.62(k) (Federal Reserve). Finally, section 355 of the USA Patriot Act specifically authorizes banks and holding companies to include suspicions of illegal activity in written employment references. *See* 12 U.S.C. § 1828(w).
Practices and	The agencies review the procedures and practices of a bank's or holding company's suspicious activity reporting filing process to

EC 10	Principle 18: Abuse of financial services
Procedures	ensure that appropriate procedures are being conducted.

EC 11	Principle 18: Abuse of financial services
Criterion	The supervisor is able to inform the financial intelligence unit and, if applicable, other designated authority of any suspicious transactions. In addition, it is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.
Legal Framework	In accordance with procedures applicable to the sharing of confidential supervisory information, the agencies are authorized to inform relevant authorities, including Treasury and FinCEN, of suspicious transactions. *See generally* 12 CFR 261, subpart C; 12 CFR 4; 12 CFR 309.6; and 12 CFR 503.2. Also within these prescribed procedures, the agencies have the authority, directly or indirectly, to share with judicial authorities information related to suspected or actual criminal activities.
Practices and Procedures	U.S. federal and state banking agencies have the ability, and consider it their supervisory responsibility, to inform FinCEN and other authorities of suspicious activity and share information with relevant judicial authorities. If a bank or holding company has not filed a SAR but federal or state supervisory agency staff determines that it should, agency staff may file a SAR on behalf of the bank or holding company, and the form will be available to authorities with database access. The Manual provides guidance for such situations when the agency should file a SAR. SARs and any information that would disclose the existence of a SAR are confidential. *See* 31 U.S.C. § 5318(g). However, the underlying documents and information pertaining to the suspicious transactions may be shared by banking supervisors with relevant judicial authorities with certain limitations. The agencies have procedural restrictions on the disclosure of confidential supervisory information (that is, information obtained through the examination process), but have established processes for obtaining the necessary review and approval to provide information. *See* 12 CFR 4 and 12 CFR 309. Information about individual customers is also subject to restrictions on disclosure by government agencies under the Right to Financial Privacy Act (12 U.S.C. § 3401 et seq.) (RFPA). In general, RFPA provides all necessary exceptions with respect to disclosures for law enforcement purposes.

EC 12	Principle 18: Abuse of financial services
Criterion	The supervisor is able, directly or indirectly, to cooperate with the relevant domestic and foreign financial sector supervisory authorities or share with them information related to suspected or actual criminal activities where this information is for supervisory purposes.
Legal Framework	As discussed under Principle 1(6), the U.S. federal banking agencies are authorized, directly or indirectly, to cooperate with the relevant domestic and foreign financial sector supervisory authorities or share with them information related to suspected or actual criminal activities where this information is for supervisory purposes.

EC 12	Principle 18: Abuse of financial services
	Section 8(v) of the Federal Deposit Insurance Act (12 U.S.C. § 1818(v)) permits the agencies to provide assistance to foreign banking authorities, if the foreign authority is conducting an investigation to determine whether there is a violation of law or regulation dealing with banking matters or currency transactions that are administered or enforced by the foreign authority. Section 15 of the International Banking Act (12 U.S.C. § 3109) authorizes sharing information with foreign bank regulatory or supervisory authorities, if such disclosure does not prejudice the interests of the United States, and the foreign authority agrees to maintain the confidentiality of the information to the extent possible under applicable law. 12 CFR 4.37 permits the Comptroller of the Currency to share non-public OCC information with certain other government agencies of foreign governments (not just foreign bank regulators or supervisors), subject to appropriate confidentiality safeguards. 12 CFR 309 gives the Federal Deposit Insurance Corporation discretion in the sharing of confidential information with the appropriate safeguards. 12 CFR 261.20 and 261.21 permit the Federal Reserve to share confidential supervisory information with other agencies under certain circumstances and subject to confidentiality safeguards. . The OTS has a similar regulation. *See* 12 CFR 510.5
Practices and Procedures	The agencies have broad authority to share relevant supervisory information with domestic banking supervisors. The agencies may also share information with other supervisory and enforcement agencies, subject to confidentiality restrictions. (See Principle 18, EC 11). Under the relevant statutes and regulations, the agencies may share with foreign bank supervisors, spontaneously or upon request. They also have authority to exchange information with foreign bodies other than banking supervisors, including foreign law enforcement agencies. 12 CFR 4.37(c); 12 U.S.C. § 326; 12 U.S.C. § 1817(a)(2)(C). All of the agencies have established procedures under which requests for information are processed. The agencies are party (either separately or jointly) to over twenty supervisory information sharing arrangements with foreign bank supervisors.

AC 1	Principle 18: Abuse of financial services
Criterion	If not done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities.
Legal Framework	
Practices and Procedures	The agencies employ highly skilled personnel for a number of specialties, including compliance and AML and terrorist financing offences. These specialists are highly skilled, receive annual continuing education training, and are deployed in the largest, most complex and high-risk institutions, and are well prepared to identify unusual or potentially criminal activity in their areas of expertise. In addition to subject matter experts, the agencies have fraud experts on staff to handle fraud cases and liaise with law enforcement such as the US Department of Justice and the Federal Bureau of Investigations. The FDIC's Office of Inspector General-Office of Investigations carries out a comprehensive nationwide program for the prevention,

AC 1	Principle 18: Abuse of financial services
	detection, and investigation of criminal or otherwise prohibited activity affecting the FDIC and its programs. The Office of Investigations coordinates with DOJ, the Federal Bureau of Investigation, the Secret Service, the Internal Revenue Service, other Office of Inspector Generals, and state and local law enforcement authorities regarding the prosecution of federal criminal offenses, including money laundering and terrorist financing offences.

Principle 19: Supervisory approach

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Overview

Banking laws vest the U.S. federal banking agencies with broad authority to regulate and supervise banks and holding companies subject to their jurisdiction. This authority includes the power to examine banks and holding companies and their affiliates and to obtain a broad array of information from both, including financial data and information on their activities, operations, structure, corporate governance, risk management, and any other details necessary to determine and enforce compliance with applicable laws and ensure the safety and soundness of the bank or holding company. *See* 12 U.S.C. §§ 93a, 161(a) and (c), 324-26, 481, 483, 602, 625, 1464(d) and (v), 1467(h) and 1467a(b)(2), 1817(a), 1817(a)(2), 1817(a)(3), 1820(b), 1844(c), 3105(c), and 3108. Banks and holding companies must provide supervisors with full and complete access to their books and records; failure to do so can result in the imposition of administrative sanctions. Under the agencies' statutory examination authority, supervisors may review all books and records maintained by a banking organization subject to the agencies' supervision. This includes access to the bank's and holding company's employees involved in a matter under review. These duties extend to the foreign operations of banks; however, it should be noted that the laws of foreign host countries may restrict U.S. banks and holding companies operating in such countries from sharing certain information with the U.S. banking agencies.

U.S. federal banking supervisors utilize this authority to develop and maintain a thorough understanding of the operations of individual banks and holding companies, to evaluate and ensure their safety and soundness and compliance with applicable laws and regulations, and to monitor the stability of the banking and financial system.

Largely compliant: The recent market turmoil has highlighted areas where regulatory oversight and coordination need to be strengthened. For example, many of the problems in the subprime mortgage market originated with mortgage brokers and lenders who were not affiliated with federally- or state-chartered depository institutions and thus were subject to limited supervision. In other cases, there were not sufficient mechanisms to stabilize or resolve systemically important nonbank firms. The U.S. Treasury Department's financial reform package addresses these gaps. Also, please see the **Summary of Recent Events and Implications** within the Introduction for more detailed discussion on initiatives that are underway to address gaps.

EC 1	**Principle 19: Supervisory approach**
Criterion	The supervisor has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks and banking groups.
Legal Framework	*See* Overview section above.

EC 1	Principle 19: Supervisory approach
Practices and Procedures	U.S. federal banking agencies use their authority to conduct on-site reviews and off-site analyses to develop a thorough understanding of the risk profile of banks and holding companies. Under U.S. law, the agencies conduct full-scope on-site examinations of banks at least once every year (for banks that have assets of at least $500 million or that are not considered well-managed or well-capitalized) or 18 months (for banks that have assets of less than $500 million and that are considered well-managed and well-capitalized). Bank holding company (BHC) inspections are mandated on an annual or two year basis depending upon size, complexity, and rating, with smaller (less than $1 billion in assets) banks subject to off-site reviews (*see* Federal Reserve's BHC Inspection Program). SLHC examinations are conducted concurrently with the OTS examination of its subsidiary savings associations. The agencies also conduct regular Consumer Compliance examinations and Community Reinvestment Act evaluations of banks to confirm that the organization is appropriately managing its compliance risk and complying with U.S. consumer protection laws and regulations. A full-scope examination addresses all key areas of a bank's operations, including capital adequacy, asset quality, management strength and quality of oversight from the bank's board of directors, compliance with laws and regulations, quality and sustainability of earnings, adequacy of liquidity sources to support ongoing cash needs, and sensitivity of a banking organization's earnings and capital position to market risk. For many larger banks and holding companies, full scope examinations/inspections consist of a series of targeted reviews during the examination cycle which culminate in a roll-up process where ratings are assigned based upon the results of these targets and the continuous monitoring activities. The requirements and mandates for these on-site activities can be found in the individual agencies' examination manuals noted in the overview section of Principle 7. Additionally, for many of the largest banks and holding companies, one or more of the banking agencies maintains a full-time, on-site examination staff to monitor the activities. During the period of time in between full-scope, on-site examinations, the agencies maintain a thorough understanding of the bank's and holding company's risk profiles. This is accomplished through the analysis of quarterly financial statements filed with their relevant agency and the review of regulatory reports that banks must file to notify the agencies of changes in their activities and structure. Further, supervisors may request and review key management information reports including, but not limited to, internal audit information, and, in the case of publicly traded banks and holding companies, the consideration of market indices that may provide insight into the market's assessment of the risk profile. These sources may be supplemented by discussions with the banking organization's management, meetings with its internal and external auditors, and, where no full-time on-site examination staff is maintained, on-site visits to maintain an up-to-date understanding of the financial condition. In addition, the agencies maintain various analytical tools that can help identify emerging risks or changes in the risk profile that may require specified follow-up steps. For additional information on the agencies' off-site surveillance procedures and analytical tools, *see* Federal Reserve SR letters 06-2 and 95-43; and OCC *Community Bank Supervision* and *Large Bank Supervision Handbooks*, and PPM 5000-34. For example, the OCC uses a variety of monitoring tools, including the Canary Early Warning System; monitoring of foreign exposures; stress testing under different macroeconomic and financial market scenarios; quarterly reports obtained from large banks that provide granular, loan level detail on various loan portfolios such as residential mortgages; and annual underwriting surveys. The FDIC maintains several monitoring systems such as Large Institution Risk Review, Real Estate Stress Test, and Growth Monitoring Screen. The

EC 1	Principle 19: Supervisory approach
	OTS issued an internal New Directions Bulletin to supervision staff providing national guidance on off-site monitoring.

EC 2	Principle 19: Supervisory approach
Criterion	The supervisor monitors and assesses trends, developments and risks for the banking system as a whole. The supervisor also takes into account developments in non-bank financial institutions through frequent contact with their regulators.
Practices and Procedures	On a quarterly basis, U. S. federal banking agencies monitor and assess banks and holding companies through financial statements that each is required to file. These financial statements consist of a balance sheet, income statement, and supporting financial schedules. Using aggregations of these data, the banking agencies complete analyses addressing overall conditions within the banking industry. These analyses highlight earnings performance, industry capitalization levels, lending concentrations, and many other fundamental and specialized areas of the bank's or holding company's operations, and are used to assess trends, developments, and risks for the banking system as a whole. The agencies also make use of higher level risk committees, made up of senior agency officials, to evaluate and assess the risks facing the financial system. In addition, the results of formal off-site monitoring programs, which utilize the submitted financial data to identify emerging problems in supervised banks and holding companies, are also used to monitor banking industry trends. *See* Principle 21 for details on Supervisory Reporting requirements. The agencies also maintain contacts with a variety of market and industry analysts to obtain insights on emerging risks that may affect the banking system and financial markets as a whole. For example, the OCC has a Financial Markets Group specifically dedicated to monitoring and analyzing market developments and trends, and maintaining contact with market participants. This group conducts periodic meetings with various market analysts, hedge fund managers, and other key players to get their insights on emerging risks. The U.S. President's Working Group on Financial Markets facilitates coordination among the agencies and other market regulators on issues and risks that cut across the financial sector. The agencies also consult regularly with the supervisors of major non-bank organizations in the United States, including the Securities and Exchange Commission (SEC) in the case of broker-dealers and the state insurance authorities in the case of insurance companies, to help to evaluate the impact of these institutions' activities on the condition of holding companies.

EC 3	Principle 19: Supervisory approach
Criterion	The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual banks or banking groups are exposed. The methodology should cover, inter alia, the business focus, the risk profile and the internal control environment, and should permit relevant comparisons between banks. Supervisory work is prioritized based on the results of these assessments.

EC 3	Principle 19: Supervisory approach
Practices and Procedures	During each supervisory cycle, the U.S. federal banking agencies formally assess the risk profile of each bank and holding company in order to determine the supervisory strategy to be followed by examination staff and prioritization of agency resources. Risk assessments are updated on a regular basis through off-site monitoring programs and on-site examinations. These risk assessments use a common framework that promote and facilitate comparisons across banking organizations. The U.S. federal banking agencies maintain continuous off-site monitoring programs to determine and assess on an ongoing basis the nature, importance, and scope of risks to which banks and holding companies are exposed. These programs draw on financial data, prior supervisory assessments, regulatory reports specifying changes in activities, and other internal and publicly available sources of information to identify banks and holding companies requiring a heightened supervisory focus. Banks and holding companies showing signs of significant deterioration or making significant changes in their business focus may be subject to immediate on-site or targeted examination under policies and procedures maintained by the banking agencies. The adequacy of internal controls is evaluated during on-site or targeted examinations and is also taken into consideration when determining the need for additional supervisory work. In addition, the banking agencies collect information on the scope of each bank's and holding company's external audit to help to gauge the quality of internal controls, and require audited financial statements and additional reporting on the quality of internal controls for banks and holding companies of significant size. The agencies' Uniform Bank Performance Report or Uniform Thrift Performance Report allows supervisors and supervisory staff to compare financial trends across groups of peer banks to identify outlier or high risk banks. The agencies also use a common UFIRS, known as CAMELS, that provides a consistent methodology and terminology for assessing and assigning risk ratings across banks. Similar uniform rating systems are used to assess holding companies, information technology, trust, and consumer compliance systems. The ROCA rating system is used for foreign banking organizations (see BCP 7). Each agency has additional tools and systems, such as horizontal examinations of a group of banks that it uses to supplement these interagency tools. *See* EC 1 above for additional information on quarterly monitoring practices. Also *see* 12 U.S.C. § 1831m(b)(2)(B)(i), addressing the annual management attestation of internal controls framework.

EC 4	Principle 19: Supervisory approach
Criterion	The supervisor confirms banks' and banking groups' compliance with prudential regulations and other legal requirements.
Legal Framework	See Overview.
Practices and Procedures	During regular on-site examinations, the U.S. federal banking agencies complete a series of testing procedures, contained in the agencies' examination manuals, to confirm banks' and holding companies' compliance with prudential regulations and other legal requirements. In addition, compliance with some rules is monitored on an ongoing basis through the collection and analysis of financial and structure reports that must be filed. U.S. federal banking supervisors confirm that banks and holding companies also maintain policies and procedures designed to ensure their compliance with applicable laws and regulations. These internal compliance programs are evaluated by the banking agencies during on-site examinations. U.S. federal banking agencies have

EC 4	Principle 19: Supervisory approach
	developed and maintain extensive supervisory guidance to evaluate compliance programs and specific areas including internal controls, audit, consumer protection, fair credit reporting, home mortgage disclosure, real estate settlement procedures, and anti-money-laundering, among others. A complete listing of the guidance is available through each agency.

EC 5	Principle 19: Supervisory approach
Criterion	The supervisor requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
Legal Framework	*See* Principle 4 regarding transfer of significant ownership and Principle 5 for major acquisitions. For additional information on requirements for BHCs, *see* the applicable sections of the Bank Holding Company Act of 1956. For national banks, examples of regulatory requirements to notify the OCC of changes include 12 CFR 5.30 - national banks must submit an application and get prior approval from the OCC to establish or relocate a branch, and 12 CFR 5.32 (12 USC § 215a-2) - for reorganization in which a national bank becomes a subsidiary of a bank holding company. *See* FDI Act sections 4 through 6 for various prudential requirements associated with required applications to FDIC. An insured savings association must provide notice to the OTS and FDIC before it establishes or acquires a subsidiary or engages in any new activity through an existing subsidiary. 12 U.S.C. § 1828(m). A SLHC must obtain approval of the OTS for certain acquisitions of more than 5 percent of a nonsubsidiary savings association or SLHC. 12 CFR 584.4.
Practices and Procedures	The U.S. federal banking agencies generally expect banks and holding companies to notify them of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements. In addition, U.S. federal banking supervisors use formal off-site monitoring programs and required regulatory reports on structure to identify banks and holding companies exhibiting deteriorating trends, breaching certain legal or prudential requirements, or substantively changing their activities. In the case of new banks and holding companies, U.S. banking agencies routinely include a condition in their approval orders that requires prior notice of any change to the new organization's business plan during the first three years of operation. After this period, changes in the activities, if permissible under state and federal law, would be subject to review during periodic safety-and-soundness examinations. Further, U.S. federal banking agencies may impose notification requirements formally or informally as determined by supervisors.

EC 6	Principle 19: Supervisory approach
Criterion	The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.
Practices and Procedures	The U.S. federal banking agencies maintain a comprehensive set of databases containing examination, financial, and structure data to facilitate the processing, monitoring, and analysis of prudential information. These data sources are used through a number of agency-specific surveillance tools to support ongoing off-site analysis of, and follow-up action on, banking conditions both at banks and holding companies and within the industry as a whole. For example, agency exam databases can identify for banks and holding

EC 6	Principle 19: Supervisory approach
	companies matters requiring the bank's, holding company's or their respective board's attention for agency follow-up. Specific to financial data, each bank is required to file complete financial data to the Central Data Repository (CDR) on a quarterly basis. The format utilized for this process is known as the Call Report. The data contained within the report is processed within the CDR by the Federal Financial Institutions Examination Council (FFIEC) and is then utilized in a multitude of distinctive formats across each of the regulatory agencies, and even by the general public. The resulting data provides the agencies the ability to produce high level reports of the condition of the banking system in various formats. Common examples of these formats include both the Uniform Bank Performance Report (UBPR) and the Uniform Bank Holding Company Performance Report (UBHCPR), both of which provide detailed analysis of a given bank's or holding company's financial condition. *See* FFIEC's website, www.ffiec.gov/secreport.htm, for further review.

AC 1	Principle 19: Supervisory approach
Criterion	The supervisor employs a well defined methodology designed to establish a forward-looking view on the risk profile of banks, positioning the supervisor better to address proactively any serious threat to the stability of the banking system from any current or emerging risks.
Practices and Procedures	Each of the U.S. federal banking agencies employs well defined off-site surveillance procedures for measuring and monitoring the risk profiles of individual banks and holding companies and the banking environment as a whole for possible systemic risks. These surveillance systems focus heavily on identifying banks and holding companies that are exhibiting problems or deteriorating so that examination resources can be directed to troubled organizations. They also flag banks and holding companies engaging in new or complex activities. These programs use a mix of predictive econometric models, expert systems based on judgmentally-determined screens, and market-based financial measures to identify banks and holding companies warranting a heightened supervisory focus. For example, the agencies have adopted a standardized request for electronic loan files that supervisors can use to analyze, sample, and report on the contents of a loan trial balance. Other examples include the Federal Reserve's SR-SABR model, the OCC's Canary Early Warning System and Global Outlook scenarios, and the FDIC's Large Insured Depository Institution (LIDI) program, the details of which are available through each agency. Through their ongoing risk assessment processes, the agencies also look for risks that may be increasing or risk-management systems that may need improvements. For example, the OCC's and the FDIC's risk assessment systems evaluate whether the direction of a bank's risk profile is increasing, decreasing, or stable. The agencies also conduct annually a joint review of the largest, complex credits that are shared by three or more banks. This annual review provides an opportunity for the agencies to identify trends in underwriting and credit classification practices, as well as overall commercial credit conditions, across the banking system. The 2008 review included 8,746 credits totaling $2.8 trillion extended to 5,742 borrowers. *See* EC 1 for more information.

Principle 20: Supervisory techniques

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Overview

Pursuant to the authorities cited in the overview to Principle 19, the U.S. federal banking agencies complement regulatory standards designed to ensure the safe and sound operation of banks and holding companies with a risk-focused supervisory approach. Supervision is accomplished through a combination of on-site examinations and off-site reviews. In general, the primary federal banking supervisor conducts annual, on-site examinations of the banks within its jurisdiction. *See* 12 U.S.C. § 1820(d). Smaller banks that satisfy certain qualifying criteria, including having less than $500 million in total assets, may be examined on an 18-month cycle. *See* 12 U.S.C. § 481; 12 CFR 4.6(OCC); 12 U.S.C. §§ 1463(a)(1) and 1464(d)(1)(B); 12 CFR 563.170 and 584.1(g)(OTS). However, the OCC, FDIC, and OTS retain authority to examine a bank as frequently as they deem necessary. For example, the FDIC would conduct annual examination of problem institutions less than $500 million, and depending on the nature of the problems, conduct more frequent visitations. *See id.* Examination areas for all banks include any cross-border operations. In addition to examining national banks and their affiliates, the OCC examines federal branches and federal agencies of foreign banks and bank service companies. The Federal Reserve alternates with state regulators in examining state licensed branches and agencies of foreign banks. *See* 12 U.S.C. §§ 1867 and 3105(c)(1)C) .

In their role as holding company supervisors, the Federal Reserve and the OTS also conduct inspections and make risk assessments of a holding company's operations. See 12 U.S.C. § 1842 a and 12 U.S.C. § 1467a(b)(4). All of the U.S. federal banking agencies examine bank service companies. *See* 12 U.S.C. § 1867. Examination areas for all banks and holding companies include any cross-border operations.

Off-site supervision involves periodic surveillance and assessment of information from a variety of sources, including the supervised bank and holding company. The information includes standard regulatory reports, which capture a host of commercial and financial information on supervised entities. The number and the type of report forms that must be filed depend on the size of a bank or holding company and the scope of its operations. Off-site surveillance also includes a review of reports of recent examinations and inspections, internal management and internal and external auditor reports (when requested by supervisors), reports filed by public companies (e.g., 10-Qs and 10-Ks), application materials, and publicly available material (e.g., information published in the financial press and elsewhere). In addition, it includes information obtained from regular discussions with management, internal and external auditors, and other supervisors, both foreign and domestic.

In on-site examinations and through continuous supervision, supervisory staff generally: (1) evaluate the soundness of the bank's or holding company's assets and the effectiveness of its internal controls, policies, and management; (2) analyze key financial factors such as the bank's and holding company's capital, earnings, liquidity, and sensitivity to interest rate risk; (3) assess the bank's or holding company's exposure to off-balance-sheet risks; (4) check for compliance with banking laws and regulations; and (5) determine the bank's or holding company's overall soundness and solvency. In addition to these specific areas, supervisors also evaluate transactions between a bank or holding company and its affiliates to determine the effect of the transactions on the bank's or holding company's condition and to ascertain whether the transactions are consistent with the limitations set forth in sections 23A and 23B of the Federal Reserve Act.

