FEDERAL RESERVE BANK OF DALLAS

2200 N. PEARL ST.

DALLAS, TX 75201-2272

February 3, 2004

Notice 04-05

TO: The Chief Executive Officer of each
financial institution and foreign agency
in the Eleventh Federal Reserve District

SUBJECT

Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization

DETAILS

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision have issued a statement titled *Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates*. The statement sets forth the collective views of the agencies concerning the safety and soundness implications of a bank providing financial support to investment funds advised by the bank or its affiliates (i.e., affiliated investment fund).

ATTACHMENTS

A copy of the Board's SR letter and the interagency statement are **attached**.

MORE INFORMATION

For more information, please contact Gayle Teague, Banking Supervision Department, at (214) 922-6151. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at **www.dallasfed.org/banking/notices/index.html**.

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 04-1
January 5, 2004

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK AND TO EACH DOMESTIC AND FOREIGN BANKING ORGANIZATION SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the agencies) have issued the attached *Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates*. This interagency policy statement sets forth the collective views of the agencies concerning the safety and soundness implications of a bank providing financial support to investment funds advised by the bank or its affiliates (i.e., affiliated investment fund).

The three core principles contained in the interagency policy statement emphasize that a bank should **not**:

- inappropriately place its resources and reputation at risk for the benefit of affiliated investment funds' investors and creditors;
- violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or
- create an expectation that the bank will prop up the advised fund(s).

In addition, bank affiliated investment advisers are

encouraged to establish alternate sources of financial support to avoid seeking support from affiliated banks. Finally, bank management is expected to notify and consult with its appropriate federal banking agency prior to (or immediately after, in the event of an emergency) providing material financial support to an affiliated investment fund.[1]

The guidance contained in the interagency policy statement is consistent with the Board's existing guidance issued in 1994 through SR letters 94-53, *Investment Adviser Activities* , and 94-54, *Contributions by Banking Organizations to Mutual Funds and Common Investment Funds* . With the issuance of this interagency policy statement, SR letter 94-54 is rescinded. However, the sound practices for management and oversight of investment adviser activities recommended in SR letter 94-53 remain valid.

As with certain other supervisory guidance issued prior to passage of the Gramm-Leach-Bliley Act (GLBA), examiners are reminded of the necessary modifications in the implementation of that guidance in the context of functional regulation. Under GLBA the SEC, as the functional regulator of the investment advisory activities of registered investment advisors, has primary rulemaking and supervisory responsibility for those advisers. Accordingly, the guidance advanced in SR letter 94-53 as it pertains to the examination of investment advisers to mutual funds should now be viewed principally as guidance applicable to the parent bank or bank holding company in its oversight and control of functionally regulated entities.[2] All other advisory activities, such as trust departments operating collective investment funds, remain subject to the guidance contained in SR letter 94-53 as well as the new interagency guidance on providing financial support to funds advised by banking organizations.

Reserve Banks are requested to send a copy of this SR letter and the interagency policy statement to senior management at domestic and foreign banking organizations supervised by the Federal Reserve. If you have any questions or are notified of actual or pending material financial support by a state member bank, or branch or agency subject to Federal Reserve supervision, please contact Jim Embersit, Deputy Associate Director (202-452-5249), or Mike Schoenfeld, Senior Supervisory Financial Analyst (202-452-2836), Market and Liquidity Risk Section.

Richard Spillenkothen
Director

Attachment

Cross reference: SR letters 94-53, SR 94-54, and SR 00-13

Modifies: SR letter 94-53

Supersedes: SR letter 94-54

Notes:

1. The deferral or waiver of fees is *not* deemed to be material financial support for this purpose.

2. Federal Reserve examiners no longer examine a registered investment adviser that solely provides advice to a mutual fund subject to SEC supervision, unless GLBA criteria are met (see SR letter 00-13 for additional details).

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

January 5, 2004

Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates

Purpose and Scope

This interagency policy is issued jointly by the federal banking agencies, including the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Board), and the Office of Thrift Supervision (OTS) (the agencies) to alert banking organizations, including their boards of directors and senior management, of the safety and soundness implications of and the legal impediments to a bank providing financial support to investment funds[1] advised by the bank, its subsidiaries, or affiliates. A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation, and can harm investors, if the associated risks are not effectively controlled. The agencies have concluded that recent market developments, including market volatility, the continued low interest rate environment, and operational and corporate governance weaknesses, warrant the issuance of this guidance.