The primary federal banking supervisor makes risk assessments with respect to the bank's operations. For larger banks and holding companies, the federal banking agency maintains resident on-site supervisors who provide continuous supervision of the banking organization and at least quarterly

Principle 20: Supervisory techniques
updates on the bank's and holding company's condition and risk. Each agency has the authority to take an enforcement action if, in the agency's opinion, the bank, holding company or any institution-affiliated party (IAP) is engaging or has engaged, or the agency has reasonable cause to believe that the bank, holding company or any IAP is about to engage in an unsafe or unsound practice, or is violating or has violated, or the agency has reasonable cause to believe that the bank,, holding company or any IAP is about to violate a law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the bank or holding company or any written agreement entered into with the agency. *See* 12 U.S.C. §§ 1813(q) and (u), and 1818. The primary federal banking agencies generally have the authority to examine affiliates of the bank under their supervision. *See* 12 U.S.C. §§ 338 (examinations of affiliates of state member banks); 481 (examinations of affiliates of national banks); 1464(d)(1)(B) (examinations of affiliates of savings associations); 1820(b)(4) (examinations of affiliates of state nonmember banks)); 1467a(b)(4)(subsidiaries of SLHCs); 1844(c)(2)(subsidiaries of BHC s). The OCC's procedures regarding a functionally regulated affiliate of a national bank are described in the Comptroller's Handbook, *Bank Supervision Process* (Sept. 2007), pages 20-22. The Federal Reserve has the authority to examine bank subsidiaries of BHCs; however, the Federal Reserve must rely to the fullest extent possible on the bank examinations conducted by the primary federal banking supervisor. The OTS is the primary federal supervisor of both SLHCs and their state and federal savings association subsidiaries and thus need not rely upon examinations of another supervisor except when state savings banks regulated by the FDIC elect to be treated as a savings association for purposes of holding company supervision. In addition, all of the federal banking agencies must rely to the fullest extent possible on the functional supervisors of the securities and insurance subsidiaries and any other subsidiary that is subject to comprehensive supervision by a federal or state authority for supervisory information to minimize duplication and unnecessary regulatory burden on regulated entities. *See* 12 U.S.C. §§ 1831v and 1844(c)(2)(E). The primary federal banking agency can conduct an examination of a functionally regulated subsidiary only if the agency has reasonable cause to believe the subsidiary is engaging in activities that pose a material risk to the bank or is not in compliance with any Federal law that it has specific jurisdiction to enforce against such subsidiary, or for other prudential reasons and the information cannot be obtained from the functional supervisor. *See* 12 U.S.C. § 1844(c)(2)(B). The U.S. federal banking agencies routinely share supervisory information with each other and with the functional supervisors, as needed. In addition, the U.S. Attorney General, Secretary of the Treasury, and the head of other federal agencies are required, unless prohibited by law, to disclose to the appropriate federal banking agency any information they believe raises significant concerns regarding the safety or soundness of any bank or holding company. *See* 12 U.S.C. § 1831m-1. In certain cases, there is overlapping examination authority among the federal supervisors. For example, 12 U.S.C. § 1820(b)(3) gives the FDIC and the Federal Reserve the authority to examine any bank, and, if necessary, to independently determine the condition of that bank for the FDIC's deposit insurance purposes.

EC 1	**Principle 20: Supervisory techniques**
Criterion	The supervisor employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks, their inherent risks, and the corrective measures necessary to address supervisory concerns. The specific mix may be determined by the particular conditions and circumstances of the country. The supervisor has policies and processes in place to assess the quality, effectiveness and integration of on-site and off-site functions, and to address any weaknesses that are identified.

EC 1	Principle 20: Supervisory techniques
Legal Framework	See Overview.
Practices and Procedures	The U.S. federal banking agencies apply a risk-based supervisory approach that focuses on evaluating risks, identifying material and emerging problems, and ensuring that these banks and holding companies take corrective action before problems compromise their safety and soundness. The agencies accomplish this through a mix of both on- and off-site supervisory activities. Under U.S. law, the agencies conduct full-scope on-site examinations of banks at least once every year (for banks that have assets of at least $500 million or that are not considered well-managed or well-capitalized) or 18 months (for banks that have assets of less than $500 million and that are considered well-managed and well-capitalized) to evaluate the condition of banks, their inherent risk, and the corrective measures necessary to address supervisory concerns. The agencies also conduct regular Consumer Compliance examinations and Community Reinvestment Act evaluations of banks to confirm that the organization is appropriately managing its compliance risk and complying with U.S. consumer protection laws and regulations. At the conclusion of each full scope exam, the board of directors receives a Report of Examination (ROE) that conveys the overall condition and risk profile, provides conclusions on the assigned supervisory ratings, discusses significant deficiencies, violations, and excessive risks, and details corrective action to which the board or management has committed. In their role as holding company supervisors, the Federal Reserve and the OTS also conduct inspections and make risk assessments of holding companies' operations. *See* 12 U.S.C. § 1844(c)(Federal Reserve); 12 U.S.C. § 1467a(b)(4)(OTS). While most banks and holding companies agree to promptly address criticisms or deficiencies that arise through the examination process, the agencies also have a variety of informal and formal enforcement tools that they can use to effect corrective actions. *See* Principle 23 for information on enforcement powers and tools of supervisors. During the time period in between on-site examinations, the agencies conduct ongoing off-site surveillance of each supervised bank and holding company and may follow up with additional on-site work and testing. Generally, the balance between on- and off-site supervisory activities is dictated by the condition and size of the subject bank or holding company, with more on-site examination work being conducted at larger or more problematic banks and holding companies. At the largest and most systemically critical banks and holding companies, the agencies' Central Point of Contact (CPC) or Examiner-in-Charge (EIC) teams provide for an ongoing, on-site presence and continuous monitoring program. For other banks and holding companies, portfolio managers are assigned responsibility for developing and executing examination strategies. The agencies monitor the success of their on- and off-site supervisory efforts in promptly identifying and addressing deteriorating banks and holding companies on a continuous basis and make adjustments to off-site surveillance programs and supervisory approaches as needed to improve their effectiveness. *See* Federal Reserve SR letters 06-2 and 97-24; OCC *Bank Supervision Process* Handbook and PPM 5000-34 (REV), "Canary Early Warning System" (Aug. 7, 2001). *Also see* response to EC 1 under Principle 19 for a summary of FDIC and OTS off-site monitoring systems.

EC 2	Principle 20: Supervisory techniques
Criterion	The supervisor has in place a coherent process for planning and executing on-site and off-site activities. There are policies and processes in place to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.
Practices and Procedures	Each of the U.S. federal banking agencies maintains written guidance for planning and executing on-site and off-site activities. Generally, agencies annually develop on- and off-site examination strategies and goals based on the risk profile of the bank or holding company. Guidance can be found in each of the agencies' examination manuals, updated regularly. The guidance specifies the objectives and expected actions and outputs for these activities, and also details basic procedures for completing on-site reviews and implementing off-site surveillance programs. Coordination and information sharing between on- and off-site supervision functions is facilitated by formal off-site monitoring programs that trigger follow-up by the on-site function when banks and holding companies meet various screening thresholds. In addition, supervisory policies require the consideration of off-site monitoring results when supervisors are determining the scope and procedures of on-site reviews. *See* Federal Reserve SR letter 06-2; OCC *Bank Supervision Process* Handbook; FDIC RMMEP section 1.1; and OTS *Holding Companies Handbook*, section 200, for more details. *Also see* Principle 7 for a listing of federal banking manuals.

EC 3	Principle 20: Supervisory techniques
Criterion	On-site work, conducted either by the supervisor's own staff or through the work of external experts, is used as a tool to: provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks; determine that information provided by banks is reliable; obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, the evaluation of material risks, and the identification of necessary remedial actions and supervisory actions, including enhanced off-site monitoring; and monitor the bank's follow-up on supervisory concerns.
Practices and Procedures	On-site examinations address all key areas of a bank's and holding company's operations, including capital adequacy, asset quality, management strength and quality of oversight from the board of directors, compliance with laws and regulations, quality and sustainability of earnings, the adequacy of liquidity sources to support ongoing cash needs, and sensitivity of earnings and capital position to market risk. These reviews incorporate independent verification of the effectiveness of risk management, internal controls, management reporting, and overall corporate governance. In addition, examination procedures may be directed to validating the reliability and accuracy of financial data reported to the agencies. Also, at each examination, supervisors evaluate any follow-up to supervisory concerns raised at prior examinations or as a result of off-site monitoring.

EC 3	Principle 20: Supervisory techniques
	During on-site examinations, U.S. federal banking supervisors review the most recent external auditor's assessment of the bank's or holding company's financials and the work of the loan review function and internal audit. Typically, supervisors review audit testing of financial and Call Report reconcilements and accuracy. For banks over $1 billion, section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (*see* 12 U.S.C. § 1831m) requires a formal attestation from company management on the quality of the internal control structure. External auditors are required to attest to, and report separately on, the assertions of the bank's management regarding internal controls. Section 404 of the Sarbanes-Oxley Act, 15 U.S.C. § 7262(b), requires an external auditor of a bank or holding company that is a public company annually to render an opinion on the effectiveness of the company's internal controls over financial reporting and make a management assessment. *Also see* Principle 17 for a further discussion. As part of their Report of Examination, supervisors will specify matters requiring attention from the board. These are practices that deviate from sound governance, internal control, and risk management principles, which may adversely impact earnings or the capital, risk profile, or reputation if not addressed, or that result in substantial noncompliance with laws and regulations, internal processes, or supervisory guidelines. Supervisors evaluate management plans for corrective action and consider whether they are likely to be effective. In cases of severe problems or where management has been unable or unwilling to correct deficiencies, either formal or informal actions are typically issued against the bank and holding company. These actions often require the bank or holding company to correct the most serious of examination findings and communicate progress of those corrections to the responsible agency, commonly on a quarterly basis. The U.S. federal banking agency then has the ability to render judgment on management's progress and can in turn structure the ongoing supervisory plan accordingly. *See* Principle 23 for details on corrective and remedial powers of the agencies.

EC 4	Principle 20: Supervisory techniques
Criterion	Off-site work is used as a tool to: regularly review and analyze the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information; follow up on matters requiring further attention, evaluate developing risks; and help identify the priorities and scope of further work; and help determine the priorities and scope of on-site work.
Practices and Procedures	As part of formal, off-site monitoring programs, the U.S. federal banking agencies use automated screening systems, regulatory reports, standardized financial reports detailing key financial ratios and measures, and public sources of financial information to monitor the performance and condition of supervised banks and holding companies and promptly identify those requiring heightened supervisory attention. Supervisors periodically (e.g., quarterly) communicate with the bank's or holding company's management to discuss emerging issues or concerns. *See* EC 2 for a more detailed description of the off-site review process of the federal banking agencies as well as various examination manuals by the agencies.

EC 4	Principle 20: Supervisory techniques
	Examination staffs also use off-site surveillance tools and reports to plan the scope of, and determine priorities for, on-site examination work, as well as to monitor the progress in responding to matters requiring further attention. *See* Principle 19 for further details.

EC 5	Principle 20: Supervisory techniques
Criterion	Based on the risk profile of individual banks, the supervisor maintains sufficiently frequent contacts as appropriate with the bank's Board, non-executive directors, Audit Committee and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems.
Practices and Procedures	During the course of regularly scheduled on-site examinations, the U.S. federal banking agencies communicate extensively with the bank's and holding company's board, non-executive directors, audit committee, and senior and middle management (including heads of individual business units and control functions). This communication facilitates the development of an understanding and assessment of such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, and risk-management systems. It also provides an opportunity for the banking agencies to deliver recommendations for corrective actions as needed and follow a bank's and holding company's progress in addressing earlier recommendations. At the conclusion of each exam, the supervisor will meet with the bank's or holding company's management and board of directors to discuss findings and any significant issues found and to obtain management's commitment to correct any weaknesses noted during the exam. The agency also provides the bank's or holding company's board of directors a written ROE for review by all directors and senior officers. The ROE conveys the overall condition and risk profile of the bank and provides conclusions on the assigned supervisory CAMELS ratings (those ratings assess the bank's Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk); identifies any violations of law; assesses compliance with the Bank Secrecy Act; and addresses compliance to consumer laws and regulations and the Community Reinvestment Act. The ROE also discusses significant deficiencies, violations, and excessive risks, and details corrective action to which the board or management has committed. For large banks and holding companies and those exhibiting a higher degree of risk, the amount of communication by the agencies with all levels of a bank's and holding company's corporate governance structure is expanded, with the frequency and scope of this contact determined based on the size or risk profile of the bank or holding company. This contact may include an ongoing, on-site presence to enable monitoring by CPC and EIC teams. Each agency has guidelines on communication expectations. *See* Federal Reserve SR letter 08-1/CA letter 08-1; OCC *Bank Supervision Process* Handbook; and OTS *Examination Handbook,* section 070 and *Holding Companies Handbook,* section 200)

EC 6	Principle 20: Supervisory techniques
Criterion	On an ongoing basis during on-site and off-site supervisory activities, the supervisor considers the quality of the Board and

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	management.
Practices and Procedures	The U.S. federal banking agencies consider the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a bank's or holding company's activities and to ensure a bank's and holding company's safe, sound, and efficient operation in compliance with applicable laws and regulations in all aspects of on- and off-site supervisory activities. The evaluation of the quality of management and the adequacy of board of directors' oversight of a bank's or holding company's activities is central to the regular full scope on-site examinations required by U.S. law. In addition, when management or the board of directors exhibit deficiencies, banks and holding companies are subject to heightened off-site monitoring and more in-depth testing as part of on-site work. As described in the overview to Principle 7, supervisors evaluate Management during the regular on-site examination process. Conclusions about management are often assigned as a result of assessments of each of other areas, under the concept that the financial condition of the bank or holding company as well as related internal controls, risk-management processes, and degree of adherence to the bank's or holding company's policies and regulations is a representation of board and management performance.

EC 7	Principle 20: Supervisory techniques
Criterion	The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.
Practices and Procedures	The U.S. federal banking agencies assess the quality and scope of every bank's and holding company's internal audit function, whether or not audits are performed by the bank's or holding company's own staff or an outside vendor. These assessments include consideration of the independence of the function, the appropriateness of the risk assessment program for addressing the activities and risks of the bank or holding company, the size and quality of staffing, and the effectiveness and completeness of audits performed. The results of this assessment are used in determining how reliable the resulting internal audit work product is and whether it may be relied upon in developing a supervisory assessment of a bank's or holding company's soundness, risk profile, and internal controls. Examination manuals maintained by the various agencies provide details of procedures used to evaluate a bank's and holding company's audit function. *See* Principle 17 for additional details on how the banking agencies evaluate the internal audit function.

EC 8	Principle 20: Supervisory techniques
Criterion	The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.
Practices and Procedures	Findings of supervisory activities are written in report format and delivered to and discussed with the bank's and holding company's management and the board of directors each examination cycle. *See* EC 5 for more details. The supervisory ratings assigned to the bank and holding company as a result of supervisory activities are also provided to the subject's board of directors and senior

EC 8	Principle 20: Supervisory techniques
	management within the written examination reports. In cases where supervisory activity results in an assessment of the bank or holding company that is less than satisfactory, the bank's or holding company's board of directors and senior management are made aware of resulting regulatory restrictions where appropriate. Examples of these restrictions are constraints on severance payments made to IAPs, requirements regarding the appointment of new directors or senior executive officers, restrictions on dividend payments while the bank or holding company is in a problem condition, and prohibition of new branches. The manner by which agencies coordinate communication of examination activities and findings varies depending on the specific condition of the bank or holding company, structure, and in the case of state counterparts, geographic location. *See* EC 23 for specific details on actions agencies may take.

AC 1	Principle 20: Supervisory techniques
Criterion	The supervisor meets periodically with senior management and the Board to discuss the results of supervisory examinations and the external audit. The supervisor should also meet separately with the independent Board members, as necessary.
Practices and Procedures	At the conclusion of regularly scheduled on-site examinations, federal banking supervisors meet with senior management and the board of directors to discuss findings of the examinations and communicate supervisory ratings assigned. Where necessary, supervisors may also meet separately with independent board members. This communication focuses primarily on the findings of supervisory reviews and testing conducted by the banking agencies and any recommended follow-up actions, but may also encompass a discussion of any significant findings of the external audit. In addition, communication is generally much more frequent for larger banks and holding companies, and those exhibiting a higher risk profile or deteriorating condition, with the scope and frequency of discussions determined by the overall risk profile. *See* EC 5 for more details.

Principle 21: Supervisory reporting
Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Overview As noted in the overview to Principle 20, off-site surveillance is a key component of the U.S. federal banking agencies' risk-focused supervisory approach. A major part of this surveillance consists of the collection, review, and analysis of regulatory reports required to be submitted to the agencies on a periodic basis. These reports capture an array of data, including financial, operational, prudential, activities, and structural information. As previously noted, the agencies' authority to require the submission of information is broad, extending to affiliates of a bank or holding company and including information on a bank's and holding company's domestic and foreign activities and operations. It includes the authority, as appropriate, to require the submission of reports necessary for the effective supervision of the particular bank or holding company or groups of organizations with similar operations and/or risks. In addition, as discussed in detail under Principle 22, banks exceeding a certain asset threshold are required to be audited at least annually by an external independent public accountant meeting certain qualifying criteria. The external audit reports are required to be provided to the appropriate federal banking agency.

EC 1	Principle 21: Supervisory reporting
Criterion	The supervisor has the power to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. These reports provide information on such matters as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk.
Legal Framework	Under the authorities cited in the overview to Principle 20, the U.S. federal banking agencies have the power to require banks and holding companies to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. Required reports provide information on balance sheet assets and liabilities, off-balance-sheet exposures, profit and loss, capital adequacy, asset quality, loan loss provisioning, affiliate and insider transactions. They also provide information allowing for an assessment of liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), foreign exposures, interest rate risk, and market risk.
Practices and Procedures	The U.S. federal banking agencies have a robust regulatory reporting framework and have the power to request information needed for supervisory purposes at regular intervals. Banks and holding companies are subject to reporting requirements that include financial and other information. Individual banks must submit reports on an entity-specific basis, while BHCs with assets of $500 million or more and SLHCs of all sizes must submit financial and supervisory information on a consolidated basis. Banks owned by a BHC must submit financial and supervisory information to the appropriate federal banking agency, and each bank must submit reports on an entity-specific (solo) basis. This

EC 1	Principle 21: Supervisory reporting
	reporting includes information about balance sheet items, off-balance-sheet exposures, profit and loss, capital adequacy, asset quality, loan loss provisioning as well as some information on interest rate risk sensitivity and market risk. Information reported in regulatory reports is used to create performance measures for analysis, including funding and liquidity, capital adequacy, asset quality and concentrations, earnings, and sensitivity to changes in market prices. The parent BHC must submit reports that include financial statements on a "stand-alone" basis and also include information on related party transactions. Moreover, a report (FR Y-8 for BHCs and Thrift Financial Report Schedule SI for SLHCs) must be submitted regarding certain related party transactions between the holding company and affiliates. In addition, all other subsidiaries are subject to reporting requirements that include financial and supervisory information if these entities exceed certain thresholds. Many performance measures are derived from information reported by banks and holding companies, and are included in the Uniform Bank Performance Report (UBPR), the Uniform Thrift Performance Report (UTPR) for thrift institutions and the Bank Holding Company Performance Report (BHCPR). U.S. federal banking agencies collaborate on an interagency basis to maintain regulatory reports under the Federal Financial Institutions Examination Council (FFIEC). Reports maintained on an interagency basis by the FFIEC can be found at the following website: www.ffiec.gov/ffiec_report_forms.htm. A subset of these reports include: FFIEC 030 – Foreign Branch Report of Condition – reported quarterly or annually, depending on size and nature of the branch FFIEC 031 - Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices – reported quarterly FFIEC 041 - Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only – reported quarterly FFIEC 002 – Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks – reported quarterly FFIEC 009 – Country Exposure Report – reported quarterly The information included in these reports is used to derive various performance measures and ratios that are included in the FFIEC's UBPRs. The Federal Reserve also maintains many regulatory reports submitted by banks and holding companies. These reports can be found at the following website: www.federalreserve.gov/reportforms. A subset of these reports, which reflect the breadth of regulatory reports at the consolidated and individual levels, include: FR Y-9C – Consolidated Financial Statements for Bank Holding Companies – reported quarterly FR Y-9LP – Parent Company Only Financial Statements for Large Bank Holding Companies – reported quarterly FR Y-9SP – Parent Company Only Financial Statements for Small Bank Holding Companies – reported semiannually

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	FR Y-11 – Financial Statements of U.S. Nonbank Subsidiaries of U.S. Bank Holding Companies – reported quarterly or annually, depending on the size and nature of the subsidiary FR 2314 – Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations – reported quarterly or annually, depending on size and nature of subsidiary FR Y-6 - Annual Report of Bank Holding Companies – reported annually FR Y-7 – Annual Report of Foreign Banking Organizations – reported annually FR Y-7N – Financial Statements of U.S. Nonbank Subsidiaries Held by Foreign Banking Organizations – reported quarterly FR Y-8 - The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates – reported quarterly FR 2886b – Consolidated Report of Condition and Income for Edge and Agreement Corporations – reported quarterly In addition to filing either FFIEC 031 or 041, each national bank is required to file with the OCC an Annual Report on Operating Subsidiaries containing a variety of information including the lines of business in which the operating subsidiary is doing business directly with consumers. *See* 12 CFR 5.34(e)(6). The OCC and OTS also collect performance data on first lien residential mortgages from a group of national banks and savings associations with the largest mortgage servicing portfolios and publish the data in OCC and OTS Mortgage Metrics Report. The OTS is responsible for maintaining the regulatory reports submitted quarterly by savings associations and SLHCs. These reports can be found at the following website: http://www.ots.treas.gov/?p=ReportFormsBulletins. SLHCs also file Form H-(b)11 Annual/Current Report. Among other items, this report requires consolidated and unconsolidated financial statements. This report can be found at the following website: files.ots.treas.gov/78171.pdf. These regulatory reports are used to facilitate off-site monitoring and on-site examinations. Further, banks are required to report public loan data for the Home Mortgage Disclosure Act (HMDA) which help supervisors in determining whether banks are serving the housing needs in their markets; in distributing public-sector investments to attract private investment where needed; and in identifying possible discriminatory lending patterns. Additionally, those banks subject to the Community Reinvestment Act's (CRA) Large Bank Evaluations must report data associated with small business and small farm loans.

EC 2	Principle 21: Supervisory reporting
Criterion	The supervisor provides report instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
Legal Framework	By statute, banks and holding companies are required to apply accounting principles that are no less stringent than U.S. generally accepted accounting principles (U.S. GAAP) in preparing and submitting financial reports or statements required to be filed with the U.S. federal banking agencies and annual financial statements must be prepared in accordance with U.S. GAAP. *See* 12 U.S.C. § 1831n(a)(2) and 1831m(b)(1). The FFIEC has generally adopted U.S. GAAP for the Consolidated Reports of Condition and Income. This requirement is reiterated in the general instructions to relevant regulatory reports. *See* "Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)," at p. 8, available at www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_041_200806_i.pdf; and "Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies (Reporting Form FR Y–9C)," at p. GEN-3, available at www.federalreserve.gov/reportforms/forms/FR_Y-9C20080630_i.pdf. The "Thrift Financial Report (OTS Form 1313) Instruction Manual – General Instructions" p. 103, available at files.ots.treas.gov/4210048.pdf. *See also* the reporting instructions for Form H-(b)11 Annual/Current Report for SLHCs at the following website: files.ots.treas.gov/78171.pdf.
Practices and Procedures	The U.S. federal banking agencies provide instructions for each report that must be submitted by banks and holding companies. The reporting instructions describe the accounting standards required in the preparation of regulatory reports. Many of the reports require the use of U.S. GAAP, which have been widely accepted over the years internationally, while other reports such as the FR Y-7 report, and, in certain instances, the FR 2314 report, allow the option of U.S. GAAP, International Accounting Standards (IFRS) or local accounting standards, depending on the nature of the report being filed and the domicile of the reporting entity. Furthermore, financial regulatory reporting by banks on forms FFIEC 031 and 041 (referred to as the Call Report) and Thrift Financial Report are required by statute to be no less stringent than U.S. GAAP, and the FFIEC has generally adopted U.S. GAAP for the Call Report. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are in the process of convergence of their accounting standards. The Securities Exchange Commission (SEC) approved the use of IFRS for foreign private issuers in 2007 and currently is evaluating the possibility of allowing U.S. companies, including banks and holding companies, to adopt IFRS for financial reporting purposes. The U.S. federal banking agencies are closely watching these developments.

EC 3	Principle 21: Supervisory reporting
Criterion	The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant.
Practices and Procedures	As described in EC 2, the U.S. federal banking agencies generally require banks and holding companies to use U.S. GAAP which apply various valuations rules to different categories of assets and liabilities. The accounting rules allow for certain assets and liabilities to be reported on a historical cost, or amortized cost basis, while the application of lower of cost or fair value, and fair value accounting is required under certain circumstances. For example, loans held for investment are accounted for at historical cost, loans held for sale are valued at the lower of cost or fair value, and trading assets and liabilities are valued at fair value.

EC 3	Principle 21: Supervisory reporting
	FASB Statement No. 157, *Fair Value Measurements* (FAS 157), issued in September 2006, defines fair value, establishes a framework for measuring the fair value of assets and liabilities based on a three-level hierarchy, and expands disclosures about fair value measurements. The FASB's three-level fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs). Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date (e.g., the reporting date). Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. According to FAS 157, observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from sources independent of the reporting entity. In contrast, unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available under the circumstances. FAS 157 is effective for fiscal years beginning after November 15, 2007, and, with certain exceptions, is to be applied prospectively. However, on February 12, 2008, the FASB issued FASB Staff Position No. FAS 157-2, which delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years, except for those items that are recognized or disclosed at fair value on a recurring basis, i.e., at least annually, in the financial statements. This delay does not apply to entities that have issued interim or annual financial statements or Call Reports that include the application of the measurement and disclosure provisions of FAS 157. Banks and holding companies must adopt FAS 157 for reporting purposes in accordance with the standard's effective date, including the delayed effective date for eligible nonfinancial assets and nonfinancial liabilities. Thus, a bank or holding company with a calendar year fiscal year must adopt FAS 157 as of January 1, 2008, except for any fair value measurements subject to the delay mentioned above. This standard did not significantly change the definition of fair value, but rather, compiled the fair valuation guidance from other areas of U.S. GAAP and established the fair value framework in one standard. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159), issued in February 2007, allows banks and holding companies to report certain financial assets and liabilities at fair value with the changes in fair value included in earnings. In general, a bank or holding company may elect the fair value option for an eligible financial asset or liability when it first recognizes the instrument on its balance sheet or enters into an eligible firm commitment. A bank or holding company may also elect the fair value option for eligible items that exist on the effective date of FAS 159. The decision to elect the fair value option for an eligible item is irrevocable. A bank or holding company that elects the fair value option is expected to apply sound risk management and control practices to the assets and liabilities that will be accounted for at fair value under the option. FAS 159 is effective as of the beginning of a bank's or holding company's first fiscal year that begins after November 15, 2007, and should not be applied retrospectively to prior fiscal years, except as permitted in the standard's early adoption provisions. The definition of fair value in U.S. GAAP is similar to the definition of fair value in IFRS. However, the accounting treatment of "day one" gains for certain financial instruments is different under IFRS and U.S. GAAP. A fair value option is also permitted under

EC 3	Principle 21: Supervisory reporting
	IFRS, with certain eligibility requirements that differ from those in U.S. GAAP. The current use of the fair value option under IFRS and U.S. GAAP is generally limited to larger, more complex banks and holding companies.

EC 4	Principle 21: Supervisory reporting
Criterion	The supervisor collects and analyses information from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.
Practices and Procedures	The U.S. federal banking agencies collect and analyze information quarterly from all banks, bank holding companies with consolidated assets of $500 million or more, and SHLCs of all sizes. If the BHC is below the $500 million threshold, then it submits a parent-only report on a semiannual basis. In addition, reports from other subsidiaries, such as nonbank subsidiaries, in the BHC are required to be submitted either quarterly or annually, depending of the size and nature of the subsidiary. See EC 1 for a listing of reports and reporting frequency. At large banks or holding companies where the agencies have on-site examination teams, supervisors receive frequent risk management reports that allow them to monitor the bank's or holding company's condition and trends in key portfolios and risk segments. Similarly, the agencies may direct individual banks and holding companies to provide information on a more frequent basis, depending on their risk profile. For example, monthly reports on key risk areas may be required from banks and holding companies that are identified as posing special supervisory concerns or that are subject to certain enforcement actions. In some situations, daily reports may be received on key funding or liquidity issues.

EC 5	Principle 21: Supervisory reporting
Criterion	In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
Practices and Procedures	The U.S. federal banking agencies collect reports on the same dates for all entities in the consolidated holding company. While the frequency may differ given the size and nature of the entity, the reporting dates are as of the calendar quarter end. Banks and holding companies are required to complete reports using a standard set of reporting instructions, thereby ensuring comparability of reported items between banks and holding companies. The agencies meet during the year to determine what revisions, if any, need to be made to regulatory reports, based on the needs of supervisors, changes in risk profiles, changes in accounting rules, or other factors. Revisions are usually made during the first calendar quarter of the following year. For example, revisions to the 2008 reporting requirements were determined during 2007, and implemented as of the first calendar quarter end for 2008 (i.e., March 31, 2008). However, changes to regulatory reports are sometimes implemented later in the year. For example, some reporting requirements changes will be implemented as of the second

EC 5	Principle 21: Supervisory reporting
	calendar quarter end for 2009 (i.e., June 30, 2009), and others will become effective as of the end of the fourth calendar quarter end (i.e., December 31, 2009). Implementation of reporting requirements is sometimes staggered to lessen the reporting burden to banks and holding companies. The agencies also work together to ensure, to the extent possible, that the information reported at the subsidiary level is comparable to information that is collected at the consolidated holding company level. In addition, revisions to supplemental reports for other entities (for example, a nonbank subsidiary report) are driven by changes made to the bank report and the consolidated holding company report which helps ensure that comparable information is reported across the holding company. *See* EC 1 for a listing of reports.

EC 6	Principle 21: Supervisory reporting
Criterion	The supervisor has the power to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or banking group, or to the assessment of the risks of the bank or banking group. This includes internal management information.
Legal Framework	As noted in the overview to Principle 19, the U.S. federal banking agencies have broad statutory authority to obtain a broad array of information from supervised banks and holding companies, including financial data and information on their activities, operations, structure, corporate governance, risk management, and any other details necessary to determine and enforce compliance with applicable laws and ensure the safety and soundness of banks and holding companies. *See* 12 U.S.C. §§ 93a, 161(a) and (c), 324-26, 481, 483, 602, 625, 1464(d) and(v), 1467 (d) and (h), 1467a(b)(2) and (4), 1467a(g), 1817(a), 1817(a)(2), 1817(a)(3), 1820(b), 1844(c), 3105(c), and 3108. Banks and holding companies must provide supervisors with full and complete access to their books, records, and employees; failure to do so can result in the imposition of administrative sanctions. These requirements extend to the foreign operations of banks and holding companies; however, it should be noted that the laws of foreign host countries may restrict U.S. banks and holding companies operating in such countries from sharing certain information with the U.S. banking agencies. Under these statutory authorities, U.S. federal banking agencies have the power to request and receive any relevant information from banks and holding companies, irrespective of their activities, where the supervisor believes that it is material to their financial situation, or to the assessment of the risks of the bank or holding company. This includes internal management information. (For national banks, *see* 12 U.S.C. § 161(a) and (c)). However, as discussed in greater detail in the overview to Principle 20, this authority is limited by the requirement that the federal banking agencies must rely to the fullest extent possible on the functional supervisors of the securities and insurance subsidiaries and any other subsidiary that is subject to functional supervision by a federal or state authority. *See* 12 U.S.C. §§ 1831v and 1844(c)(2)(E). Further, as noted under EC 4, the agencies have the authority to request more frequent and supplemental reports.
Practices and Procedures	U.S. federal banking agencies have the power and authorization to request any relevant information from banks and holding companies that is deemed necessary for supervisory purposes. Even affiliates of banks and holding companies that may generally

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	be exempt from reporting certain information can be required to do so by their U.S. federal banking agency. U.S. federal banking supervisors can request and obtain internal management information. In addition, an agency may request information from the functional supervisor for entities it does not supervise (for example, an insurance underwriting subsidiary that is functionally regulated by an insurance supervisor). *See* Principle 20 Overview for a more detailed discussion of functional regulation.

EC 7	Principle 21: Supervisory reporting
Criterion	The supervisor has the power of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management and staff, when required.
Legal Framework	Under the authorities cited in EC 6, the U.S. federal banking agencies have the power of full access to all bank and holding company records for the furtherance of supervisory work. The agencies also have similar access to the bank's or holding company's board, management, and staff, when required.
Practices and Procedures	U.S. federal banking agencies have the authority to review all books and records of a bank or holding company that are deemed necessary for supervisory purposes. The agencies have access to the bank's or holding company's board, management, and staff when required to discuss supervisory matters. Furthermore, the agencies have the authority to require a bank or holding company to submit any information if there is a supervisory need, even when a particular bank or holding company would not be otherwise required to submit such information.

EC 8	Principle 21: Supervisory reporting
Criterion	The supervisor has a means of enforcing compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for misreporting and persistent errors, and can require that inaccurate information be amended.
Legal Framework	As discussed under EC 6, banks and holding companies are required by statute to comply with reporting requirements and information disclosure requests of federal banking agencies. A failure to comply (including by submitting an untimely report or for misreporting or persistent errors) can provide the basis for informal or formal enforcement measures, including cease-and-desist (C&D) proceedings and the imposition of civil monetary penalties (CMP), against a bank or holding company and/or its institution-affiliated parties (IAPs). Under certain circumstances, a culpable IAP also may be subject to suspension and debarment. *See* 12 U.S.C. §§ 1817(a) and 1818(b) and (i). The remedial provisions are structured to be appropriate to the severity of the violation. These measures help ensure compliance with the requirement that information be submitted on a timely and accurate basis.

EC 8	Principle 21: Supervisory reporting
	As described more fully in Principle 22, public companies, including banks and holding companies that are required to file reports with the SEC, are required by the Sarbanes-Oxley Act of 2002[1] to obtain an annual audit of the financial statements and the internal controls over financial reporting. Public company officers must acknowledge in writing that they have evaluated the company's internal financial controls and the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) are required to sign and certify that they have reported to the independent auditors and to the audit committee all information regarding significant deficiencies in internal controls that could adversely affect the company's ability to provide accurate financial reports. *See* 15 U.S.C. § 7241. As described more fully in EC 10 and 11, for banks with assets of $1 billion or more, the agencies require annually (1) a statement of management's responsibilities for preparing the bank's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness; (2) an assessment by management of the bank's compliance with such laws and regulations during such fiscal year; and (3) an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. *See* 12 CFR 363.2.
Practices and Procedures	U.S. federal banking agencies can impose CMPs, negotiate memoranda of understanding (MOU) and issue C&D orders to banks and holding companies if information is not reported on a timely basis or on an accurate basis. The agencies can and do require banks and holding companies to amend previously filed reports when material errors have occurred. The consolidated financial statements for banks and holding companies must be signed by the CFO (or the individual performing the equivalent function) and this representative must attest that the report has been prepared in conformance with the instructions and the information contained therein is true and correct to the best of their knowledge and belief. The bank level report must also be signed by the CFO (or equivalent) as well as three members of the bank's board of directors and all attest that the report has been prepared in conformance with the instruction and the information contained therein is believed to be true and correct.

EC 9	Principle 21: Supervisory reporting
Criterion	The supervisor utilises policies and processes to confirm the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts.
Practices and Procedures	U.S. federal banking supervisors review and verify regulatory reports during the course of on-site examinations of banks and holding companies. For example, an area of significant regulatory interest and scrutiny is the accuracy of the reported allowance for loan and lease losses (ALLL). Comprehensive examination procedures are used to evaluate the ALLL. In addition, the U.S. federal banking agencies utilize extensive off-site automated programs that provide validity and quality checks ("edits") against the regulatory reports submitted by banks and holding companies. Some edits check the mathematical accuracy of certain areas of the regulatory reports (so-called "validity edits") while other edits review relationships between various aspects of

[1] Pub. L. 107-204 (July 30, 2002), 116 Stat. 745.

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	the reports and certain qualitative measures (called "quality edits"). All edit exceptions must either be corrected or explained. If an edit explanation provided by the reporting bank or holding company is found to be unacceptable by the federal banking agency, additional investigative work is performed with the reporting bank or holding company until the edit exception is resolved (sometimes resulting in amended reports). There cannot be any validity edits exceptions on the regulatory reports and all quality edit exceptions must be considered reasonable by the federal banking agency before the report is accepted by the federal banking agency. All edit explanations are documented and reviewed during the reports submission process. The agencies can require banks and holding companies to submit amended reports when supervisors identify material errors in information submitted to the agencies. For consumer compliance examinations, supervisors verify the accuracy of the HMDA and CRA data submitted and will require corrections if necessary.

EC 10	Principle 21: Supervisory reporting
Criterion	The supervisor clearly defines and documents the roles and responsibilities of external experts, including the scope of the work, when they are appointed to conduct supervisory tasks and monitors the quality of the work. External experts may be utilized for routine validation or to examine specific aspects of banks' operations.
Practices and Procedures	The banking agencies generally do not utilize external experts to perform supervisory tasks. However, on an as needed basis or during periods where staffing needs to be augmented, the agencies may use external experts to perform specific tasks such as commercial credit reviews. Tasks and deliverables are outlined in a formal contract with a defined timeline. Further, these roles are typically filled with former supervisors or subject matter experts who are supervised by agency personnel.

EC 11	Principle 21: Supervisory reporting
Criterion	The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.
Practices and Procedures	When banking agencies engage consultants or external experts (*see* EC 10), such experts and consultants are under the direct supervision of on-site agency personnel, and as a result, their findings are reported to the agencies.

Principle 22: Accounting and disclosure

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

(Reference document: *Enhancing bank transparency, September 1998.)*

Overview

Section 36 of the FDI Act, 12 U.S.C. § 1831m, requires, each bank exceeding a minimum asset threshold to submit an annual report to the appropriate U.S. federal and state banking agencies containing a report signed by the chief executive officer and the chief accounting or financial officer of the bank which includes a statement of management's responsibilities for preparing financial statements, establishing and maintaining an adequate internal control structure and procedures for financial reporting; and complying with safety-and-soundness laws and regulations. *See* 12 U.S.C. § 1831m(b)(2) and 12 CFR 363.2(b). The report must include an assessment, as of the end of the bank's most recent fiscal year, of (a) the effectiveness of such internal control structure and procedures; and (b) the bank's compliance with applicable safety-and-soundness laws and regulations. *See* 12 U.S.C. § 1831m(b)(2)(A) and (B). An independent public accountant must attest to and report separately on management's assertions. Id. at § 1831m(c).

The banks exceeding the minimum asset threshold are required to prepare annual financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP). *See* 12 U.S.C. § 1831m(b)(1) and section 37 of FDI Act, 12 U.S.C. § 1831n. However, the appropriate federal banking agency may determine that the application of any U.S. GAAP principle to any bank is inconsistent with the objectives of section 37 of the FDI Act, and may, with respect to reports or statements required to be filed with such agency, prescribe an accounting principle which is applicable to such banks and holding companies which is no less stringent than U.S. GAAP. These financial statements must be audited by an independent public accountant in accordance with U.S. GAAP. Id. § 1831m(d)(1). The accountant is required to determine and report whether the financial statements are presented fairly under U.S. GAAP. *See* 1831m(d)(2). Publicly traded institutions registered with the SECs are required to undergo a quarterly review of their financial statements by an independent public accountant, who must report findings to the bank's audit committee. That committee, in turn, must provide the accountant's report to any appropriate federal or state banking agency. Id. § 1831m(g)(2).

Independent public accountants providing these services to banks must meet certain statutory qualifying criteria. *See* 12 U.S.C. § 1831m(g)(3). The FDIC or an appropriate U.S. federal banking agency may remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing the audit services described above. Id. § 1831m(g)(4) and, for national banks, 12 CFR 19.243. In addition, an accountant, as an institution-affiliated party (IAP), may be subject to enforcement actions such as section 8 actions under the FDI Act, C&D proceedings, the imposition of CMP, and/or suspension or industry-wide debarment in connection with services provided to a bank. *See* 12 U.S.C. §§ 1813(u)(4), 1818(b). FDIC regulations elaborate on the duties of the independent public accountants. *See* 12 CFR 363.

Statutes and regulations address the applicability of the foregoing requirements to banks that are part of a holding company. In certain instances the audit requirements applicable under 12 U.S.C. § 1831m may be satisfied at the holding company level. In addition, the federal banking agencies have issued an interagency policy statement addressing external auditing programs. *See* "Interagency Policy Statement on External Auditing Programs of

Principle 22: Accounting and disclosure
Banks and Savings Associations," 64 *Fed. Reg.* 52319 (Sept. 28, 1999). The agencies apply this statement to all banks and holding companies. *See* Federal Reserve SR letter 99-33 (SUP) and OCC Bulletin 99-37, "Interagency Policy Statement on External Auditing Program" (Oct. 7, 1999)[1]. The agencies apply this statement to encourage all banking organizations not subject to other audit requirements to adopt an external auditing program, and they also support BCBS's report "Enhancing Bank Transparency," September 1998, available at www.bis.org/publ/bcbs41.pdf?noframes=1. The OTS requires an independent audit by a qualified independent public accountant of a savings association with a composite rating of 3, 4, or 5 or a SLHC that controls savings association subsidiaries with aggregate consolidated assets of $500 million or more. *See* 12 CFR 562.4(b)-(d).

EC 1	Principle 22: Accounting and disclosure
Criterion	The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that financial record-keeping systems and the data they produce are reliable.
Legal Framework	The information required to be provided by banks and holding companies is required to be accurate. (For national banks, *see* 12 U.S.C. § 161). To ensure accuracy and reliability, banks and holding companies must establish and maintain adequate financial record-keeping systems. *See* 12 U.S.C. § 1831m. As indicated in the overview to this principle, the federal banking agencies have broad remedial authority to take enforcement actions against a bank and its IAPs, including board members and management, if they provide misleading or false information.
Practices and Procedures	The U.S federal banking agencies have the supervisory power and responsibility to evaluate management's governance process and associated policies and procedures to ensure that entities are operating in a safe and sound manner and have sufficient capital to support the level of risk. The board of directors and senior managers of a bank or holding company are responsible for ensuring that the bank operates in a safe and sound manner. To meet the safety and soundness guidelines of section 39 of the FDI Act (*see* 12 U.S.C. § 1831p-1), the bank should maintain effective systems and internal controls to produce reliable and accurate financial reports. For national banks, *see generally* 12 CFR 30. Banks and holding companies are required to submit quarterly regulatory financial reports such as the Consolidated Reports of Condition and Income (Call Report) for banks, the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C) for BHCs, and the Thrift Financial Reports (TFRs) for OTS regulated savings associations and TFR Schedule HC and Form H-(b)11 Annual/current Report for SLHCs. These reports require the CFO (or equivalent) to attest to the accuracy of the report and its preparation in accordance with regulatory reporting instructions. Such instructions require the reports to be prepared in accordance with U.S. GAAP. Furthermore, Call Reports and TFRs require the bank's director (trustee) to certify the accuracy of the reporting prepared in accordance with regulatory reporting instructions which are based on U.S.GAAP. These reports are further described in Principle 21. Federal banking agency staff regularly review the accuracy of accounting data submitted to supervisors, and supervisors conduct periodic reviews of Call Report or TFRs and other data to determine whether the bank has effective policies and procedures in place to accurately report such data.

[1] The OCC encourages all national banks to have independent external audits of their operations and financial records. *See* OCC Bulletin. 99-37 and the Comptroller's Handbook, *Internal and External Audits* (Apr. 2003).

EC 1	Principle 22: Accounting and disclosure
	Banks that exceed a prescribed threshold are required by section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA 112) (*see* 12 U.S.C. § 1831m) and its implementing rules in 12 CFR 363 to obtain an independent external audit of its annual financial statements that are prepared in accordance with U.S. GAAP. The reporting threshold is currently established for banks with total assets of $500 million or more. In addition, at banks with total assets of $1 billion or more, management is required to provide an assessment of the effectiveness of the internal control structure and procedures and also to obtain an independent public accountant's assessment on the bank's internal control structure and procedures for financial reporting. *See* 12 CFR 363.3. Public companies, including banks and holding companies that are publicly registered must comply with SEC requirements, including the Sarbanes-Oxley Act of 2002[2] to obtain an annual audit of the financial statements and the internal controls over financial reporting. Public company officers must acknowledge in writing that they have evaluated the company's internal financial controls and the CEO and CFO are required to sign and certify that they have reported to the independent auditors and to the audit committee all information regarding significant deficiencies in internal controls that could adversely affect the company's ability to provide accurate financial reports. *See* 15 U.S.C. § 7241. Furthermore, it is unlawful for any officer or director of a public company, or any other person acting under their direction, to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant performing an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading. *See* id. § 7242. U. S. federal banking agencies review of safety and soundness includes review of risk management and accounting and financial controls. If the U. S. supervisor determines management's risk management or control process to be deficient, the supervisor has a number of available responses to address such deficiencies, including requiring increased regulatory capital or other supervisory measures. Further discussion of the available supervisory measures is included in other principles, including Principle 21, EC 8.

EC 2	Principle 22: Accounting and disclosure
Criterion	The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that the financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
Legal Framework	The broad remedial authority cited in the overview to this principle and referenced under EC 1 provides a sound basis for holding a bank's or holding company's board members and management responsible for ensuring that the financial statements issued annually to the public are reviewed and properly verified by an independent, appropriately credentialed public accountant, for those banks or holding companies that have external audit requirements as described in this principle.
Practices and Procedures	U. S. federal banking agencies, through regulation and guidance, strongly endorse sound corporate governance and auditing policies and practices for all banks. Supervisory regulation and guidance require banking organizations, including management and its

[2] Pub. L. 107-204 (July 30, 2002), 116 Stat. 745.