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise has included credit extensions, cash infusions, asset purchases, and acquisition of fund shares. In very limited circumstances, certain arrangements between banks and funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns.

Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR 223) place quantitative limits and collateral and market terms requirements on many transactions between a bank and certain of its advised funds.

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[1] Bank advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice. For purposes of this guidance, "banks" includes banks and savings associations regulated by the federal banking or thrift agencies.

Additionally, the OCC's fiduciary activities regulation (12 CFR 9) may restrict transactions between a bank and its advised funds.[2]

Policy

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank advised investment funds. Such policies and procedures should be designed to ensure that the bank will not (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities[3] that include:

- Establishing alternative sources of emergency support from the parent holding company, non-bank affiliates or external third parties prior to seeking support from the bank.

- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to ensure that appropriate policies and procedures were followed.

- Implementing an effective risk management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.

- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.

- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with FAS 5, and fiduciary settlements, surcharges, and other losses arising out of its

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[2] Banks should be aware that other legal requirements may also restrict or prohibit transactions between a bank and its advised funds, including the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Employee Retirement Income Security Act of 1974 (ERISA).

[3] The agencies acknowledge the SEC's functional regulatory authority over the investment advisory activities of SEC registered investment advisers. However, the agencies remain responsible for evaluating the consolidated risk profiles of banking organizations, which may include assessing the risks posed to the bank from the activities and obligations of any subsidiary or affiliate.

investment advisory activities in accordance with the instructions for completing Call Report Schedule RC-T – Fiduciary and Related Services.

Notification

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to (or immediately after, in the event of an emergency) the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 94-53 (FIS)
October 25, 1994

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Investment Adviser Activities

Within the last several months, some bank holding companies whose subsidiaries act as investment advisers to proprietary money market mutual funds have provided financial support to their respective funds to offset declines in portfolio values resulting from reductions in the market value of complex investment products such as high risk CMOs and structured securities.[1] A few state member banks have had to address similar circumstances with respect to their trust departments' common investment funds (CIFs) that are advised by the bank.

These events underscore the importance to banking organizations acting as investment advisers of having appropriate policies and procedures that address the management and operations of investment adviser activities. These policies and procedures should assure that the adviser is aware of the risks associated with the investment products it recommends to its client funds, particularly with respect to complex derivative products, structured notes, and other high risk investments. Further, the adviser should determine that investment products are appropriate and consistent with the funds' prospectuses and stated objectives.[2]

Banking organizations that engage in investment adviser activities should have policies and procedures for addressing, monitoring, and controlling all significant risks associated with the advisory activity, including legal, operating, reputational, fiduciary, and financial risks. The latter includes the possible exposure associated with providing direct financial support to advised funds. Losses incurred by the advised fund could also pose an indirect financial risk to the advising banking organization if depositors or other providers of funds were to lose confidence in the organization, leading to possible deposit withdrawals or the termination of credit lines. Before commencing the activity of acting as investment adviser, banking organizations should assess all significant risks associated with the activity and should establish policies and systems to monitor and control such risks. In addition, all major policies and procedures pertaining to advisory activities should be reviewed periodically and approved by the organizations' boards of directors.

As a result of recent events, it is appropriate to reiterate the importance of the Federal Reserve's established bank and bank holding company[3] supervision policies and examination procedures that address the risks associated with acting as an investment adviser. Reserve Banks are instructed to continue to monitor carefully investment adviser activities and, where necessary, to enhance their review and assessment of bank and bank holding company policies, procedures and internal controls in the investment adviser function during the examination of banks, bank holding companies, or nonbank subsidiaries that act as investment advisers to mutual funds or CIFs.

Review of Investment Adviser Activities

Examiners should give special attention to the organization's policies and procedures pertaining

to investment adviser activities and to contingencies that could arise with this activity. The Federal Reserve's examination guidelines and related procedures pertaining to investment advisory activities of bank holding companies and their nonbank subsidiaries and state member banks' trust departments are contained in the Bank Holding Company Supervision Manual (Section 3130)[4] and the Trust Examination Manual (Sections 4 and 5), respectively. These examination procedures indicate that an adviser is obligated to provide advice that is consistent with the stated investment objectives as set forth in the prospectus and with the liquidity needs applicable to a fund or account.

In addition, a recent supervisory letter on structured securities[5] which focused on the use of these instruments by banking organizations in trading, investment, or trust operations, emphasized that failure of management to understand adequately the dimensions of the risks in complex derivative products can constitute an unsafe and unsound practice. Similarly, an investment adviser is expected to understand fully the risks involved in any investment product recommended to its client funds and how these risks relate to the funds' stated investment objectives.