EC 2	Principle 22: Accounting and disclosure
	board, to have in place adequate governance and controls related to financial reporting. U. S. federal banking agencies require independent external audits on annual financial statements and related internal controls based on prescribed thresholds, regardless of whether the bank is public or non-public. Banks and holding companies that are publicly registered also must comply with SEC requirements, including the Sarbanes-Oxley Act to obtain an annual audit of the financial statements and the internal controls over financial reporting and are subject to the SEC's reporting requirements, including public reporting of quarterly and annual financial reporting. The audited annual financial statements, as well as quarterly financial statements, of public companies are made publicly available by the SEC and by the OTS for certain publicly reporting savings associations that are subject to CEO and CFO certification. U. S. supervisors require banks and holding companies to file applicable financial reports that include financial statements and reports of condition that reflect the capital to be accurate. These reports, for both public and non-public banks and holding companies, are made public by the federal banking agencies with the exception of certain information deemed confidential (such as certain data related to Fiduciary and Related Services). As described in EC 3 for this principle, such financial statements are required to be certified by the bank's or holding company's CFO and a specified number of directors (trustees).

EC 3	Principle 22: Accounting and disclosure
Criterion	The supervisor requires banks and holding companies to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits net of appropriate provisions.
Practices and Procedures	U. S. supervisors require banks and holding companies to file applicable financial reports via Call Reports, TFRs or Consolidated Financial Statements that result in financial statements and reports of condition that reflect the capital to be accurate. The accounting principles applicable to reports or statements required to be filed with federal banking agencies by all banks and holding companies shall be uniform and consistent with, and no less stringent than U.S. GAAP as required in Section 37 of the FDI Act. *See* 12 U.S.C. § 1831n(a)(2). The supervisors' requirements for banks to utilize valuation rules that are consistent, realistic, and prudent, taking account of current values, where relevant, are further described in EC 3 of Principle 21. The banking agencies, through the Federal Financial Institutions Examination Council (FFIEC), issue reporting instructions for required regulatory financial reports. Those reporting instructions require banks to report pretax income net of the provision for loan and lease losses. The supervisory approach related to banks' provisions and reserves is included in Principle 9. *See* "Interagency Policy Statement on the Allowance for Loan and Lease Losses," 66 *Fed. Reg.* 35629 (July 6, 2001); FDIC FIL-1-5-2006; and OCC Bulletin 2001-37, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions" (July 20, 2001).

EC 4	Principle 22: Accounting and disclosure

EC 4	Principle 22: Accounting and disclosure
Criterion	Laws or regulations set, or the supervisor has the power, in appropriate circumstances, to establish, the scope of external audits of individual banks and holding companies and the standards to be followed in performing such audits.
Legal Framework	In general, external auditors must determine and report whether the financial statements of a bank are presented fairly in accordance with GAAP. *See* 12 U.S.C. § 1831m(d)(2). In general, the external audits must meet or exceed the scope and procedures required by generally accepted auditing standards (GAAS). Id. § 1831m(f).
Practices and Procedures	The U.S. supervisors require banks covered by section 36 of the Federal Deposit Insurance Act (12 U.S.C. § 1831m), as implemented by part 363 of the FDIC's regulations (12 CFR 363) (i.e., banks with more than $500 million in total assets at the beginning of their fiscal year), to have an external financial statement audit by an independent public accountant. *See* 12 U.S.C. §§ 1831m(d)(1) and (g)(1). Savings associations with composite ratings of less than "1" or "2," including those with less than $500 million in total assets, also require an independent audit. SLHCs that control savings association subsidiaries with aggregate consolidated assets of $500 million or more also require an independent audit. 12 CFR 562.4(b). These banks and holding companies are required, and all other banks and holding companies are encouraged, to have an external audit performed in accordance with GAAS. The scope of the audit engagement shall be sufficient to permit an auditor to determine and report whether the financial statements taken as a whole are presented fairly and in accordance with U.S. GAAP. The audit shall be conducted in accordance with GAAS and section 37 of the FDI Act. *See* 12 U.S.C. § 1831n. An "Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations" was issued in September 1999, (64 *Fed. Reg*. 52319 (Sept. 28, 1999)), to provide guidance to banks in maintaining effective systems and internal control to produce reliable and accurate financial reports. For national banks, *see* 12 CFR 30, appendix A, § II.A. While some banks and holding companies are not subject to independent audit requirements, the agencies encourage them to obtain independent audits. *See, e.g.,* OCC Bulletin 1999-37 (Oct. 7, 1999), "Interagency Policy Statement On External Auditing Programs" (Oct. 7, 1999) and Comptroller's Handbook, *Internal and External Audits* (Apr. 2003). GAAS generally require an auditor to adequately plan the audit, be independent, and obtain reliable evidence. Audit standards for non-public and public companies are prescribed by the American Institute of Certified Public Accountants (AICPA) and the Public Company Accounting Oversight Board (PCAOB), respectively.

EC 5	Principle 22: Accounting and disclosure
Criterion	Supervisory guidelines or local auditing standards determine that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, and the adequacy of internal controls over financial reporting.
Legal Framework	As noted under EC 4, external audits generally must meet or exceed the scope and procedures required by GAAS. External audits may have to comport with additional requirements, as determined by the supervisor by regulation, guideline, guidance, or other related materials.

EC 5	Principle 22: Accounting and disclosure
Practices and Procedures	As previously discussed, U. S. supervisors require certain banks and holding companies to obtain annual audits of financial statements performed in accordance with appropriate U.S. GAAP and GAAS and external audits of internal controls over financial reporting. Financial statement audits cover areas such as loans, allowance for loan losses, and asset valuations as appropriate to enable the auditor to provide an opinion on whether the financial statements as a whole are presented fairly. Approximately 97 percent of consolidated assets in U.S. bank holding companies were audited as of year-end 2007 as compiled from the item, "Name of the External Auditing Firm" collected on the *Consolidated Financial Statements for Bank Holding Companies*—FR Y-9C and on the *Parent Company Only Financial Statements for Small Bank Holding Companies*—FR Y-9SP. For a smaller bank not subject to the audit requirements, a non-audit attestation engagement is likely to be less costly than an audit of its financial statements. Such an attestation engagement may be performed for all internal controls relating to the preparation of annual financial statements or specified schedules of the bank's regulatory reports. This type of engagement is performed under generally accepted standards for attestation engagements. This report could provide recommendations for improving internal control, including suggestions to mitigate risks.

EC 6	Principle 22: Accounting and disclosure
Criterion	The supervisor has the power to reject and rescind the appointment of an external auditor that is deemed to have inadequate expertise or independence, or not to be subject to or not to follow established professional standards.
Legal Framework	As noted in the overview to this principle, independent public accountants providing these services to banks must meet certain statutory qualifying criteria. *See* 12 U.S.C. § 1831m(g)(3). The FDIC or an appropriate federal banking agency may remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing the required audit services for a bank. Id. § 1831m(g)(4) and, for national banks, 12 CFR 19.243. "Good cause" would exist, for example, when the external auditor is determined to have inadequate expertise or independence or not to be subject to or follow established professional standards. For national banks, *see* 12 CFR 19.243(a). Each bank is required to provide the FDIC and the appropriate federal banking agency with written notice, within a specified time period, of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged and must include a statement of the reason for such event. *See* 12 CFR 363.4(d). An independent public accountant performing an audit who ceases to be the accountant for a bank is required to notify the FDIC and the appropriate federal banking agency in writing of such termination within a specified time period and set forth the reasons for the termination. *See* 12 CFR 363.3(c).
Practices and Procedures	In the US, auditors are licensed by individual states and must comply with appropriate licensing requirements. Individual states can censure or remove auditors who have been deemed not to comply with appropriate auditing standards. In addition, auditors who audit public companies must register with the PCAOB which reviews selected audits and evaluates adherence to U.S. GAAP and GAAS. These reviews are performed at least every three years. The larger public accounting firms are evaluated every year. Section 36 of the FDI Act indicates that all auditors who provide services under the FDI Act must be subject to an outside (peer) review. *See* 12 U.S.C. § 1831m(g)(3)(A). Banking agencies have the authority to remove, suspend or bar an independent public

EC 6	Principle 22: Accounting and disclosure
	accountant upon showing of good cause from performing audit services under the act. For national banks, *see* 12 CFR 19.243. In addition, in 1999 the federal banking agencies issued rules of practice with respect to the FDI Act ("Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions," 64 *Fed. Reg*. 52319 (Sept. 28, 1999)) which include supervisor guidance with respect to external audits. *See* 12 CFR 363. The key is that the board or audit committee approve the external audit program, the firm is independent, the engagement letter is adequate, and the board exercises adequate due diligence. U.S. supervisors typically review board minutes and other documents to evaluate external audit's independence as well as review part 363 Annual Reports and Peer Review reports submitted by certain banks. In addition, the supervisors may review the audit work papers. If there is evidence that the work would not meet appropriate external audit standards, further action would be taken, including disbarment of the accountant. If a supervisor concludes, based on the review of the specific work performed, discussions with the audit firm, or other documentation, that the external auditor does not have the requisite expertise, independence, or does not follow established professional standards, the supervisor discusses these findings and the actions the agency may take with the bank's senior management, board of directors (or audit committee), and the external auditor. If the issue cannot be resolved, then the banking agency can bar the accountant from performing audits under the act.

EC 7	Principle 22: Accounting and disclosure
Criterion	The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that are widely accepted internationally and have been audited in accordance with internationally accepted auditing practices and standards.
Legal Framework	As discussed in the overview to this principle, banks are required by statute to produce annual audited financial statements based on U.S. GAAP and that have been audited in accordance with GAAS. Other audit requirements apply to holding companies.
Practices and Procedures	U.S. federal banking agencies require banks to submit quarterly regulatory financial reports such as the Consolidated Reports of Condition and Income (Call Report) for banks, the TFR for OTS institutions, the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C) for BHCs, and TFR Schedule HC and Form H-(b)11 Annual/Current Report for SLHCs that are prepared in accordance with U.S. GAAP. These reports follow U.S. GAAP, which is accepted internationally. A limited number of other reports for foreign-based banking organizations currently allow the option of U.S. GAAP or other accounting principles, such as International Financial Reporting Standards (IFRS). Banks that exceed a prescribed threshold are required by FDICIA 112 (12 U.S.C. § 1831m) and its implementing rules in 12 CFR 363, to obtain an independent external audit of their annual financial statements. Annual financial statements must be prepared in accordance with U.S. GAAP and external audits must be prepared in accordance with GAAS. *See* 12 U.S.C. §§ 1831m(b)(1) and (d)(1) and 12 CFR 363.2(a) and 363.3(a).

EC 8	Principle 22: Accounting and disclosure
Criterion	Laws, regulations or the supervisor require periodic public disclosures of information by banks and holding companies that adequately reflect the bank's true financial condition. The requirements imposed should promote the comparability, relevance, reliability and timeliness of the information disclosed.
Legal Framework	Under the statutory provisions cited in the overview to this principle, interagency guidelines implementing the advanced Basel II approaches, and supervisory guidance, the federal banking agencies require the periodic public disclosures of information by banks and holding companies that adequately reflect their true financial condition, including capital adequacy. For national banks, *see generally* 12 CFR 3 and 18. The disclosure requirements are broadly applicable, subject to uniform submission deadlines, and ensure the timeliness and relevance of information. Uniform requirements ensure comparability of information. Accuracy and reliability are ensured by separate requirements regarding the adequacy of financial record-keeping systems; adherence to these requirements is reinforced by the specter of substantial remedial consequences for submitting misleading or false information.
Practices and Procedures	As cited previously in this principle, banking supervisors require banks and holding companies to complete and submit prescribed regulatory reports which the supervisors make publicly available quarterly. These regulatory reports are based on regulatory reporting instructions that follow U.S. GAAP. These accounting principles and the required standardized regulatory reporting forms and instructions for required quarterly regulatory reporting promote the comparability, relevance, and reliability of information in a timely fashion. Furthermore, banks and holding companies registered with the SEC and the OTS have additional quarterly and annual financial reporting and disclosure requirements. Federal banking agencies review regulatory reports on a periodic basis and if the agencies determine that the information or disclosures are incorrect, they may require that the bank or holding company restate regulatory reports. Information in regulatory reports may differ from that required in audited financial statements. U.S. banks adopting the Advanced Approaches or Standardized Approach rules under Basel II will also be subject to the Pillar 3 public disclosure requirements. For national banks, *see* 12 CFR 3, appendix C, Part VIII.

EC 9	Principle 22: Accounting and disclosure
Criterion	The required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance. The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and complexity of a bank's operations.
Practices and Procedures	As described previously, federal banking agencies require that banks follow U.S. GAAP in their financial reporting, including regulatory reporting. U.S. GAAP provides guidance on financial reporting and disclosures matters, including qualitative and quantitative information. Financial reports of publicly traded banks [and holding companies] include financial statements with all U.S. GAAP and PCAOB disclosures and Management's Discussion and Analysis. Regulatory reports (such as the Call Report, TFR, and the FR Y-9C) consider the size and complexity of a bank's or holding company's operations in the scope and content of required information and the commensurate level of disaggregation and detail. For example, banks with a significant amount of trading activity (trading assets and trading liabilities that exceed a prescribed threshold)

EC 9	Principle 22: Accounting and disclosure
	are required to complete a detailed trading schedule. In addition, some of the regulatory reports provide the opportunity for the reporting banks to provide footnotes or narrative disclosures, which may be either quantitative or qualitative in nature. As mentioned previously, U.S. banks adopting Basel II will be subject to the Pillar 3 disclosure requirements; these disclosures are both qualitative and quantitative in nature as well.

EC 10	Principle 22: Accounting and disclosure
Criterion	Laws, regulations or the supervisor provide effective review and enforcement mechanisms designed to confirm compliance with disclosure standards.
Legal Framework	As discussed under ECs 6 and 8 to Principle 21, federal banking agencies require by statute that banks comply with reporting requirements and information disclosure requests of federal banking agencies. Failure to comply can provide the basis for informal or formal enforcement measures, including cease-and-desist (C&D) proceedings and the imposition of civil monetary penalties (CMP), against a bank and/or its IAPs. *See* 12 U.S.C. §§ 1813(u), 1817(a), and 1818(b) and (i). Under certain circumstances a culpable IAP (such as an auditor) also may be subject to suspension and debarment. *See* 12 U.S.C. § 1818(e). The remedial provisions are structured to be appropriate to the severity of the violation. These measures help ensure compliance with the disclosure standards.
Practices and Procedures	The supervisory review of a bank's safety and soundness includes review of internal controls related to financial reporting and Basel II Pillar 3 disclosures when implemented for applicable U.S. banks. If the supervisor determines management's risk management or control process to be deficient, the supervisor has a number of available responses to address such deficiencies, including requiring increased regulatory capital or other supervisory measures. Further discussion of the available supervisory measures is included in other principles, including Principle 21, EC 8. All regulatory reports filed with the federal bank supervisor are reviewed for accuracy and completeness (i.e., validity checks; see EC 9 of Principle 21). Follow-up with reporting banks is performed when necessary. The SEC has the primary responsibility for ensuring review of public disclosures of public companies and for taking enforcement action, as necessary. The SEC coordinates with the appropriate banking supervisory on enforcement matters affecting banks. The PCAOB reviews the auditors of public companies to ensure that the auditors comply with prescribed accounting regulations and disclosures.

EC 11	Principle 22: Accounting and disclosure
Criterion	The supervisor or other relevant bodies publish aggregate information on the banking system to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and

EC 11	Principle 22: Accounting and disclosure
	statistical parameters that reflect the principal aspects of banks and holding companies' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).
Legal Framework	The federal banking agencies publish aggregate information on the banking system, including balance sheet indicators and statistical parameters reflecting the principal aspects of banks' operations (e.g., balance sheet structure, capital ratios, income earning capacity, and risk profiles). This facilitates public understanding of the banking system and the exercise of market discipline.
Practices and Procedures	For each bank, the banking agencies publish Uniform Bank Performance Reports (UBPR) and the OTS publishes the Uniform Thrift Performance reports (UTPR) which are primarily based on the information reported on the Call Reports and TFRs. These reports are also made publicly available by the banking supervisors. The UBPR and TFR include various indicators and ratios involving financial position, financial performance, and capital for peer groups, including deposit composition and stability, ratios of loan commitments to total loans and of standby letters of credit to total loans, the loan-to-deposit ratio (at community banks), the ratio of temporary investments to volatile liabilities, and the ratio of pledged securities to total securities. A similar report is produced by the Federal Reserve for aggregated BHC information, the Bank Holding Company Performance Report (BHCPR).

AC 1	Principle 22: Accounting and disclosure
Criterion	The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.
Practices and Procedures	The federal banking agencies meet periodically with external audit firms as well as the FASB, AICPA and the PCAOB to discuss accounting, audit, and financial disclosure issues related to banks and holding companies. Supervisors also meet periodically with external audit firms with respect to individual banks and holding companies to discuss general and specific issues with respect to their accounting and disclosure practices. In addition, external auditors will typically ask to speak to the supervisors before signing off on annual financial statements to ensure that the supervisors do not have information that would preclude their sign-off.

AC 2	Principle 22: Accounting and disclosure
Criterion	External auditors, whether or not utilised by the supervisor for supervisory purposes, have the duty to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, or other matters which they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations ensure that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.
Legal Framework	External auditors, as with banking organizations and other IAPs, must not provide inaccurate or misleading information to supervisors.
Practices and Procedures	Supervisors in the United States do not use auditors for supervisory purposes. However, as part of the evaluation of a bank's compliance with part 363 of the FDIC rules, supervisors would review communication to management and the audit committee

AC 2	Principle 22: Accounting and disclosure
	made by the external auditors. External auditors will also notify management and the audit committee (or board of directors) of any control issues noted as a result of the financial statement audit (usually contained in a management letter). An external auditor may also be engaged to audit or examine the effectiveness of a bank's internal control over financial reporting and express an opinion on it at the end of the fiscal year under section 112 of FDICIA (*see* 12 U.S.C. § 1831m or section 404 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7262)). In connection with such an engagement, the auditor also has a responsibility to communicate certain information concerning internal control matters to management and the audit committee. Banks subject to part 363 of the FDIC rules and regulations must provide any management letter or other report from their auditor to the appropriate federal and state supervisors within 15 days of receipt of such communication. (*see* guideline 25 of part 363) Guidelines and professional standards related to the auditor's communication of internal control deficiencies are continually evolving. Standards are established by the AICPA for nonpublic company audits and attestation engagements and by the PCAOB for public company audits. Depending on a bank's size and whether it or its parent is a public company, internal control-related reports submitted pursuant to part 363 would include the auditor's report on the effectiveness of internal control over financial reporting, either as part of the part 363 annual report or separately; reports on significant deficiencies and material weaknesses; and reports on other internal control matters, which may be in the form of a management letter. Supervisory guidance requires audits of banking organizations to be performed in accordance with the PCAOB's or AICPA's auditing standards. Under those standards, when an auditor concludes that an illegal act (i.e., violations of laws or government regulations) has or is likely to have occurred, the auditor is expected to consider the effect of the illegal act on the financial statements and to ensure that those charged with governance are adequately informed of the illegal act. The communication to those charged with governance may be conveyed either orally or in writing. However, if the communication is oral, the audit workpapers must document the communication. Supervisory guidance gives federal banking supervisors access to communications between the auditor and the bank client. In addition, federal banking supervisors have the authority to review auditors' workpapers.

AC 3	Principle 22: Accounting and disclosure
Criterion	Laws, regulations or the supervisor require banks and holding companies to rotate their external auditors (either the firm or individuals within the firm) from time to time.
Legal Framework	Section 203 of the Sarbanes Oxley Act of 2002 made it unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer. *See* 15 U.S.C. § 78j-1(j).
Practices and Procedures	To strengthen auditor independence and improve audit quality, the Sarbanes-Oxley Act includes a provision regarding mandatory audit partner rotation for firms auditing public companies. The act requires the lead audit partner and audit review partner (or concurring reviewer) to be rotated every five years on all public company audits. *See* 15 U.S.C. § 78j-1(j). The act requires a

AC 3	Principle 22: Accounting and disclosure
	concurring review of all audits of issuers (as defined in the act). *See* id. § 7213(a)(2)(A)(ii). The SEC adopted rules to effectuate the statutory requirement of audit partner rotation found in section 203 of the Sarbanes-Oxley Act. *See* 17 CFR 210.2-01(c)(6). In addition to the five-year rotation requirement of the lead and concurring audit partners, the rules also mandate a five-year "timeout" period after rotation. The rules, as adopted, specify that certain other significant audit partners will be subject to a seven-year rotation requirement with a two-year "timeout" period. The rule provides an alternative for firms with fewer than five public audit clients and fewer than ten partners. The alternative requires the PCAOB to review all of the firm's engagements subject to the rule at least once every three years. As described in the "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters," (*see* 71 *Fed. Reg.* 6847 (Feb. 9, 2006), FIL-13-2006, OCC Bulletin 2006-7 (Feb. 9, 2006)), auditor independence standard-setters include the SEC, PCAOB, and the AICPA. Auditors of large banks are required to satisfy the independence requirements of the SEC, PCAOB and AICPA. Auditors of all other banks are required to comply with the independence standards issued by one or more of these standard-setters. For other non-public banks that are not required to have an annual independent audit pursuant to either part 363 of the FDIC's regulations or section 562.4 of the OTS's regulations, an external auditor must meet only the AICPA independence standards.

AC 4	Principle 22: Accounting and disclosure
Criterion	The supervisor requires banks and holding companies to have a formal disclosure policy.
Legal Framework	Banks, particularly those adhering to the interagency guidelines on the 1996 Market Risk Amendment and the Basel II approaches, are required to have a formal disclosure policy.
Practices and Procedures	The accounting systems and procedures used for general-purpose financial statements and regulatory reporting purposes are critically important to enhancing the transparency of a bank's risk profile and financial position. Adequate disclosure allows market participants to better understand the bank's financial condition and apply market discipline, thus creating incentives to reduce inappropriate risk-taking or inadequate risk-management practices. Accordingly, a bank is required to have an appropriate governance and control structure over the preparation of financial reporting and disclosures. This includes properly approved written policies that provide clear guidelines on accounting and disclosure matters, consistent with U.S. GAAP and the bank's regulatory requirements.

AC 5	Principle 22: Accounting and disclosure
Criterion	The supervisor has the power to access external auditors' working papers, where necessary.
Legal	External auditors of large banks are required to agree to provide related audit working papers, policies, and procedures to

AC 5	Principle 22: Accounting and disclosure
Framework	supervisors, if requested. *See* 12 U.S.C. § 1831m(g)(3)(A). As a matter of best practice, supervisors expect all banks, regardless of asset size, to obtain agreement of an independent public accountant or other external auditor in the engagement letter to grant supervisors access to all the accountant's or auditor's work papers and other material pertaining to the bank prepared in the course of performing the completed external auditing program.
Practices and Procedures	The independent public accountant or external auditor of a large bank is required to provide the supervisor with access to the audit working papers. As set forth in "Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions," (*see* 64 *Fed. Reg*. 52319 (Sept. 28, 1999)), banks should obtain an engagement letter from their auditors which states that supervisors will be granted immediate and full access to the external auditing reports and related workpapers prepared by the auditor. Banks that fail to grant access of such audit working papers are subject to informal or formal enforcement actions as previously discussed. *See* Federal Reserve SR letter 99-33 (SUP) and OCC Bulletin 99-37.

Principle 23: Corrective and remedial powers of supervisors

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.