In this regard, examiners should determine whether an investment adviser has policies and procedures to ensure that the fund portfolios it advises are operated in a manner fully consistent with the funds' objectives or, if applicable, SEC requirements. Investment advisers should have policies and procedures that subject advised funds to appropriate "stress testing" or contingency planning on a periodic basis in an effort to determine whether the investments will continue to conform to the funds' objectives in periods of market uncertainty and volatility.

Examiners should also determine that the investment adviser has policies and procedures in place that ensure compliance with applicable laws and SEC requirements such as those pertaining to the permissibility of certain high risk investments for money market mutual funds. Further, the adviser should have procedures to ensure that management of advised funds is fully informed of the risk character of the overall portfolio, including the presence of any complex investment products or other high risk investments. This is necessary to ensure that the funds' management and their distributors are able to make any necessary disclosures to investors in conformance with SEC requirements.

With regard to the inspection of the parent bank holding company, examiners should determine that the holding company's senior management and its board of directors have policies and procedures in place to monitor the activities of investment adviser subsidiaries to ensure that the risks associated with the conduct of this activity are not in conflict with the parent company's overall risk tolerance parameters. The parent should be able to assess at all times the extent of its exposure to financial, litigation, or reputational risk, if any, that stems from the investment advisory activities conducted by subsidiaries, and whether any such exposure would have a material adverse effect on the parent company's ability to act as a source of strength to its banks. In addition, the parent bank holding company should assure that the internal audit function monitors the activities of the investment adviser for compliance with any limits or internal controls that are intended to restrict its activities.

The examination frequency of investment adviser activities historically has been dependent on the volume and scope of advisory activities and the results of previous Reserve Bank (or SEC) examinations. Given the significance of investment advisory activities and the potential for off-balance sheet risk, such activities should generally be examined as part of the bank holding company's or bank's annual safety and soundness or trust examination. Particular attention should be focused on an investment adviser that places orders directly on behalf of a fund, or provides other portfolio management services such as safekeeping of securities or recordkeeping. As in the past, Reserve Banks should consider using trust examiners to conduct or participate in examinations and inspections of investment advisory activities because of their familiarity with the subject.[6]

It is requested that you distribute a copy of this letter to bank holding companies, state member banks, and state-licensed U.S. branches and agencies of foreign banks in your district that are engaged or intend to engage in the activity of providing investment advisory services to mutual funds or trust department

CIFs. Should you have any questions regarding this letter or the examination of investment advisory activities, please contact either Howard Amer (x2958) or Angela Desmond (x3497).

Richard Spillenkothen
Director

Cross Reference: SR 81-216
SR 88-11
SR 91-4
SR 94-45

Footnotes

1. Some bank holding companies have chosen, for business reasons, to provide the financial support necessary to maintain the $1.00 per share net asset value of proprietary money market mutual funds even though the companies were under no legal obligation, barring a breach of fiduciary responsibility, to do so. In general, the support provided was treated as an expense by the bank holding companies.

2. In a June 16, 1994 letter to the CEOs of large money market funds, the Chairman of the SEC strongly encouraged the management of every fund that holds derivative instruments to take steps that will ensure the proper understanding and effective management of derivatives risk. He also indicated that fund managers must implement policies to ensure that use of derivatives is fully consistent with the fund's investment objectives. In a June 30, 1994 follow-up letter to the ICI, SEC staff advised that funds should dispose of five types of structured securities, specifically, inverse floaters, cost-of-funds index floaters, constant-maturity Treasury floaters, dual-index floaters and range floaters.

3. This supervisory letter is applicable throughout to foreign banking organizations and their U.S. branches and agencies.

4. See SR 91-4 (SA), dated February 8, 1991, which also incorporated previously issued supervisory policy and procedures contained in earlier supervisory letters.

5. SR 94-45, dated August 5, 1994.

6. See Section 3130.1.3 of the Bank Holding Company Supervision Manual and SR 88-11, dated April 28, 1988.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 94-54 (FIS)
October 27, 1994

**TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK**

SUBJECT: Contributions by Banking Organizations to Mutual Funds and Common Investment Funds (CIFs)

In order to stay informed regarding contributions of funds by banks, bank holding companies and foreign banking organizations to mutual funds or trust department CIFs they advise, and to aid in determining the appropriate supervisory response with regard to a specific situation as well as industry practices in general, Reserve Banks are requested to notify Board staff on a timely basis of proposed or actual instances of such contributions. As was the case with the specific transactions that have already occurred, Reserve Banks also are requested to provide us with a written review of the transaction.