(Reference document: *Parallel-owned banking structures, January 2003)*

Overview

If a U.S. federal banking agency determines that a bank or holding company has problems that may affect safety and soundness or is not in compliance with laws and regulations, it may take a supervisory action to ensure that the bank or holding company undertakes corrective measures. Typically, such findings are communicated to the management and directors of a bank or holding company in a written report. The management and directors are then asked to address all identified problems voluntarily and to take measures to ensure that the problems are corrected and will not recur. Most problems are resolved promptly after they are brought to the attention of a bank's or holding company's management and directors. In some situations, however, the appropriate agency may need to take an informal supervisory action, requesting that a bank or holding company adopt a board resolution or agree to the provisions of a memorandum of understanding to address the problem.

If necessary, the appropriate agency may take formal enforcement actions to compel the management and directors of a troubled bank or holding company, or persons associated with it, to address the bank's or holding company's problems. For example, if a bank or holding company has significant deficiencies or fails to comply with an informal action, the agency may enter into a written agreement with the troubled bank or holding company or may issue a cease-and-desist order against the bank or holding company or against an individual associated with it, such as an officer or director. The agency may also assess a fine (a "civil monetary penalty" or "CMP"); remove an officer or director from office and permanently bar him or her from the banking industry, or both. CMPs are tiered and applied in accordance with the severity of the violation at issue. All final formal enforcement orders issued and written agreements executed by the agencies are published on the agencies' public websites.

A special remedial regime applies when a bank has a capital deficiency. Under this so-called Prompt Corrective Action or PCA regime, the agencies and banks are required to take certain actions promptly to resolve capital deficiencies . The PCA statute, 12 U.S.C. § 1831o, establishes mandatory and discretionary restrictions on any bank that fails to remain at least adequately capitalized. By regulation, the agencies have defined the capital categories and the restrictions each triggers. *See*12 CFR 208.43 (Federal Reserve), 12 CFR 6 (OCC), and 12 CFR 565 (OTS). The primary federal banking supervisor for a bank may take a range of mandatory and discretionary actions if a bank's capital falls below the required minimum level for any relevant capital measure. The severity of the supervisory action depends on the severity of the capital shortfall.

In addition to the remedies discussed above, there are also other actions to penalize banks and holding companies and their management for violating rules and regulations and failing to correct safety-and-soundness concerns. These actions can include restricting new activities or acquisitions and, in the most serious instances, revoking the charter of the bank and terminating Federal Reserve membership or federal deposit insurance.

EC 1	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor raises supervisory concerns with management or, where appropriate, the Board, at an early stage, and requires that

EC 1	Principle 23: Corrective and remedial powers of supervisors
	these concerns are addressed in a timely manner. Where the supervisor requires the bank to take significant remedial actions, these are addressed in a written document to the Board. The supervisor requires the bank to submit regular written progress reports and checks that remedial actions are completed satisfactorily.
Practices and Procedures	Generally, U.S. federal banking agencies identify problems or deficiencies at a bank or holding company during on-site examinations. Most problems or deficiencies are resolved informally during the course of the examination through discussions with the bank's or holding company's management and directors in which the bank or holding company immediately takes steps to correct or commits to promptly correct the problems or deficiencies and address the regulatory concerns. At the conclusion of the examination of a bank, supervisors send a written "Report of Examination" (ROE) to the bank for review by all directors and senior officers. The ROE assesses the condition of the bank's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS); identifies any violations of law; assesses compliance with the Bank Secrecy Act; and addresses compliance to consumer laws and regulations and the Community Reinvestment Act. *See* Attachment A of the Interagency Adopted "Uniform Financial Institutions Rating System" as described in Principle 7. The narrative of the ROE also calls attention to matters that need attention. One example of a U.S. federal banking agency policy on communication of examination findings is the Federal Reserve's 2008 supervisory letter "Communication of Examination/Inspection Findings" at www.federalreserve.gov/BoardDocs/srletters/2008/SR0801.htm. Similarly, the OCC's policy on communication can be found in the *Bank Supervision Process*, *Community Bank Supervision*, and *Large Bank Supervision* booklets of the OCC Comptroller's Handbook[1], and OTS's communication policy can be found in Regulatory Bulletin 37-4, "Ratings, Assigning, and Presenting." Similar reports are issued after the inspection of a holding company. Holding company rating systems are somewhat different from those of banks and are described in connection with Principle 6, EC 3. Some problems or deficiencies may not be easily addressed through discussion with the bank's or holding company's management, especially if the problems or deficiencies are serious, pervasive, or repeated. In such cases, the agencies may take supervisory actions, which are described in detail in the responses to EC 3, 4, and 5. Generally, supervisory actions require a bank or holding company to take certain affirmative actions and make periodic (monthly or quarterly) reports to the federal banking agency on the progress that the bank or holding company has made to address the deficiencies identified in the examination. Detailed policies and action plans with specific target dates may be requested from a bank or holding company, and supervisors will review the plan for sufficiency and examine progress against key milestone dates.

EC 2	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor participates in deciding when and how to affect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
Practices and	Please see the responses to EC 3, 4, and 5 for a description of supervisory tools available to address problems, deficiencies, or

[1] www.occ.gov/handbook/banksup.pdf; www.occ.gov/handbook/cbsh2003intro.pdf; www.occ.gov/handbook/lbs.pdf.

EC 2	Principle 23: Corrective and remedial powers of supervisors
Procedures	violations at banks and holding companies. When a problem bank does not have the ability or resources to solve its deficiencies, the U.S. federal banking agencies have authority to appoint a conservator or a receiver.[2] The agencies may appoint a conservator or receiver under a variety of circumstances, including when a bank is critically undercapitalized or when it is undercapitalized and has no reasonable prospect of becoming adequately capitalized; is unable to meet depositors' demands for payment; or is operating in an unsafe or unsound condition that would likely cause insolvency or substantially dissipate the bank's assets. It should be noted, the Federal Reserve's ability to appoint a conservator or receiver for a holding company is more limited by statute than the OCC's, FDIC's, and OTS'sfor a bank. The FDIC may use its back-up authority to appoint itself conservator or receiver of any insured bank under these same criteria. The conservator takes full control of the bank and assumes the powers of the shareholders and board of directors. Under federal law, a conservator can repudiate contracts and temporarily limit customer withdrawals and payments to creditors, thereby avoiding a liquidity crisis and liability for failure to make payments. If the bank returns to a safe and sound condition, the conservator may return control of the bank to the shareholders or prepare the bank for sale. The agencies may generally close a bank and appoint a receiver on the same grounds described above for conservatorship. (For state-chartered banks, the appropriate state banking agencies have concurrent powers to close banks, but the grounds vary by state). By law, the FDIC is always appointed the receiver for closed insured banks.

EC 3	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor has available an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation.
Legal Framework	As described in the overview to this principle, U.S. federal banking agencies have a range of supervisory options when, in the supervisors' judgment, a bank or holding company is not complying with laws, regulations or supervisory decisions, or is engaged in an unsafe and unsound practice. The agencies may take prompt remedial action and impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation. *See* 12 U.S.C. § 1818 for a description of many of the types of formal enforcement actions that the agencies are authorized to take.
Practices and Procedures	U.S. federal banking agencies have a broad range of supervisory tools to address problems or deficiencies at the banks and holding companies they supervise. Supervisory actions are generally remedial and are intended to provide the bank or holding company with

[2] A holding company is subject to the same Federal bankruptcy laws that apply to other types of companies.

EC 3	Principle 23: Corrective and remedial powers of supervisors
	guidance on how to fix the problems or deficiencies identified at the examination. Informal, non-public supervisory action is usually sufficient to resolve most deficiencies. Such action may include requiring the bank's or holding company's board of directors to adopt a resolution to cure the deficiencies, develop and implement a safety-and-soundness plan, conform to individual minimum capital ratios established by the agencies (applicable to banks only), or execute a memorandum of understanding with the supervisor. In the event that the problems, deficiencies or violations of law are pervasive, repeated, unresolved by management, or otherwise of serious concern, the agencies may exercise their statutory enforcement authority by taking a formal enforcement action against a bank or holding company. Formal enforcement actions against banks and holding companies include (i) Formal or Written Agreements (Agreements); (ii) Cease and Desist Orders (C&D); (iii) Safety and Soundness Orders; (iv) Capital Directives; (v) PCA Directives (applicable to banks only); and (vi) Civil Money Penalty Assessments (CMP). Federal banking agencies may also take temporary injunctive action using a temporary C&D order under certain conditions. The federal enforcement statutes associated with such actions are the same for all of the agencies. Formal enforcement action often requires affirmative action by the bank or holding company and may include restitution or reimbursement. In determining whether a formal enforcement action is appropriate, the agency staffs consider all relevant factors, including the nature, severity, and duration of the problem, the risks presented at the particular bank or holding company, the anticipated resources and actions necessary to resolve the problem, and the responsiveness of the directors and management. Under certain circumstances, such as the failure of a bank to establish or correct problems with an anti-money laundering compliance program , the federal enforcement statutes require formal enforcement action. See 12 U.S.C. § 1818(s)(3) Formal enforcement actions are legally enforceable, remain in effect until modified or terminated, and must be publicly disclosed by the appropriate agency. See 12 U.S.C. §1818(u). In addition to the overall enforcement authority of the federal banking agencies, specific statutes authorize the agencies to take actions. For example, under the Truth in Lending Act (15 U.S.C. § 1601 *et seq*.), the federal banking agencies, may order creditors to make monetary and other adjustments to the accounts of consumers in cases where an annual percentage rate or finance charge was inaccurately disclosed. For more details on the guidelines regarding these orders of restitution, *see* the *Joint Policy Statement on Administrative Enforcement of the Truth in Lending Act – Restitution*. www.fdic.gov/regulations/laws/federal/98TILFF.pdf (*See also* statutory requirement that federal banking agencies use C&D orders for failures to establish or correct problems with anti-money laundering compliance, 12 USC § 1818(s). For specific examples, links to the agencies' enforcement actions public websites are Federal Reserve: www.federalreserve.gov/boarddocs/enforcement/search.cfm OCC: www.occ.treas.gov/enforcementactions/ FDIC: www.fdic.gov/bank/individual/enforcement/index.html OTS: www.ots.treas.gov?p=Enforcement

EC 3	Principle 23: Corrective and remedial powers of supervisors
	A CMP may be assessed by the agencies under various federal banking laws. See, e.g., 12 U.S.C. § 1818(i). The bases for such assessments may include violations of law, regulation, or the terms of a formal supervisory action, or failure to meet regulatory reporting requirements. Assessments are based on an analysis of the facts and circumstances of the case and consideration of any mitigating factors that are required to be taken into account by law, such as the financial resources of the bank, holding company, or individual, good faith, gravity of the violation, history of previous violations, and other mitigating factors. All informal supervisory actions and Agreements are taken with the consent of the bank or holding company. C&D orders and CMP assessments are generally issued with the consent of the bank or holding company. In the event that a bank or holding company fails to consent, the agency may initiate a contested proceeding to impose the order or assessment. In cases where there is an immediate threat to the viability of the bank or holding company or to the depositors' interests, due to violations of law, regulation, or ongoing unsafe or unsound practices, an agency may take immediate action by issuing a temporary order to C&D. Such an order is effective immediately and may be issued with or without the bank's or holding company's consent. The provisions are narrowly focused to address the cause of immediate harm to the bank or holding company. The temporary order to cease and desist remains in place until either the bank or holding company consents to a C&D order or the conclusion of a contested proceeding to impose a C&D order. As more fully described in the response to EC 5, the agencies are also required by statute to take action to promptly address capital deficiencies at banks.

EC 4	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor has available a broad range of possible measures to address such scenarios as described in EC 3 above and provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, Board directors or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license.
Legal Framework	The U. S. federal banking agencies have available a broad range of possible measures to address the scenarios described in EC 3. Together, statutes, regulations, guidelines, and guidance contain clear prudential objectives and set out the actions to be taken. Possible remedial measures include restricting the current activities and operations of the bank or holding company; withholding or conditioning approval of new activities or acquisitions; restricting or suspending payments to shareholders or share repurchases; restricting asset transfers; barring individuals from banking; replacing or restricting the powers of managers, board directors, or controlling owners; facilitating a takeover by, or merger with, a healthier bank or holding company, providing for the interim management of the bank or holding company; and revoking or recommending the revocation of the banking license.

EC 4	Principle 23: Corrective and remedial powers of supervisors
Practices and Procedures	As specifically authorized by statute, the U.S. federal banking agencies may, through formal supervisory action, require the bank or holding company to cease and desist from violations of law or regulation or unsafe or unsound practices and take affirmative actions. Among the actions specifically enumerated in the statute, an agency may restrict the bank's or holding company's growth; require the bank or holding company to dispose of any loan or asset involved in the violation or unsafe or unsound practice; require the bank or holding company to employ qualified officers and employees; and take any other action that the agency deems appropriate. Formal enforcement actions generally include provisions that specifically address the bank's or holding company's problems, deficiencies, violations, or unsafe or unsound practices. The provisions may require the bank or holding company to stop certain actions or to take affirmative actions. Some provisions may require a bank or holding company to submit specific plans, policies, or procedures that are acceptable to the federal banking agency. Common provisions for formal enforcement actions require the bank or holding company to cure specified violations, correct risk management or board of directors oversight weaknesses, submit an acceptable plan to increase or maintain sufficient capital, provide for an adequate allowance for loan and lease losses, employ qualified officers and employees, and restrict the payment of dividends. As described in the response to EC 2, the agencies generally have the power to provide interim management (conservatorship) for a bank or to close a bank (receivership) under a variety of circumstances. As described in the response to EC 6, the agencies also have statutory authority to take formal enforcement actions against officers, directors, or employees of a bank or holding company supervised by the federal banking agencies. Enforcement action examples: Federal Reserve Agreement with First Pryority Bank, Pryor, Oklahoma: dated March 23, 2008, requires capital maintenance plan and improvements in corporate governance, loan policies, and credit administration. www.federalreserve.gov/newsevents/press/enforcement/enf20080403a1.pdf OCC Agreement with Millennium Bank, N.A., Reston, Virginia: dated January 24, 2008, requires maintenance of specific capital ratios, hiring a senior lending officer, and improvements to lending policies, loan portfolio management, and asset/liability management. www.occ.treas.gov/FTP/EAs/ea2008-012.pdf FDIC Cease and Desist Order against Integrity Bank, Alpharetta, Georgia: dated February 20, 2008, requires improvements to board of directors' oversight, maintenance of specific capital ratios, and reductions in classified assets. www.fdic.gov/bank/individual/enforcement/2008-02-02.pdf OTS Cease and Desist Order against Downey Savings and Loan Association, Newport Beach, California: dated September 5, 2008, requires capital augmentation, reduction of classified assets, disposition of real estate owned, strengthening of management, and implementation of a business plan, and imposes restrictions on asset growth, management changes, employment contracts and

EC 4	Principle 23: Corrective and remedial powers of supervisors
	compensation arrangements, severance and indemnification arrangements, capital distributions, transactions with affiliates, and certain forms of lending. http://files.ots.treas.gov/enforcement/97011.pdf

EC 5	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor has the power to take measures should a bank fall below the minimum capital ratio, and seeks to intervene at an early stage to prevent capital from falling below the minimum. The supervisor has a range of options to address such scenarios.
Legal Framework	As discussed in the overview to this principle and under EC 6 to Principle 6 (on capital adequacy), a PCA regime applies to those instances in which a bank's capital falls below the minimum ratios. The regime encourages intervention at an early stage to resolve issues and prevent further deterioration. The specific capital level triggers and remedial consequences attached to each are described in detail under EC 6 of Principle 6. In addition, under 12 U.S.C. § 3907 the federal banking agencies are required to "cause banking institutions to achieve and maintain adequate capital" by, among other things, establishing minimum capital levels. If a bank or holding company fails to maintain capital at or above its minimum level, the statue specifically provides that the appropriate federal banking agency may deem the failure an unsafe or unsound practice within the meaning of 12 U.S.C. §1818 and issue a capital directive – enforceable to the same extent as a C&D – that requires the bank or holding company to submit a capital plan to achieve its required capital level. The federal banking agencies have issued implementing regulations. See, e.g., 12 CFR 263.80, et seq. (Federal Reserve).
Practices and Procedures	The above-described PCA statute and accompanying regulations were enacted to promptly resolve capital deficiencies at banks and thereby reduce failures, as well as to impose mandatory and discretionary restrictions on a bank that fails to remain at least adequately capitalized. For example, any bank that is less than adequately capitalized cannot pay dividends and must submit a capital restoration plan that is acceptable to the supervisor. Capital categories definitions, which are uniform for each of the U.S. federal banking agencies, can be found at edocket.access.gpo.gov/cfr_2007/janqtr/pdf/12cfr208.43.pdf. Additional mandatory restrictions apply to significantly and critically undercapitalized banks, such as limitations on growth. The agencies may also take several discretionary actions when the bank is less than adequately capitalized. These restrictions are imposed by the agency's issuance of a PCA Directive, with or without the consent of the bank. For a bank that is critically undercapitalized, the statute generally requires that the bank be recapitalized, sold, merged, or liquidated within 90 days. Procedurally, once a bank becomes less than adequately capitalized, it must submit, within 45 days or less, an acceptable plan to its agency to restore the bank to an adequately capitalized condition. The above-described capital directive scheme is another option available to federal banking agencies to facilitate the prompt resolution of capital deficiencies at banks and holding companies. It should be noted that the agencies intervene at even earlier stages to address capital weaknesses through the types of supervisory

EC 5	Principle 23: Corrective and remedial powers of supervisors
	actions described in the response to EC 3. PCA examples: OCC Prompt Corrective Action Directive against Community National Bank: dated June 19, 2008, requires the bank to dismiss the CEO and president and sever ties with themwww.occ.treas.gov/FTP/EAs/ea2008-062.pdf Federal Reserve Prompt Corrective Action Directive against Neighborhood Community Bank, Newnan, Georgia: dated May 27, 2009, requires the sale or merger of the bank within 30 days. http://www.federalreserve.gov/newsevents/press/enforcement/enf20090528a1.pdf OTS Prompt Corrective Action Directive against Imperial Savings and Loan Association, Martinsville, Virginia: dated June 11, 2008, requires the sale or merger of the bank within 60 days; imposes mandatory restrictions on dividends, management fees, growth, brokered deposits, and executive compensation. files.ots.treas.gov/enforcement/96377.pdf

EC 6	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor applies penalties and sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.
Legal Framework	As discussed in the overview to this principle, remedial penalties and sanctions may be applied to banks and holding companies and, when appropriate, to management, board members, employees, and other individuals who participate in a bank's or holding company's affairs (Institution-Affiliated Parties or IAPs).
Practices and Procedures	Formal supervisory actions, including penalties and sanctions, may be taken against the bank or holding company and its IAPs. These actions include: Cease and Desist Order – provisions may limit the individual's activities at the bank or holding company, require the individual to take affirmative action, or make restitution or reimbursement to the bank or holding company if the individual was unjustly enriched by the violation or practice or demonstrated reckless disregard for the law. Removal and Prohibition Order – a U.S. federal banking agency may remove any current IAP from the bank or holding company for violations of law and other misconduct and prohibit any current or former IAP from further participation in the banking industry. A removed or prohibited individual may not serve as an officer, director, or employee of a bank or holding company, acquire shares of a bank or holding company, or exercise certain shareholder rights without prior regulatory approval. To support a Removal and

EC 6	Principle 23: Corrective and remedial powers of supervisors
	Prohibition order, in addition to determining that the individual involved has engaged in a violation of law or regulation or in other specified misconduct, the agency must determine that the individual's misconduct caused or will probably cause loss to the bank or holding company, prejudice depositors, or resulted in gain to the individual and that the individual has demonstrated continuing or willful disregard for the safety and soundness of the bank or holding company or the individual's action involved personal dishonesty. Suspension Order – an agency may suspend a current IAP if the agency determines that the party's conduct meets the standard for removal and that a suspension is necessary to protect the bank or holding company or its depositors. A Suspension order is immediately effective upon being served and remains in effect until the proceeding on the proposed Removal and Prohibition order is resolved, unless stayed by a court. Civil Money Penalty – may be assessed by an agency against an individual under the same circumstances as described in the response to EC 3. Examples of enforcement actions against an individual: FDIC Prohibition Order and Assessment of a Civil Money Penalty: *In the Matter of Bobby G. Sorrells, an Institution-Affiliated Party of Valley State Bank, Russellville, Alabama*, dated February 8, 2008, prohibits the individual from participation in any bankor holding company supervised by the agencies and requires the payment of a civil money penalty of $30,000. www.fdic.gov/bank/individual/enforcement/2008-02-10.pdf OCC Order of Prohibition, Removal, Restitution, and Assessment of a Civil Money Penalty: *In the Matter of Carlos Bernace, former President and Director, Hamilton Bank, N.A., Miami, Florida*, dated October 31, 2002, prohibits the individual from participation in any bankor holding company supervised by the agencies, requires restitution of $210,000, and requires the payment of a civil money penalty of $40,000. www.occ.treas.gov/FTP/EAs/ea2003-122.pdf OTS Order of Prohibition: *In the Matter of Curtis VanDerWal, former Loan Officer and Institution-Affiliated Party, Horizon Federal Savings Bank, Oskaloosa, Iowa*, dated April 30, 2008, prohibits the individual from participation in any bankor holding company supervised by the agencies. files.ots.treas.gov/enforcement/96369.pdf Federal Reserve Order of Prohibition and Order of Assessment of Civil Money Penalty Issued Upon Consent: *In the Matter of G. Craig Chupik, a Former Institution-Affiliated Party of PlainsCapital Bank, Dallas, Texas,* dated March 19, prohibits the individual from participation in any banking organization supervised by the agencies and requires the payment of a civil money penalty of $20,000. http://www.federalreserve.gov/newsevents/press/enforcement/enf20090323b1.pdf

AC 1	Principle 23: Corrective and remedial powers of supervisors
Criterion	Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.
Legal Framework	The PCA statute requires early intervention by supervisors to address capital shortfalls of banks. The capital levels triggering supervisory action are clear and objective, and the associated remedial measures are mandatory.
Practices and Procedures	In general, the U.S. federal banking agencies strive to promptly address deficiencies, problems, or violations of law or regulation at the supervised banks and holding companies. As described in the response to EC 1, the deficiencies or problems are most often resolved through the ongoing dialogue that occurs during the examination process. When further supervisory action is necessary, it is, again, most often accomplished through informal supervisory action (which is not mandated by statute). When formal supervisory action is necessary, the agencies take appropriate measures in a timely manner. Aside from PCA, there are generally no specific statutory requirements that establish timetables for taking supervisory action. However, formal enforcement actions require that corrective measures should be established within adequate timeframes for each of the articles in the enforcement action. As described in the response to EC 5, PCA requires the agencies to take actions to promptly address capital deficiencies at banks. A bank or holding company must submit a capital restoration plan within 45 days or less of becoming less than adequately capitalized; the agency must review the plan within 60 days of submission and determine if it is acceptable.

AC 2	Principle 23: Corrective and remedial powers of supervisors
Criterion	The supervisor has the power to take remedial actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related companies in matters that could impair the safety and soundness of the bank.
Legal Framework	The U.S. federal banking agencies have the authority to impose conditions on the relationships between banks and any other entity, including a holding company, subsidiary, parallel owned banking organization or other related company in order to prevent or address a threat to the safety and soundness of the banks.
Practices and Procedures	As described in the responses to EC 3 and 4, the U.S. federal banking agencies have broad powers to order remedial actions that can protect a bank from adverse actions by its holding company or affiliate. For example, remedial actions may limit or prohibit payments from the bank to its holding company or affiliates. The Federal Reserve and the OTS, as the supervisors of holding companies, have the authority to take a full range of enforcement actions against holding companies and their nonbank affiliates. Provisions of such enforcement actions may include restrictions on intercorporate transactions, prohibitions on the holding company accepting payments from the bank, and requirements for the holding company to provide managerial and financial support to the bank.

AC 2	Principle 23: Corrective and remedial powers of supervisors
	Enforcement action examples: Federal Reserve Agreement with WSB Financial Group, Inc., Bremerton, Washington: dated April 23, 2008, limits the parent bank holding company from taking dividends or other payments from the bank. www.federalreserve.gov/newsevents/press/enforcement/enf200800429a1.pdf Federal Reserve Agreement with Heritage Bancorp Company, Inc. and First Bank of Cleveland, Cleveland, Oklahoma: dated October 26, 1999, *see* paragraphs 25 and 26 for limitations on intercorporate and affiliate transactions. www.federalreserve.gov/boarddocs/press/enforcement/1999/199911163/Attachment.pdf OCC C&D Order against International City Bank dated February 12, 2009; prohibits transactions with affiliates without prior formal board approval. http://www.occ.treas.gov/FTP/EAs/ea2009-011.pdf OTS Cease and Desist Order: *In the Matter of American Sterling Corporation, Foothill Ranch, California*, dated August 26, 2008 limits holding company transactions with its bank subsidiary, requires a capital augmentation plan, limits holding company debt, requires liquidity reports and notices of changes of directors or senior executive officers, and restricts severance and other compensation arrangements. files.ots.treas.gov/enforcement/97009.pdf

AC 3	Principle 23: Corrective and remedial powers of supervisors
Criterion	When taking formal remedial action in relation to a bank, the supervisor ensures that the regulators of non-bank related financial entities are aware of its actions and, where appropriate, coordinates its actions with them.
Legal Framework	The "Policy Statement on Interagency Notification and Coordination of Enforcement Actions" discusses federal banking agency coordination. *See* Federal Reserve SR letter 97-5 (ENF) and 62 *Fed. Reg*. 7782 (1997) .
Practices and Procedures	The U.S. federal banking agencies work closely together to address supervisory concerns of common interest. The Federal Reserve and the OTS, as the "umbrella" supervisors of holding companies and their subsidiaries, rely on the federal and state supervisors of "functionally regulated" subsidiaries to examine those subsidiaries and take supervisory actions when appropriate. The Federal Reserve and OTS coordinate their actions and share information where appropriate with other U.S. federal banking agencies and foreign supervisors to effect supervisory action and reduce regulatory redundancies. The following examples illustrate coordination of supervisory actions among the supervisors. In 2005, the Federal Reserve, OCC, and SEC took separate, coordinated formal supervisory actions against Bank of America

AC 3	Principle 23: Corrective and remedial powers of supervisors
	Corporation, Charlotte, N.C., a bank holding company; its wholly owned subsidiary bank, Bank of America, N.A., Charlotte, N.C.; and Banc of America Capital Management LLC, a registered investment adviser; BACAP Distributors, LLC, a registered investment adviser; and Banc of America Securities, LLC, a registered investment adviser and broker dealer, respectively. www.federalreserve.gov/boarddocs/press/enforcement/2005/20050209/attachment.pdf In 2006, the Federal Reserve, FDIC, OTS and SEC took separate, coordinated formal supervisory actions against three Puerto Rico holding companies and their wholly owned subsidiary banks (Doral Financial Corp. and Doral Bank; R&G Financial Corp. and RG Premier Bank; First Bancorp and First Bank). www.federalreserve.gov/newsevents/press/enforcement/enf20060317c1.pdf www.federalreserve.gov/newsevents/press/enforcement/enf20060317a1.pdf www.federalreserve.gov/newsevents/press/enforcement/enf20060317b1.pdf

Principle 24: Consolidated supervision
An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Overview The Federal Reserve is responsible for the comprehensive consolidated supervision for U.S. bank holding companies (BHCs), including financial holding companies (FHCs). The Federal Reserve's recently issued supervisory guidance entitled, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations," provides comprehensive guidance on this issue. ((www.federalreserve.gov/boarddocs/srletters/2008/SR0809.htm) SR letter 08-9). With respect to savings and loan holding companies (SLHCs), the consolidated supervisor is the OTS. See the OTS's *Holding Companies Handbook*. Other reference documents of interest include[1]: C*onsolidated supervision of banks' international activities, March 1979; Principles for the supervision of banks' foreign establishments, May 1983; Minimum standards for the supervision of international banking groups and their cross-border establishments, July 1992;* and *The supervision of cross-border banking, October 1996; Home-host information sharing for effective Basel II implementation, June 2006.*

EC 1	**Principle 24: Consolidated supervision**
Criterion	The supervisor is familiar with the overall structure of banking groups and has an understanding of the activities of all material parts of these groups, domestic and cross-border.
Legal Framework	As an essential component of consolidated supervision, the consolidating supervisors have and maintain a current understanding of all material parts of these groups, including their domestic and cross-border operations. For BHCs, the consolidating supervisor is the Federal Reserve, as set out in the Bank Holding Company Act (BHC Act) and enhanced by Gramm-Leach Bliley Act (GLBA). With respect to SLHCs, the consolidating supervisor is the OTS, as set forth in the Home Owners' Loan Act (HOLA). The Federal Reserve and OTS rely on relevant primary supervisors[2] and functional regulators for information about financial institutions within holding companies. The Federal Reserve and the OTS obtain this information at the time of formation of a holding company, authorization of a new activity or activity including in a new supervisory jurisdiction, changes in a bank's or holding company's structure, in the course of ongoing supervision, in identifying and addressing supervisory concerns, in crisis situations, and as part of periodic and ad hoc meetings among supervisors and with the banking group's management. Among other things, the agencies are familiar with the banking group's legal structure and entities, nature and locus of activities, interrelationships among entities (transactions among affiliates), and methods for exercising oversight over domestic and cross-border operations (including manner of implementing policies and procedures, such as by or across legal entities).
Practices and	All BHCs (including FHCs) are subject to supervision by the Federal Reserve on a consolidated basis. All SLHCs are subject to

[1] www.bis.org/publ/bcbsc112.pdf?noframes=1; www.bis.org/publ/bcbsc312.pdf?noframes=1; www.bis.org/publ/bcbsc314.pdf?noframes=1; www.bis.org/publ/bcbs27.pdf?noframes=1; and www.bis.org/publ/bcbs125.pdf?noframes=1.

[2] The term "primary supervisor" refers to the primary federal banking supervisor of a bank or savings association subsidiary of a holding company or of a U.S. banking office of an FBO. *See* the self assessment introduction for a description of supervisory responsibilities held by primary supervisors.

EC 1	Principle 24: Consolidated supervision
Procedures	supervision by the OTS on a consolidated basis (*See* OTS *Holding Companies Handbook*.) Consolidated supervision allows the consolidated supervisor to understand the banking organization's structure, activities, resources and risks and address financial, managerial, operational or other deficiencies before they pose a danger to the holding company's subsidiary banks. In order to develop a risk assessment and supervisory plan, the consolidated supervisor must have an understanding of the legal, operating, and corporate governance structure of the consolidated organization (domestic and cross-border) and its primary strategies, businesses, and risk management and internal controls functions. As described above, the Federal Reserve and OTS rely on primary supervisors to obtain much of this information. (*See* SR letter 08-9 attachment A.1, for a description of key elements of the supervisory strategy and the OTS *Holding Companies Handbook*.)

EC 2	Principle 24: Consolidated supervision
Criterion	The supervisor has the power to review the overall activities of a BHC, both domestic and cross-border. The supervisor has the power to supervise the foreign activities of banks incorporated within its jurisdiction.
Legal Framework	The BHC Act grants the Federal Reserve broad authority to inspect and obtain reports from a BHC and its subsidiaries concerning, among other things, the organization's financial condition, systems for monitoring and controlling financial and operational risks, and compliance with the BHC Act and other federal law (including consumer protection laws) that the Federal Reserve has specific jurisdiction to enforce. Similarly, the HOLA grants the OTS broad authority to examine, regulate, and supervise SLHCs, as well as to take any necessary actions against these entities to prevent them from engaging in unsafe or unsound practices or violations of the law. In addition, federal law authorizes the Federal Reserve and the OTS to take action against a holding company or nonbank subsidiary to prevent these entities from engaging in unsafe or unsound practices, or to address violations of law that occur in connection with their own business operations even if those operations are not directly connected to the holding company's subsidiary banks. The Federal Reserve has also established consolidated capital standards for BHCs. The OTS requires SLHCs to maintain capital levels that are sufficient to support the risk profile of the overall SLHC enterprise. These capital requirements and standards help ensure that a SLHC maintains adequate capital to support its consolidated activities, does not become excessively leveraged, and is able to serve as a source of strength for its bank subsidiaries. *Foreign Operations of Domestic Banking Organizations.* The consolidated supervisor has broad authority to review, through on-site examinations and off-site surveillance, the activities of a bank and holding company whether conducted domestically or cross-border. This extends to obtaining information (directly or indirectly, from other supervisors) on affiliates of a domestic bank (wherever located) necessary to assess the impact of those affiliates on the bank and holding company. *See* 12 U.S.C. §§ 338; 1467a(b)(4). The U.S. federal banking agencies are authorized by statute to regulate and supervise the foreign activities of banks. For example, the Federal Reserve has statutory power to authorize the establishment of foreign branches of member banks, authorize the establishment of so-called Edge corporations (essentially, domestically chartered entities through which member banks and their BHCs hold foreign operations), authorize the investments and activities of Edges and so-called agreement corporations (state

EC 2	Principle 24: Consolidated supervision
	chartered corporations that agree with the Federal Reserve to limit their activities to those permissible for Edges), and authorize the acquisition of foreign banking organizations by member banks or BHCs. *See* 12 U.S.C. §§ 601-02 and 12 CFR 211.3-10. The Federal Reserve also is expressly authorized to supervise these operations. *See* 12 U.S.C. § 602. The OCC has authority to supervise foreign branches of national banks as well as other foreign operations undertaken by national banks or national bank subsidiaries. In fact, the OCC has examination staff located in London to assist in the on-site supervision of the U.S. bank operations in Europe. *See* 12 U.S.C. §§ 161, 481, 602, and 12 CFR 28.3(c). The OTS has broad authority to supervise savings associations, SLHCs, and their affiliates, wherever located. *See* 12 U.S.C. §§ 1464(a) and (d)(1)(B)(i), 1467a(b). As part of its regulation and supervision of banks and holding companies, the relevant U.S. supervisor evaluates the extent to which foreign legal requirements might restrict its access to information necessary to determine and enforce compliance with relevant U.S. laws. If material impediments exist and cannot be adequately addressed, the U.S. banking supervisor may refuse to allow a U.S. bank or holding company to expand in a foreign jurisdiction that restricts access to essential information. The U.S. supervisor may also take remedial actions if information cannot be obtained due to foreign law restrictions. Such actions may include the termination of the foreign operations.[3]

EC 3	Principle 24: Consolidated supervision
Criterion	The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
Legal Framework	The U.S. federal banking agencies have implemented a comprehensive supervisory framework that evaluates the risks non-banking activities conducted by banks and holding companies may pose to the consolidated organization. The authority for this stems from the overarching duty of the agencies to protect the safety and soundness of banks, 12 U.S.C. § 1831p-1, including through the imposition of prudential safeguards. Statutory provisions expressly authorize examinations of and the submission of reports by regulated banks, *see*, 12 U.S.C. §§ 324-26 & 438 (the Federal Reserve with respect to member banks and their affiliates), 12 U.S.C. §§ 334, 338, and 1844(c), including parent holding companies; 12 U.S.C. §§ 161, 481 and 602 (the OCC with respect to national banks), 12 U.S.C. §§ 1464(d)(1) and 1467 a(b)(4) (OTS with respect to savings associations and SLHCs and their affiliates).
Practices and Procedures	As the U.S. federal banking agencies charged with supervising holding companies on a consolidated basis, the Federal Reserve and the OTS have the authority and responsibility to understand and assess the risks that the parent holding company and its nonbank subsidiaries may pose to itself or its banks. *See* SR letter 08-9 for a description of the primary objectives of Federal Reserve supervision of the nonbank subsidiaries of a BHC and the OTS *Holding Company Handbook* for the supervisory approach that applies to SLHCs. Supervisory activities: For all significant nonbanking subsidiaries and nonbanking activities of the parent holding company, the Federal Reserve and the OTS use continuous monitoring activities and periodic discovery review examination activities to (i)

[3] *See, e.g.,* page 158 of the 2007 FFIEC BSA/AML Examination Manual (www.occ.gov/handbook/1-BSA-AMLwhole.pdf).

EC 3	Principle 24: Consolidated supervision
	maintain an understanding of these units' operations, financial condition, inherent risks and risk-management practices, and (ii) assess the adequacy of risk management and internal controls, including those relating to compliance risk. Periodic testing examination activities may also be used to ensure that key risk management and internal control practices conform to legal requirements and to internal policies, and to understand and assess operations presenting a moderate or greater likelihood of significant negative impact to a subsidiary bank 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 bank, or to the holding company's ability to serve as a source of financial and managerial strength to its bank subsidiaries, and testing will focus on controls for identifying, monitoring, and controlling such risks. • Functionally regulated subsidiaries - In all situations, the consolidated supervisors rely to the fullest extent possible on the information and assessments developed by the appropriate functional regulator of a functionally regulated subsidiary. In addition, the consolidated supervisors adhere to the procedural and other requirements governing examinations of, or requests for a specialized report from, a functionally regulated subsidiary. Under these provisions, for example, the consolidated supervisors may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, they reasonably determine that the examination is necessary to adequately inform the consolidated supervisors about 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 bank subsidiary of the organization. *See* 12 U.S.C. § 1844(c)(2)(B)

EC 4	Principle 24: Consolidated supervision
Criterion	The supervisor has the power to impose prudential standards on a consolidated basis for the banking group. The supervisor uses its power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. The supervisor collects consolidated financial information for each banking group.
Legal Framework	In general, the consolidated supervisors impose the prudential standards discussed under Principles 6-16 (on capital adequacy, risk management, and risk-specific measures), the internal audit and controls measures described under Principle 17, and the accounting and disclosure standards discussed under Principle 22 on a consolidated, group-wide basis. As those discussions indicate, the authority to impose measures in this manner is explicitly conferred by statute or expressly addressed by regulation, interagency guideline, supervisory guidance, or related materials. In addition, this authority is implicit in the U.S. federal banking agencies' responsibility for safeguarding the safety and soundness of banks.
Practices and Procedures	Holding companies are expected to serve as sources of financial and managerial strength to their subsidiary banks including by standing ready to use available resources to provide adequate capital funds during periods of financial stress or adversity and maintaining the financial flexibility and capital-raising capacity to obtain additional resources for providing assistance as needed. Holding companies must comply with a broad range of prudential standards aimed to assure their ongoing ability to act as a source of financial and managerial strength to subsidiary banks. The agencies apply a common standard for measuring risk-based capital adequacy that is consistent with the Basel Accord. BHCs

EC 4	Principle 24: Consolidated supervision
	and U.S. banks are subject to tier 1 risk-based and total risk-based capital ratio requirements on a consolidated basis. They also are subject on a consolidated basis to a capital requirement (a leverage ratio) that is not adjusted for risk. The minimum capital requirements for BHCs and U.S. banks are 4 percent tier 1 risk-based capital, 8 percent total risk-based capital, and 4 percent tier 1 leverage capital (3 percent for certain strong BHCs). Most BHCs, particularly those that are expanding or experiencing unusual or high levels of risk, operate with capital levels well above these minimums. An FHC must comply with the capital rules applicable to BHCs. Moreover, to qualify as and to remain an FHC, each bank subsidiary of the FHC must, among other things, be well-capitalized (i.e., maintain tier 1 leverage, tier 1 risk-based, and total risk-based capital ratios of at least 5 percent, 6 percent, and 10 percent, respectively) and well-managed (as determined by the rating assigned management by the primary supervisor). Functionally regulated subsidiaries of BHCs and FHCs are subject to any capital requirements imposed by their functional regulator. BHCs must report all relevant capital measures to U.S. federal banking agencies quarterly. This information is publicly available. Leverage and risk-based capital minimums apply to banks and BHCs, and federal banking agencies require banks and BHCs to have internal capital management processes and capital levels that meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the bank and BHC's capital needs. Current capital adequacy and future capital needs are evaluated in a systematic and comprehensive manner in light of their risk profiles and business plans (*See* SR letter 99-18, sections 300 and 940 of the OTS *Holding Companies Handbook*, and OCC's *Capital and Dividend Accounts Handbook*[4]). These internal capital management processes are subject to regular internal review as well as review during the supervisory examination or inspection process. While the OTS maintains standardized capital requirements for all savings associations, the OTS does not apply a single standardized requirement to all SLHCs. SLHCs are too diverse to develop a single, meaningful capital ratio requirement since many are engaged in significant lines of business other than banking. The OTS takes a case-by-case approach, which considers the overall risk profile of the entire conglomerate to ensure solvency and assess the adequacy of capital on a consolidated basis. Generally, the OTS considers three capital measures in determining SLHC capital sufficiency: GAAP equity, tangible capital, and a measure similar to tier 1 core capital ratio for SLHCs that are primarily engaged in financial activities. Other functional or foreign regulators may impose additional regulatory capital measures. SLHCs must report GAAP capital and tangible capital components to the OTS on a quarterly basis. The quarterly SLHC financial schedule filed with the OTS became public as of the quarter ended March 31, 2009. Holding companies file consolidated financial reports on a quarterly basis and most of the content of these reports is available publicly. In addition, publicly traded holding companies are subject to SEC filing requirements, which include quarterly and annual reports containing extensive quantitative and qualitative data. Disclosure information is verified on an ongoing basis through the

[4] www.occ.gov/handbook/Capital1.pdf

EC 4	Principle 24: Consolidated supervision
	examination process and through the review of surveillance data.

EC 5	Principle 24: Consolidated supervision
Criterion	The supervisor has arrangements with other relevant supervisors, domestic and cross-border, to receive information on the financial condition and adequacy of risk management and controls of the different entities of the banking group.
Legal Framework	*See* Principle 1(6).
Practices and Procedures	Under the information sharing arrangements described under Principle 1(6), the U.S. federal banking agencies receive information from other supervisors, domestic and foreign, on the financial condition and adequacy of risk management and controls of the different entities of the bank or holding company. Effective consolidated supervision requires strong, cooperative relationships between the federal banking agencies and relevant domestic and foreign primary banking supervisors or functional regulators. These relationships respect the individual statutory authorities and responsibilities of the respective supervisors and regulators and provide for appropriate information flows and coordination so that individual responsibilities can be carried out effectively while limiting the potential for duplication or undue burden. Information sharing among domestic and international supervisors, consistent with applicable law and the jurisdiction of each supervisor, is essential to ensure that a bank's and holding company's global activities are supervised on a consolidated basis. These concepts underlie the provisions of the GLBA that govern the interaction between the Federal Reserve and the OTS as consolidated supervisors, and the other primary banking supervisors and functional regulators. Under these provisions, in conducting consolidated supervisory responsibilities the Federal Reserve and the OTS rely to the fullest extent possible on (i) reports that a bank holding company or its subsidiary has provided to other federal or state supervisors or to an appropriate self-regulatory organization; (ii) information that is otherwise required to be reported publicly; and (iii) externally audited financial statements. In addition, the Federal Reserve and the OTS rely to the fullest extent possible on the reports of examination of (i) a bank made by its appropriate federal or state supervisory authority, (ii) a broker-dealer or investment adviser made by or on behalf of the SEC or Commodity Futures Trading Commission (CFTC), relevant state regulatory authority, or (iii) a licensed insurance company made by, or on behalf of, its appropriate state regulatory authority. In developing its overall assessment of a bank and holding company, the Federal Reserve and the OTS also rely to the fullest extent possible on the assessments and information developed by these other supervisors and regulators. The federal banking agencies assist each other by sharing pertinent information to the extent permissible. This includes information regarding the financial condition, risk-management policies, and operations of a bank and holding company that may have a material impact on the bank subsidiaries, as well as information concerning transactions or relationships between the bank and its affiliates. The U.S. federal banking agencies, in conjunction with state bank and thrift supervisors, have in place a number of formal and

EC 5	Principle 24: Consolidated supervision
	informal mechanisms to facilitate consolidated supervision. These mechanisms cover, among other things, the coordination of examinations, communication protocols for emergency situations, and shared access to electronic databases that contain examination reports, financial records, and other supervisory information. In addition, functional regulators, such as the SEC, the CFTC and state insurance supervisors exchange information with the federal banking agencies related to securities and insurance companies in a holding company or a financial conglomerate that includes a bank. U.S. law authorizes the federal banking agencies to exchange financial records, examination reports and other information regarding banks and holding companies. Information sharing among international supervisors, consistent with applicable law, is essential to ensure that a bank's and holding company's global activities are supervised on a consolidated basis. *See* Principle 25 for more details.

EC 6	Principle 24: Consolidated supervision
Criterion	The supervisor has the power to limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted; the supervisor uses this power to determine that the activities are properly supervised and that the safety and soundness of the bank are not compromised.
Legal Framework/ Practices and Procedures	As discussed under Principles 3, 23, and 25, the U.S. federal banking agencies have the power, at authorization or as a remedial measure, to limit the range of activities a bank or holding company may conduct and the locations in which activities can be conducted. In practice, the federal banking agencies use this power to ensure that the consolidated organization's activities are properly supervised and that the safety and soundness of the bank and holding company are not compromised.

EC 7	Principle 24: Consolidated supervision
Criterion	The supervisor determines that management is maintaining proper oversight of the bank's foreign operations, including branches, joint ventures and subsidiaries. The supervisor also determines that banks' policies and processes ensure that the local management of any cross-border operations has the necessary expertise to manage those operations in a safe and sound manner and in compliance with supervisory and regulatory requirements.
Practices and Procedures	As outlined in SR letter 08-9, section 3, the Federal Reserve's processes for understanding and assessing firm-wide legal and compliance risk management 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 banks and holding companies, and include proper oversight of licensed operations, operating in compliance with supervisory and regulatory requirements, and the sufficiency of MIS. The OTS's assessment of a SLHC's risk-management function also includes both domestic and international holding companies. *See* OTS *Holding Companies Handbook*, sections 200, 400 and 500. The supervisory approach used by the federal banking agencies is implemented on an enterprise-wide basis, across legal entities. In so doing, the agencies evaluate the effectiveness of the bank's and holding company's policies, procedures, controls, and risk-

EC 7	Principle 24: Consolidated supervision
	management processes across the organization. This includes audit programs, management information systems, and review processes that provide the organization with input on the performance of local managers. An assessment of cross-border operations is incorporated into the evaluation of key corporate governance functions and primary firm-wide risk management and internal control functions, including legal and regulatory risk management. Usually there are issues that are unique to a bank's or 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, which often requires the organization to devote additional resources necessary for maintaining expertise in local regulatory requirements. In some instances, privacy concerns have led to limits being placed on information that can be shared by a foreign office with its parent holding company, limiting the parent holding company's ability to exercise consolidated risk management on a global basis. In these cases, strong internal controls and audit processes are particularly important. Supervisory activities: The Federal Reserve and the OTS conduct continuous monitoring activities to understand and assess each holding company's cross-border strategy, trends, and legal entity structure, and related governance, risk management and internal controls. For a holding company with international operations or risks, an assessment of cross-border operations is incorporated into the evaluation of key corporate governance functions and primary firm-wide risk management and internal control functions, including legal and regulatory risk management. In addition, the agencies review materials prepared by host country supervisors, including examination reports and assessments, and conduct ongoing communication with involved foreign and domestic supervisors regarding trends and assessment of cross-border operations. These continuous monitoring activities are supplemented, as appropriate, by examination activities to understand and assess the large, complex bank's or holding company's cross-border strategy, trends, and legal entity structure, and related governance, risk management and internal controls. For example, in the case of large, complex banking organizations with foreign operations, OCC supervisors perform on-site inspections of high-risk foreign operations and analyze the macroecomonic and market risks in countries in which U.S. banks operate. (*See* SR letter 08-9 and OCC's *Bank Supervision Process* and *Large Bank Supervision* Handbooks.[5])

EC 8	Principle 24: Consolidated supervision
Criterion	The supervisor determines that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) includes: (i) information reporting on its foreign operations that is adequate in scope and frequency to manage their overall risk profile and is periodically verified; (ii) assessing in an appropriate manner compliance with internal controls; and (iii) ensuring effective local oversight of foreign operations. For the purposes of consolidated risk management and supervision, there should be no hindrance in host countries for the parent

[5] www.occ.gov/handbook/banksup.pdf; and www.occ.gov/handbook/lbs.pdf

EC 8	Principle 24: Consolidated supervision
	bank to have access to all the material information from their foreign branches and subsidiaries. Transmission of such information is on the understanding that the parent bank itself undertakes to maintain the confidentiality of the data submitted and to make them available only to the parent supervisory authority and when legally compelled to do so.
Practices and Procedures	As noted in EC 7, for a holding company with international operations or risks, an assessment of cross-border operations is incorporated into the processes for developing an understanding and assessment of key corporate governance functions and primary firm-wide risk management and internal control functions, including legal and regulatory risk management. U.S. banks and holding companies are required by regulation to provide federal banking agencies with specific information regarding their foreign operations and any other information supervisors deem necessary to determine compliance with U.S. banking laws. However, there is not a separate and distinct assessment regarding management's oversight of a holding company's foreign operations. Assessments of the capability of the board and management encompass the entirety of a holding company's domestic and foreign operations. The consolidated supervisor may obtain information about management's assessment of foreign operations through functional regulators. For example, under the OCC's risk-based approach to supervision, an evaluation of a bank's corporate lending program or country risk management includes review of the policies, procedures, controls, systems (including audit and management information systems), and effectiveness of management and board oversight across the organization. Generally, testing and verification procedures are performed in locations with the highest risk exposure. In some jurisdictions, the OCC has encountered restrictions on the access to customer records. Federal banking agencies assess restrictions under host country laws that may limit the ability of banks or holding companies to obtain information on host country operations. They obtain information for this purpose from the relevant bank or holding company as well as from the host country supervisor. Communications with host country authorities may be ad hoc, as part of the federal banking agencies' consideration of specific expansionary proposals, and/or as part of supervisors' on-going discussions with host authorities.

EC 9	Principle 24: Consolidated supervision
Criterion	The home supervisor has the power to require the closing of foreign offices, or to impose limitations on their activities, if: it determines that oversight by the bank and/or supervision by the host supervisor is not adequate relative to the risks the office presents; and/or it cannot gain access to the information required for the exercise of supervision on a consolidated basis.
Legal Framework	As discussed under EC 2, where material impediments exist, the agencies can take remedial measures, which may include imposing limits on the foreign operations or requiring the bank or holding company to terminate those operations. A material impediment

EC 9	Principle 24: Consolidated supervision
	could include where management oversight and/or supervision by the host supervisor is not adequate relative to the risks the foreign operations present. When a U.S. bank or holding company wishes to establish or acquire operations in a foreign jurisdiction, the U.S. banking supervisor evaluates the extent to which foreign legal requirements may restrict its access to information necessary to determine and enforce compliance with relevant U.S. laws. If material impediments exist and cannot be adequately addressed, the U.S. banking supervisor would not permit the U.S. bank or holding company to expand in the foreign jurisdiction.
Practices and Procedures	U.S. federal banking agencies expect U.S. banks and holding companies to supervise and administer their foreign operations in such a manner as to ensure that their operations conform to high standards of banking and financial prudence. U.S. federal banking agencies may prohibit or require termination of, or modification to, a bank's foreign operations' and/or activities that present safety and soundness concerns, including those which might hamper adequate consolidated supervision.

EC 10	Principle 24: Consolidated supervision
Criterion	The supervisor confirms that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is particularly close when the foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes differing fundamentally from those of the bank's home country.
Practices and Procedures	As described in EC 8, the agencies evaluate risk-management processes for banking products or lines of business across legal entities and perform testing procedures where the exposure or risk is greatest. In implementing this risk-based approach to supervision, the agencies may not focus on a jurisdiction even though its supervisory regime may be significantly different.

AC 1	Principle 24: Consolidated supervision
Criterion	For those countries that allow corporate ownership of banking companies: the supervisor has the power to review the activities of parent companies and of companies affiliated with the parent companies, and uses the power in practice to determine the safety and soundness of the bank; and the supervisor has the power to establish and enforce fit and proper standards for owners and senior management of parent companies.
Legal Framework	As discussions under the preceding principles indicate, the Federal Reserve and OTS have the power to review the activities of parent holding companies and of companies affiliated with those and use this power to determine and ensure the safety and soundness of bank subsidiaries. As discussed under Principle 4, the Federal Reserve and the OTS have the authority to evaluate the suitability of owners and senior management of holding companies. The Federal Reserve and the OTS use this power in practice to

AC 1	Principle 24: Consolidated supervision
	ensure the safety and soundness of bank subsidiaries.
Practices and Procedures	As noted in EC3, the Federal Reserve and the OTS, as consolidated supervisors, have the authority and responsibility to understand and assess the risks that the parent holding company may pose to the holding company itself or its bank subsidiaries, and as noted in EC6, they have the authority to take action against a parent holding company to prevent it from engaging in unsafe or unsound practices, or to address violations of law that occur in connection with its own business operations even if those operations are not directly connected to the holding company's subsidiary banks.

AC 2	Principle 24: Consolidated supervision
Criterion	The home supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.
Legal Framework	As discussed under Principles 5 and 25, the federal banking agencies assess the quality of supervision conducted in the countries in which its banks and holding companies seek to establish material operations. Once material operations are established, the federal banking agencies informally evaluate host country supervisors through ongoing communication with host supervisors and evaluation and inspection of the cross-border establishments.
Practices and Procedures	As noted in EC 7, for a holding company with international operations or risks, an assessment of cross-border operations is incorporated into the processes for developing an understanding and assessment of key corporate governance functions and primary firm-wide risk management and internal control functions, including legal and regulatory risk management. Any limits to the Federal Reserve's or the OTS's ability to access information on host country operations or to engage in on-site activities is considered when assessing the appropriate extent of the organization's activities in that jurisdiction.

AC 3	Principle 24: Consolidated supervision
Criterion	The supervisor arranges to visit the foreign locations periodically, the frequency being determined by the size and risk profile of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.
Practices and Procedures	As noted in EC 7, for holding companies with international operations or risks, the federal banking agencies assess cross-border operations as part of their evaluation of key corporate governance functions and primary firm-wide risk management and internal control functions. Also, the federal banking agencies' formal strategies for the supervision of individual banks and holding companies include assessments of risk, including risks of foreign operations. On-site work is performed where risks are greatest. When foreign offices are inspected, supervisors meet with host supervisors. Agencies have the ability to use a wide variety of approaches to supervision and have, for example, required special reports and audits of foreign offices.

AC 3	Principle 24: Consolidated supervision
	Additionally, the U.S. federal banking supervisors have worked for many years with counterparts from various countries to strengthen communication and cooperation as it relates to the supervision of banks and holding companies that operate across borders. These efforts have intensified in recent years and now take place in a variety of settings at the multilateral level and bilateral level. At the multilateral level, the BCBS is a forum in which supervisors from member countries meet to discuss important issues, foster consistent supervision of banks with similar business and risk profiles, promote the sharing of best supervisory practices, and formulate guidance to enhance and refine the process of banking supervision globally. As discussed in Principle 25, the agencies have formal information sharing arrangements with many supervisors. These arrangements set out essential elements in the areas of on-site inspections, ongoing coordination, and protection of information, and facilitate timelier sharing of information. Also, the agencies make periodic visits to develop working relationships with many foreign supervisors. During these visits there are banking industry discussions and strategy sessions focusing on specific supervisory issues and initiatives.

Principle 25: Home-host relationships

Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

Overview

The federal banking agencies are responsible for comprehensive supervision of globally active banks and holding companies while each host country supervisor is responsible for supervision of the offices and subsidiaries in its jurisdiction. The federal banking agencies (except the OTS) carry out their responsibilities as host country supervisors through the risk-focused procedures including the *Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations* (Federal Reserve SR letter 00-14 http://fedweb.frb.gov/fedweb/bsr/srltrs/SR0014.htm). *See also* the OCC's *Federal Branches and Agencies Supervision Handbook*[1]. The program coordinates the supervision and examination of foreign banking organizations' operations in the United States in a similar manner to the supervision of large, complex U.S. banks and holding companies. The OTS applies a single examination and risk assessment program to both U.S. and foreign-owned SLHCs and their savings association subsidiaries. See the OTS's *Holding Companies Handbook*. As a host supervisor, OTS coordinates the application of this program with home country supervisory authorities.

Over the past decade, information sharing through *Memorandums of Understanding* (MoU), Statements of Cooperation (SOC) or similar arrangements has become increasingly common. These vehicles, while not legally binding, broadly govern information access and information sharing between supervisors acting in a home and host capacity. U.S. federal banking agencies are authorized to share relevant supervisory information with foreign banking supervisors even in the absence of a formal arrangement such as an MoU, and in practice the agencies share significant information with foreign supervisors whether the U.S. agencies act in a home or host capacity. All sharing is subject to certain statutory requirements including those relating to the ability of the foreign bank supervisor to maintain the confidentiality of information provided to it. In appropriate cases the agencies also have the authority to share information with financial supervisors other than bank supervisors.

Typically, an MoU addresses sharing of information, including contact during the authorization process of a cross-border establishment and contact and communication in the ongoing supervision of such entities; supervisory cooperation in carrying out inspections in the host jurisdiction, as well as cooperation in BSA/AML violations, terrorist financing, and unauthorized banking business; information sharing about parallel banking organizations; sharing and safeguarding confidential information and using it for lawful supervisory purposes only; encouraging continuous and informal contacts between the supervisors; and arranging visits and internships where practical.

Also, the agencies support the following reference documents[2]: *Principles for the supervision of banks' foreign establishments (Concordat)*, May 1983; *Information flows between Banking Supervisory Authorities, April 1990; Report on Cross-Border Banking Supervision*, October 1996; *Shell banks and booking offices*, January 2003; and *The high-level principles for the cross-border implementation of the New Accord*, August 2003; and *Home-host information sharing for effective Basel II implementation, June 2006*.

[1] www.occ.treas.gov/handbook/fba.pdf

[2] www.bis.org/publ/bcbsc312.pdf?noframes=1; www.bis.org/publ/bcbsc313.pdf?noframes=1; www.bis.org/publ/bcbs27.pdf?noframes=1; www.bis.org/publ/bcbs95.pdf?noframes=1; http://www.bis.org/publ/bcbs100.pdf?noframes=1; and www.bis.org/publ/bcbs125.pdf?noframes=1

EC 1	Principle 25: Home-host relationships
Criterion	Information to be exchanged by home and host supervisors should be adequate for their respective roles and responsibilities.
Legal Framework	As discussed in detail under Principle 1(6), U.S. federal banking agencies have clear authority to share confidential supervisory information with domestic and foreign banking and other financial sector supervisors. In general, the information must be used for lawful supervisory purposes only, and the recipients of such information must keep it confidential. The responses to ECs 1-4 and AC 1 address the practical application of this authority and assume that all sharing described would comply with any legal restrictions on information sharing.
Practices and Procedures	U.S. federal banking agencies provide adequate data and information in a timely manner to host country supervisors about U.S. banks and holding companies, including any significant issues of a supervisory nature, to enable the host authority to supervise the overseas operations of the U.S. banks effectively and appropriately. The U.S. federal banking agencies have ongoing contact with supervisors in other countries in which U.S. banks have material operations. Information sharing by the U.S. agencies as both home and host supervisors involves sharing significant supervisory concerns and supervisory documents; providing information to assist with the authorization process and with investigations; discussing and coordinating supervisory plans and strategies with foreign supervisors; managing and participating in bilateral and multilateral meetings in the United States and overseas; developing joint enforcement actions when warranted; and participating in "colleges" of supervisors to focus on a specific bank, holding company or supervisory issue. Additionally, U.S. supervision staff periodically visit foreign supervisory authorities to discuss supervisory issues. *See* Overview for how these responsibilities are discharged.

EC 2	Principle 25: Home-host relationships
Criterion	For material cross-border operations of its banks, the supervisor identifies all other relevant supervisors and establishes informal or formal arrangements (such as memoranda of understanding) for appropriate information sharing, on a confidential basis, on the financial condition and performance of such operations in the home or host country. Where formal cooperation arrangements are agreed, their existence should be communicated to the banks and banking groups affected.
Legal Framework	Typically, the U.S. federal banking agencies identify other relevant supervisors at the time a banking organization seeks authority, or provides notice of its intent, to establish operations in a foreign jurisdiction. The federal banking agencies will evaluate any restrictions on disclosure that may exist under the laws of the foreign jurisdiction and will confirm, indirectly through the bank/ holding company or directly with the foreign supervisor, that the agencies will have access to all information necessary to determine and enforce compliance with relevant U.S. laws. If material impediments exist and cannot be adequately addressed, the agencies would not permit the bank to expand in the foreign jurisdiction. As appropriate, the agencies will establish formal or informal arrangements for the sharing of relevant confidential supervisory information regarding the bank's operations in the home or host country. Information sharing arrangements with foreign supervisors are made available to the public through the Freedom of Information Act process. The existence of institution- or group-specific arrangements generally is disclosed to the involved bank but is not otherwise made publicly known.
Practices and	Today, federal banking agencies have joint information sharing arrangements in place with banking supervisors in many foreign

EC 2	Principle 25: Home-host relationships
Procedures	jurisdictions. These arrangements, while not required by law, support the agencies' efforts to oversee the operations of foreign banks operating in the United States as well as to supervise the foreign operations of U.S. banks. Information sharing arrangements are in process or near completion with supervisors in several additional jurisdictions. These arrangements generally cover those elements set forth in the Basel Committee's paper *"Essential elements of a statement of cooperation between banking supervisors" (May, 2001).*[3] The above processes are buttressed by an informal system which relies on peer-to-peer contact, and this informal network remains an invaluable complement to the overall, global, consolidated supervisory process. *See* Overview for a description of MoUs.

EC 3	Principle 25: Home-host relationships
Criterion	The home supervisor provides information to host supervisors, on a timely basis, concerning: • the overall framework of supervision in which the banking group operates; • the bank or banking group, to allow a proper perspective of the activities conducted within the host country's borders; • the specific operations in the host country; and • where possible and appropriate, significant problems arising in the head office or other parts of the banking group if these are likely to have a material effect on the safety and soundness of subsidiaries or branches in host countries. A minimum level of information on the bank or banking group will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of a bank's or banking group's activities to the financial sector of the host country. In this context, the host supervisor will inform the home supervisor when a local operation is material to the financial sector of the host country.
Practices and Procedures	The U.S. banking supervisors provide relevant information on U.S. banks and holding companies to host supervisors in response to specific requests regarding their supervision and provide information on significant problems that might have a material effect on the subsidiaries or branches in the host country. Information on a home to host basis is also provided for in MoUs and similar arrangements. These arrangements provide for cooperation during the licensing process, in the supervision of ongoing activities, and in the handling of problem banks. U.S. federal banking agencies endeavor to inform host country supervisors in a timely manner about events that could endanger the stability of cross-border establishments in the host country. The federal banking agencies also inform host country supervisors when administrative penalties have been imposed or any other formal enforcement action has been taken against a U.S. bank or holding company if the agencies believe such information will be important to the host country supervisor as it may relate to the cross-border operations in that country.

EC 4	Principle 25: Home-host relationships

[3] www.bis.org/publ/bcbs83.pdf?noframes=1

EC 4	Principle 25: Home-host relationships
Criterion	The host supervisor provides information to home supervisors, on a timely basis, concerning: • material or persistent non-compliance with relevant supervisory requirements, such as capital ratios or operational limits, specifically applied to a bank's operations in the host country; • adverse or potentially adverse developments in the local operations of a bank or banking group regulated by the home supervisor; • adverse assessments of such qualitative aspects of a bank's operations as risk management and controls at the offices in the host country; and • any material remedial action it takes regarding the operations of a bank regulated by the home supervisor. A minimum level of information on the bank or banking group, including the overall supervisory framework in which they operate, will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of the cross-border operations to the bank or banking group and financial sector of the home country. In this context, the home supervisor will inform the host supervisor when the cross-border operation is material to the bank or banking group and financial sector of the home country.
Legal Framework	The federal banking agencies have authority to share supervisory information with home country banking supervisors. *See* Principle 1(6) and 12 U.S.C. § 3109. The agencies have adopted internal procedures to facilitate the provision of relevant information to home country banking supervisors.
Practices and Procedures	As a host country supervisor, the agencies cooperate with the home country supervisors of foreign banking organizations (FBOs) with U.S. banking operations in order to facilitate the consolidated supervision activities of those supervisors. (*See* EC 2 for a discussion of information sharing.) Under the FBO Supervision Program *(Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, i.e.,* Federal Reserve SR letter 00-14 and OCC's *Federal Branches and Agencies Supervision Handbook*[4]), the Federal Reserve and the OCC routinely provide copies of essential supervisory products to home country supervisors. This includes an annual assessment of the combined U.S. operations of the FBO which contains a supervisory rating, summary examination and supervisory findings along with details of areas requiring management attention, and notice of any proposed or pending formal or informal supervisory action; a copy of the notification to the head office of the FBOs *Strength-of-Support Assessment* ranking (the SOSA) that is a considered assessment by the U.S. supervisor of the support that the parent bank/head office provides to its U.S. operations. Where specifically requested by the home country supervisor, copies of examination reports of the U.S. operations of the FBOs may be provided to the home country supervisor. See also the OTS's *Holding Companies Handbook* (information sharing regarding cross-border operations of SLHCs.) Similarly, the federal banking agencies communicate with home country supervisors on subsidiaries of foreign banks and banking organizations. The agencies will apprise home supervisors of significant concerns and impending supervisory actions, and will provide reports of examination upon request.

[4] www.occ.treas.gov/handbook/fba.pdf

EC 5	Principle 25: Home-host relationships
Criterion	A host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks.
Legal Framework	The local operations of foreign banks are subject to prudential, inspection, and regulatory reporting requirements similar to those applicable to domestic banks. In general, these requirements can be found in the statutes and regulations applicable to domestic banks and in the International Banking Act (IBA), 12 U.S.C. § 3101 et seq., and its implementing regulations, *see* 12 CFR 211, subpart B and 12 CFR 28, subpart B.
Practices and Procedures	The IBA provides for "national treatment" of foreign banks doing business in the United States. The principle of "national treatment" means that the U.S. law generally accords the same treatment to FBOs as it does to domestic (i.e., U.S.) banks. However, a number of regulations do not apply to FBOs that do not have retail operations. The Federal Reserve's CA letter 04-3 and the OCC's *Federal Branches and Agencies Supervision Handbook*[5] provide guidance for assessing whether a consumer compliance or Community Reinvestment Act (CRA) examination of an FBO is necessary (*see* 12 CFR 228.11(c)(3)). These assessments are conducted according to the frequencies mandated in the OCC's *Bank Supervision Process Handbook*[6] and the Federal Reserve's CA letter 03-12. Where foreign banking organizations own and/or control subsidiary U.S. savings associations, those savings associations are subject to the same requirements and treatment as savings associations[7]

EC 6	Principle 25: Home-host relationships
Criterion	Before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.
Legal Framework	As discussed under EC 11 to Principle 3, a foreign entity must obtain approval from the Federal Reserve and either the OCC[8] or a state banking supervisor before establishing a banking office or a subsidiary bank in the United States. A foreign entity must obtain the approval of OTS to establish or acquire a subsidiary savings association or SLHC. The FDIC does not issue licenses but must grant deposit insurance approval before a subsidiary bank is licensed. The Federal Reserve or OTS, as applicable, routinely contacts the home country supervisor during the application process and, in making a decision on an application, takes into account whether the home country supervisor has approved (or expressed no objection) to the proposal. If the foreign entity is a foreign bank, the

[5] www.occ.gov/handbook/fba.pdf
[6] www.occ.treas.gov/handbook/banksup.pdf (pages 17-19)
[7] The statute and regulations governing SLHCs apply to both foreign and domestic SLHCs. See generally, 12 U.S.C.1467a; 12 CFR Parts 583-585.
[8] A foreign bank wishing to establish a federal branch or agency in the United States must receive approval from the OCC. *See* 12 U.S.C. § 3102(a). In evaluating a foreign bank's application for a federal branch or agency, the OCC considers whether the home country supervisor has consented to the proposed establishment of the office. 12 CFR 28.12(b)(6). With respect to applications to establish a federal branch or agency outside of a foreign bank's home state, the OCC also considers whether the applicant foreign bank is subject to CCS by its home country supervisor.

EC 6	Principle 25: Home-host relationships
	Federal Reserve or OTS, as applicable, must determine that the foreign bank, and any foreign bank parent, is subject to comprehensive and consolidated supervision by its home country supervisor. The Federal Reserve or OTS also assesses the extent to which home country supervisors oversee or monitor the operations between a foreign bank and any foreign non-bank parent. The adequacy of home country supervision is evaluated at authorization, and as part of on-going supervision. Consideration of home country supervision and head office support is part of regular risk assessment.
Practices and Procedures	The assessment of whether a home supervisor practices global consolidated supervision depends on a methodical analysis conducted by the primary U. S. federal banking agency. This process was legally mandated by the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) as a required standard for allowing a foreign bank to establish a branch or agency or subsidiary bank or savings association in the United States. The objective of the analysis, known as "CCS" (for *Comprehensive Consolidated Supervision*) is to determine whether the foreign bank is supervised or regulated in a manner such that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank—including affiliated parties—to assess the foreign bank's overall financial condition and compliance with law and regulation. The assessment of CCS is not based on a rigid formula and looks to the same objectives as the Basel Core Principles. A full CCS finding is not required for approval of branch and agency applications but the Federal Reserve must find that the home supervisor is "actively working towards" establishing arrangements for CCS. 12 U.S.C. § 3105 (d)(6).

EC 7	Principle 25: Home-host relationships
Criterion	Home country supervisors are given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with KYC requirements. Home supervisors should inform host supervisors of intended visits to local offices and subsidiaries of banking groups.
Legal Framework	Nothing in U.S. federal law would prevent a home supervisor from conducting on-site inspections of U.S. offices and subsidiaries of foreign banks to assess the banking organization's safety and soundness and compliance with KYC requirements.
Practices and Procedures	Foreign supervisors may conduct on-site examinations of their banks' cross-border establishments in the United States and would generally have access to all information, including individual customer account information, necessary for assessing safety and soundness and compliance with KYC requirements. Before conducting such examinations, foreign supervisors should contact the relevant federal banking agencies and the state banking authority if the operations to be examined are state-chartered or state-licensed. With prior arrangement, foreign supervisors typically may conduct their on-site examinations without being accompanied by representatives of the federal banking agencies. Note, however, there may be state laws (e.g. FLA.STAT. 655.059 (2007)) that limit access to certain types of information at state-licensed entities. In general, the U.S. banking agencies expect to be permitted on-site access to foreign offices and subsidiaries of a U.S. bank and holding company's foreign operations in order to facilitate their assessment of the bank and holding company's safety and soundness and compliance with KYC requirements. The U.S. agencies inform host supervisors in advance of intended visits to foreign offices

EC 7	Principle 25: Home-host relationships
	and subsidiaries. MOUs and SOCs generally contain provisions regarding on-site examinations.

EC 8	Principle 25: Home-host relationships
Criterion	The host supervisor supervises shell banks, where they still exist, and booking offices in a manner consistent with internationally agreed standards.
Legal Framework	The establishment of shell banks is not permitted in the United States, at the federal or state levels, and no legacy shell banks or booking offices exist in the United States.
Practices and Procedures	A foreign shell bank is a foreign bank without a physical presence in any country. Shell banks are not permitted to operate in the United States. In addition, the United States has taken measures to prevent foreign shell banks from directly or indirectly accessing the U.S. financial system. Banks also must take reasonable steps to ensure that any correspondent account established, maintained, administered, or managed in the United States for a foreign bank is not being used by that foreign bank to provide banking services indirectly to foreign shell banks, i.e., that the foreign correspondent bank of the U.S. bank does not in turn give a foreign shell bank the ability to access the U.S. correspondent account through its account. A bank is required to terminate immediately any account that it knows to be the account of a foreign shell bank or that it knows is being used indirectly by a foreign shell bank. Recent amendments to the Bank Secrecy Act (BSA) prohibit U.S. banks from establishing, maintaining, administering or managing a correspondent account in the United States for any foreign shell bank other than a regulated affiliate of a U.S. or foreign bank. *See* 31 CFR 103.177

EC 9	Principle 25: Home-host relationships
Criterion	A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action.
Practices and Procedures	Effective cross-border supervision relies on clear, open communication between home and host supervisors. This is particularly the case where a banking supervisor contacts a supervisor in another country about significant or serious (including criminal) supervisory issues requiring attention. By the very nature of U.S. federal (and state) banking supervision, the agencies involved work within a communication web that demands continuous coordination and consideration. The same methodology applies with cross-border information exchanges and requests for action or opinions. In such cases, the agencies always confer at the appropriate level and to the appropriate extent with the foreign supervisor before taking any action. *See* Federal Reserve AD letter 03-27/SR letter 01-21/AD letter 01-30; and OCC's PPM 5500-1.

AC 1	Principle 25: Home-host relationships

AC 1	Principle 25: Home-host relationships
Criterion	Where necessary, the home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy should reflect the size and complexity of the cross-border operations of the bank or banking group.
Practices and Procedures	The U.S. banking supervisors establish communication strategies through formal processes (i.e., MOUs and SOCs) and informal processes (e.g., Basel II and Financial Stability Board supervisory colleges). For example, in relation to Basel II, the U.S. supervisors hold periodic meetings with host supervisors to share information as applicable on home country risk-management practices and models which may be employed in host country entities of the globally supervised banks and holding companies. Also, the U.S. supervisors are implementing the Financial Stability Board's protocols for establishing supervisory colleges for major global banks. In doing so, the U.S. supervisors have convened supervisory colleges with host supervisors of significant operations of U.S. banks.

Glossary of Terms

This glossary gives basic definitions of terms used in the text.

A

Administrative Procedures Act (APA)
Federal legislation that, in part, sets up a process for the U.S. federal courts to directly review agency decisions. Under the APA, persons aggrieved by a final agency action—including promulgation of a rule or policy or application of that policy to a particular circumstance—can challenge the agency's action in court. Interested parties also may petition for issuance, amendment, or repeal of a rule or to compel agency action that is "unlawfully withheld or unreasonably delayed." The standard of judicial review in these instances generally is high.

affiliate transactions
Sections 23A and 23B of the Federal Reserve Act, and their implementing regulation, Regulation W, restrict a bank's transactions with its affiliates to safeguard the interests of banks and prevent abuses by banks' affiliates. The laws establish certain quantitative limits and other prudential requirements for loans, purchases of assets, and certain other transactions between a member bank and its affiliates. Regulation W (12 CFR 223) implements sections 23A and 23B by defining terms used in the statute, explaining the statute's requirements, and exempting certain transactions.

agreement corporation
Corporation chartered by a state to engage in international banking; so named because the corporation enters into an "agreement" with the Board of Governors to limit its activities to those permitted an Edge Act corporation. Typically organized as a subsidiary of a bank, an agreement corporation may conduct activities abroad that are permissible to foreign banks abroad but that may not otherwise be permissible for U.S. banks.

Allowance for Loan and Lease Losses (ALLL)
An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. For purposes of this, the term "estimated credit losses" means an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans.

Attorney General
In the context of the Federal Tort Claims Act in Principle 1, the attorney general refers to the U.S. Attorney General, who is the head of the Department of Justice and chief law enforcement officer of the federal government.

B

bank
All FDIC-insured national banks (supervised by the OCC), FDIC-insured state-chartered banks (both Federal Reserve member (supervised by the Federal Reserve) and nonmember (supervised by the FDIC), and FDIC-insured savings associations (supervised by the OTS), unless the content otherwise requires.

Bank for International Settlements (BIS)
International organization established in 1930 and based in Basel, Switzerland, that serves as a forum for central banks for collecting information, developing analyses, and cooperating on a wide range of policy-related matters; also provides certain financial services to central banks.

bank holding companies (BHCs) and savings and loan holding companies (SLHCs)
Any company that has control over a bank or savings association, respectively**.** For the purposes of this document, they are referred to as "*holding companies*" except in cases where there is a material difference between BHCs and SLHCs (in terms of legal authority, operations, or structure). BHCs are supervised by the Federal Reserve and SLHCs are supervised by the OTS.

Bank Holding Company Act of 1956
Federal legislation that establishes the legal framework under which bank holding companies operate and places the formation of bank holding companies and their acquisition of banking and nonbanking interests under the supervision of the Federal Reserve.

banking group or banking organization
A holding company and its banking subsidiaries, excluding certain nonbank subsidiaries.

Basel Committee on Banking Supervision (BCBS)
An international committee of bank supervisors, associated with the BIS, that is headquartered in Basel, Switzerland, and is composed of bank supervisors from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Basel II
Informal name for the 2004 agreement updating the Basel Accord. Also known as the New Basel Accord, Basel II has three pillars: minimum capital requirements, supervisory oversight, and market discipline.

Board of Governors
Central, governmental agency of the Federal Reserve System, located in Washington, D.C., and composed of seven members, who are appointed by the President and confirmed by the Senate. The Board, with other components of the System, has responsibilities associated with the conduct of monetary policy, the supervision and regulation of certain banking organizations, the operation of much of the nation's payments system, and the administration of many federal laws that protect consumers in credit transactions. The Board also supervises the Federal Reserve Banks.

C

Call Report
Informal name for quarterly Reports of Condition and Income (*See* **Reports of Condition and Income**).

CAMELS
Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk—The six essential components of a bank's financial condition in the UFIRS (*See* **Uniform Financial Institutions Ratings System)**.

Change in Bank Control Act (CBCA)
Federal legislation that requires any party seeking to acquire the power to vote 25 percent or more of a class of voting securities of a bank to give notice to the appropriate federal banking agency prior to the acquisition. In addition, persons seeking to acquire the power to vote 10 percent or more of a class of voting securities are presumed to have acquired control in certain circumstances. This includes situations when two or more persons simultaneously acquire equal percentages of 10 percent or more of a bank's voting securities. Also, persons acting in concert will have their interests in a bank considered collectively.

civil money penalties (CMPs)
Civil money penalties , which require monetary payments, penalize directors or other persons participating in the affairs of the bank for violations of laws, regulations, orders, conditions imposed in writing, and written agreements; unsafe or unsound practices; and breaches of fiduciary duty. CMPs may be used alone or in combination with informal or formal enforcement actions.

Code of Federal Regulations (CFR)
Title 12 of the CFR contains the regulations of the U.S. federal banking agencies. Parts 1-199 contain the OCC's regulations, parts 200-299 contain the Federal Reserve's regulations, parts 300-499 contain the FDIC's regulations, and parts 500-599 contain the OTS's regulations.

commercial bank
"Bank" as described above, but excluding savings associations.

consolidated organization
The consolidated entity including the parent and its bank and nonbank subsidiaries.

E

Edge Act corporation (or Edge corporation)
Corporation chartered by the Federal Reserve to engage in international banking. The Board of Governors acts on applications to establish Edge Act corporations and also examines the corporations and their subsidiaries. Typically organized as a subsidiary of a bank, an Edge Act corporation may conduct activities abroad that are permissible to foreign banks abroad but that may not otherwise be permissible to U.S. banks. Named after Senator Walter Edge of New Jersey, who sponsored the original legislation to permit formation of such organizations. (*Compare* **agreement corporation**.)

F

Federal Advisory Committee Act (FACA)
Federal legislation that formalized a process for establishing, operating, overseeing, and terminating advisory committees, which may be composed of representatives from industry. The FACA ensures that advice rendered to the executive branch by advisory committees, task forces, boards, and commissions is both objective and accessible to the public.

Federal Deposit Insurance Act (FDI Act)
Derived from a 1933 amendment to the Federal Reserve Act, the FDI Act creates the Federal Deposit Insurance Corporation to insure the deposits of banks and savings associations; provides the FDIC with powers and authority to supervise state-chartered nonmember banks and provide backup supervision and enforcement to all insured depository institutions regardless of charter; and establishes the regime under which the FDIC resolves failed, insured depository institutions.

Federal Deposit Insurance Corporation (FDIC)
An independent agency of the federal government that is managed by a five-member board of directors appointed by the President and confirmed by the Senate. The heads of the OCC and OTS hold seats on the FDIC board. The FDIC is subject to audits by the Government Accountability Office and oversight by Congress. Besides being the federal regulator for nonmember state banks (i.e., not a member of the Federal Reserve System), the FDIC administers the federal deposit insurance fund.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)
Federal legislation that greatly increased the powers and authority of the FDIC. Major provisions recapitalized the Bank Insurance Fund (since merged with the Savings Association Insurance Fund into the Deposit Insurance Fund) and allowed the FDIC to borrow from the Treasury. Among other significant changes, the FDICIA mandated a least-cost resolution method and a prompt resolution approach to problem and failing banks; ordered a risk-based deposit insurance assessment scheme; and restricted brokered deposits and the solicitation of deposits, as well as the nonbank activities of insured state banks.

FDIC Financial Institution Letter (FIL)
Financial Institution Letters (FILs) are addressed to the Chief Executive Officers of the financial institutions on the FIL distribution list—generally, FDIC-supervised institutions. FILs may announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association.

Federal Financial Institutions Examination Council (FFIEC)
The FFIEC was established by Congress under Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The FFIEC is composed of the chairpersons of the FDIC and the National Credit Union Administration, the Comptroller of the Currency, the director of the OTS, a governor of the Federal Reserve Board, and the Chair of the FFIEC State Liaison Committee. The State Liaison Committee is composed of five representatives of state agencies that supervise financial institutions. The FFIEC prescribes uniform federal principles and standards for the examination of depository institutions, promotes coordination of bank supervision among the U.S. federal banking agencies, and encourages better coordination of federal and state regulatory activities.

Federal Reserve Act
Federal legislation, enacted in 1913, that established the Federal Reserve System.

Federal Reserve Bank
One of the twelve operating arms of the Federal Reserve System, located throughout the nation, that together with their Branches carry out various System functions, including providing payment services to depository institutions, distributing the nation's currency and coin, and supervising and regulating member banks and bank holding companies. The Reserve Banks also serve as a fiscal agent for the U.S. government.

Federal Reserve District (Reserve District, or District)
One of the twelve geographic regions served by a Federal Reserve Bank.

Federal Reserve System (Federal Reserve)
The central bank of the United States, created by the Federal Reserve Act and made up of a seven-member Board of Governors in Washington, D.C.; twelve regional Federal Reserve Banks; and Branches of the Federal Reserve Banks.

Federal Tort Claims Act
Federal legislation that allows lawsuits against federal banking agencies' employees for acts and/or omissions that cause injuries while acting within the scope of their employment. In such a case, the United States would substitute itself as the defendant upon the Attorney General's certification that an employee was acting within the scope of his/her office or employment at the time of the incident giving rise to the tort claim. Moreover, an exception to the act protects employees from lawsuits involving the execution of a statute or regulation or the exercise or performance or the failure to exercise or perform a discretionary function or duty, whether or not the employee abused the discretion involved.

financial holding company
Bank holding companies, whose depository institution subsidiaries meet enhanced capital and managerial standards, that are authorized to engage in expanded financial activities, including securities, insurance, and merchant banking.

foreign banking organization (FBO)
Foreign banks that conduct commercial banking operations in the United States.

Freedom of Information Act (FOIA)
Federal legislation that serves as the vehicle to obtain federal agency records, unless the records (or any portion thereof) are protected from disclosure by one of the FOIA's nine exemptions or by one of its three special law enforcement record exclusions.

functionally regulated entity
Entities within the consolidated organization that are regulated by the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, or state insurance regulators.

G

Government Accountability Office (GAO)
GAO is an independent, nonpartisan agency that works for Congress. Often called the "congressional watchdog," GAO investigates how the federal government spends taxpayer dollars.

Government Performance and Results Act of 1993
Federal legislation that provides, among other things, for the establishment of strategic planning and performance measurement in the federal government. A primary purpose is to improve the confidence of the American people in the capability of the federal government, by systematically holding federal agencies accountable for achieving program results. Each of the U.S. federal banking agencies complies with the act, which requires federal agencies, in consultation with Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. The performance plans and assessments are incorporated into the agencies' annual reports, which are required to be made public.

Gramm-Leach-Bliley Act (GLBA)
Federal legislation that allows affiliations among banks, securities firms, and insurance companies under a financial holding company structure. The GLBA reaffirmed the Federal Reserve's role as "umbrella supervisor" over organizations that control banks, while also requiring that bank regulators and functional regulators exercise their respective supervisory authority over supervised subsidiaries of a financial holding company.

H

Home Owners' Loan Act (HOLA)
Federal legislation that provided for a type of savings association to be chartered and regulated by a federal agency, now the OTS. OTS also regulates state-chartered savings associations and holding companies of both federal and state-chartered savings associations (*See* **bank holding companies (BHCs) and savings and loan holding companies (SLHCs).**

Housing and Economic Recovery Act of 2008
Federal legislation under which the agencies are developing a system to register mortgage loan originators at banks with the Nationwide Mortgage Licensing System and Registry, which was developed by state regulators.

I

Institution-affiliated party (IAP)
An institution-affiliated party refers to (1) any director, officer, employee, or controlling shareholder (other than a bank holding company) of, or agent for, an insured bank; (2) any other person who has filed or is required to file a change-in-control notice with the appropriate federal banking agency under section 1817(j) of the ??? ; (3) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured bank; and (4) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in

(A) any violation of any law or regulation; (B) any breach of fiduciary duty; or (C) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured bank.

interagency guidance
Guidance issued jointly by more than one U.S. federal banking agency to banks and/or holding companies.

International Banking Act of 1978 (IBA)
Federal legislation that subjected foreign banks with U.S. branches and agencies to federal regulations. The IBA required these banks to maintain reserves and generally limited their activities and geographic expansion in the United States in accordance with the comparable limitations applicable to U.S. banking organizations. Based on a policy of national treatment, the IBA also attempted to adapt the dual banking system—the U.S. system permitting banks to be chartered by either state or federal authorities—to the unique characteristics of foreign bank branches and agencies.

M

member bank
A bank that is a member of the Federal Reserve System. All national banks are, by law, members of the System; state-chartered banks may choose to apply to join the System. The term does not include a savings association.

N

national bank
A commercial bank that is chartered by the Office of the Comptroller of the Currency. By law, national banks are members of the Federal Reserve System. Some national banks are chartered for a special purpose and limit their operations to such things as credit card lending or fiduciary activities. For purposes of this FSAP, we have limited the discussion to insured national banks, however, it should be noted that the OCC also supervises a small number of *uninsured* national trust banks.

National Bank Act (NBA)
Federal legislation signed into law by President Lincoln in 1864. The NBA revised the National Currency Act which had been passed by Congress in 1863. These laws established a new system of national banks and a new government agency headed by a Comptroller of the Currency. The Comptroller's job was to organize and supervise the new banking system through regulations and periodic examinations.

National Information Center (NIC)
A central repository of data about banks and other institutions for which the Federal Reserve has a supervisory, regulatory, or research interest, including both domestic and foreign banking organizations operating in the United States.

nonmember bank
A state-chartered commercial bank that is not a member of the Federal Reserve System.

O

OCC Advisory Letters
Advise bankers and bank directors about activities and situations that could contribute to, or detract from, the safe and sound management of national banks.

OCC Bulletins
Provide information of continuing concern on OCC or OCC-supported policies and guidelines, and inform readers of pending regulatory changes and other general information.

OCC PPM
Internal Policies and Procedures Manual for OCC supervisors.

Office of the Comptroller of the Currency (OCC)
A bureau of the U.S. Department of the Treasury. The OCC charters, regulates, and supervises all national banks. It also licenses and is the primary supervisor of federally licensed branches and agencies of foreign banks. The head of the OCC is the Comptroller of the Currency.

Officer of Inspector General (OIG)
Each federal banking agency is subject to oversight by an OIG, with broad authority to identify and investigate fraud, waste, and abuse within the agency. The OIGs conduct statutorily required and ad hoc reviews of agency operations, and have independent reporting lines to Congress.

Office of Thrift Supervision (OTS)
A bureau of the U.S. Department of the Treasury. The OTS is responsible for chartering federal savings associations and for regulating and supervising federal- and state-chartered savings associations and their holding companies, commonly referred to as thrift institutions and savings and loan holding companies, respectively. The head of the OTS is formerly called the Director.

OTS CEO Memorandums
Supervisory memos to the Chief Executive Officers of all OTS-regulated savings associations and/or savings and loan holding companies.

OTS Thrift Bulletins
Directives to thrift institutions and/or savings and loan holding companies providing clarification of regulations or laws, or specifying guidelines and procedures.

P

prompt corrective action (PCA)
Supervisory framework, created under the FDICIA (*see* **Federal Deposit Insurance Corporation Improvement Act of 1991**), that links enforcement actions closely to the level of capital held by banks.

R

Reports of Condition and Income
Quarterly financial reports that all banks, Edge and agreement corporations, and certain other types of organizations must file with a federal regulatory agency. (*See* **Call Report**.)

Riegle Community Development and Regulatory Improvement Act
Federal legislation that requires the federal banking agencies to submit a joint report annually to Congress (section 305 of the act) describing the coordination of examinations and supervision of institutions that are subject to multiple supervisors. The basic principles governing these activities are set forth in the Interagency Policy Statement on Examination Coordination, issued in 1993. This report evidences the high priority the agencies place on working together to identify and reduce regulatory burden and on coordinating supervisory activities, not only with each other and state bank and thrift supervisors, but also with U.S. securities and insurance regulators and foreign financial institution supervisors.

S

savings association
A type of bank that is encouraged by law to focus on home mortgage lending. It may be chartered either by the OTS or by a state supervisor. OTS regulates all savings associations.

Securities and Exchange Commission (SEC)
An independent agency of the U.S. government that holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other electronic securities markets.

SR Letter
Supervision and Regulation letters that address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. These letters are issued by the Board of Governors' Division of Banking Supervision and Regulation and are a means of disseminating information to banking supervision staff at the Board and the Reserve Banks, as well as to supervised banking organizations. Letters concerning financial institution supervision are designated with [SUP].

state bank
A bank that is chartered by a state. State banks are primarily supervised by state banking authorities; however, the FDIC also has supervisory authority over state banks that are not members of the Federal Reserve System, and the Federal Reserve also has supervisory authority over state banks that are members of the Federal Reserve System.

state banking agencies
The United States has a "dual banking system," which refers to the parallel state and federal banking systems that co-exist in the United States. The federal system (1) is based on a federal bank charter, (2) has powers defined under federal law, (3) operates under federal standards, and (4) provides oversight by a federal banking agency or supervisor. The state system (1) is based on a state charter, (2) has powers established under state law, (3) operates under state standards, and (4) provides oversight by state banking agencies or supervisors. A list of state banking agencies can be found at www.csbs.org.

subpoena
An official summons requiring a witness to attend a legal proceeding such as a trial or a deposition at a specific time and place to give testimony on a certain matter. A person failing to obey a subpoena summoning them to appear before a court is liable to be punished for contempt of court

subsidiary
Company that is controlled by another corporation (called the parent corporation), typically through stock ownership or voting control.

T

Thrift Financial Report or TFR
Quarterly report of condition filed with the OTS by all savings associations, similar to the Call Report filed by other types of banks with their federal regulators.

U

Uniform Bank Performance Report, Uniform Bank Holding Company Performance Report, and Uniform Thrift Performance Report
Each bank is required to file complete financial data to the Central Data Repository (CDR) on a quarterly basis. The format used for this process is known as the Call Report. The data contained within the report is processed within the CDR by the Federal Financial Institutions Examination Council (FFIEC) and is then used in a multitude of distinctive formats across each of the regulatory agencies, and even by the general public. The resulting data provides the agencies the ability to produce high level reports of the condition of the banking system in various formats. Common examples of these reports include the Uniform Bank Performance Report (UBPR), the Uniform Bank Holding Company Performance Report (UBHCPR), and the Uniform Thrift Performance Report (UTPR). Each UBPR also contains corresponding average data for the bank's peer group and percentile rankings for most ratios. The UBPR therefore permits evaluation of a bank's current condition, trends in its financial performance, and comparisons with the performance of its peer group. Generally peer groups are assigned based on average assets size, number of banking offices, and metropolitan or nonmetropolitan area. The system has the capability to run custom peer group information.

Uniform Financial Institutions Rating System (UFIRS)
Uniform Financial Institutions Ratings System was adopted by the FFIEC on November 13, 1979. Each bank is assigned a composite rating based on an evaluation and rating of six essential components of a bank's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. (*See* **CAMELS.**) Evaluations of the components take into consideration the bank's size and sophistication, the nature and complexity of its activities, and its risk profile.

United States Code (USC)
Title 12 of the USC, *Banks and Banking*, contains the majority of specific U.S. federal banking law, and is the most often cited title in this FSAP. Title 15 contains a number of other banking-related laws and banks are, of course, subject to federal laws located in other titles of the USC.

U.S. federal banking agencies
Includes the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS). Also referred to as the “federal banking agencies” or the “agencies.”

U.S. federal banking supervisors
Includes the staff of the U.S. federal banking agencies. Also referred to as the "supervisors," which in this context is interchangeable with "regulators" and "examiners."