The review should be thorough and include, at a minimum, the following information:

- the names and relationships of the legal entities concerned
- the underlying cause of the losses sustained by the fund and the amount and nature of the specific investment products that declined in value
- the amount and form of the contribution or support provided by the banking organization to the fund
- the degree of financial effect the contribution has on the banking organization
- any proposed supervisory response

Please forward your notices and reviews directly to me. Should you have any questions, please contact Howard Amer (x2958).

James I. Garner
Deputy Associate Director

Cross Reference: SR 94-53

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 00-13 (SUP)
August 15, 2000

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY STAFF AT EACH FEDERAL RESERVE BANK AND TO FINANCIAL HOLDING COMPANIES

SUBJECT: Framework for Financial Holding Company Supervision

Introduction

The Gramm-Leach-Bliley Act ("GLB Act") repeals those provisions of the Glass-Steagall Act and the Bank Holding Company Act that restrict the ability of bank holding companies ("BHCs") to affiliate with securities firms and insurance companies. The GLB Act authorizes qualifying BHCs to operate as *financial* holding companies ("FHCs") and to engage in a diversified range of financial activities. In addition to controlling depository institutions, permissible activities for FHCs include conducting securities underwriting and dealing, serving as an insurance agent and insurance underwriter, acting as a futures commission merchant, and engaging in merchant banking. Permissible activities also include those that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities, or that the Board determines is complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Under the GLB Act, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs. The statute includes provisions that streamline various aspects of the Federal Reserve's supervision for all BHCs and sets forth parameters for the relationship between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with regulators of depository institutions and functional regulators, which include insurance, securities and commodities regulators. There should be minimal, if any, noticeable change in the well-established relationships between the Federal Reserve as BHC (including FHC) supervisor and bank and thrift supervisors

(federal and state). The Federal Reserve's relationships with functional regulators will, in practice, depend upon the extent to which an FHC is engaged in functionally regulated activities and also will be influenced by already established working arrangements.

This SR letter provides guidance concerning the purpose and scope of the Federal Reserve's supervision of FHCs, with particular focus on the legislation's requirements for working with functional regulators. The framework should be used by Federal Reserve staff in supervising FHCs and coordinating activities with the appropriate primary supervisors of an FHC's banking, insurance, and securities subsidiaries.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not viewed as an extension of more traditional bank-like supervision throughout an FHC. The FHC framework set forth in this letter is consistent with and incorporates principles that are well established for BHCs. Because the GLB Act does not require significant changes in supervisory practice for non-FHC BHCs, this document focuses on addressing supervisory practice for, and relationships with, FHCs, particularly those that are engaged in securities or insurance activities.

Roles of Supervisors

The Federal Reserve is responsible for the consolidated supervision of FHCs. In this regard, the Federal Reserve will assess the holding company on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its depository institution subsidiaries. The manner in which the Federal Reserve fulfills this role will likely evolve along with the activities and structure of FHCs and may differ depending on the mix of banking, securities, and insurance activities of an FHC.

Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). The GLB Act did not alter the role of the Federal Reserve, as holding company supervisor, *vis-a-vis* the primary supervisors of FHC-associated bank and thrift subsidiaries because the Federal Reserve has traditionally relied to the fullest extent possible on those supervisors.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities or insurance activities are supervised by their appropriate functional regulators. Such functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the SEC (or, in the case of an investment adviser, registered

with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in CFTC-regulated activities.

Objectives of Financial Holding Company Supervision

The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with those activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company in order to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

Accordingly, the Federal Reserve will focus on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess the internal policies, reports, and procedures and effectiveness of the FHC consolidated risk management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

As noted above, financial holding company supervision is not intended to impose bank-like supervision on FHCs, nor is it intended to duplicate or replace supervision by the primary bank, thrift, or functional regulators of FHC subsidiaries. Rather, it seeks, on the one hand, to balance the objective of protecting the depository institution subsidiaries of increasingly complex organizations with significant inter-related activities and risks, against, on the other, the objective of not imposing an unduly duplicative or onerous burden on the subsidiaries of the organization. Effective financial holding company supervision requires:

- Strong, cooperative relationships between the Federal Reserve and primary bank, thrift, and functional regulators and foreign supervisors. These relationships respect the individual statutory authorities and responsibilities of the respective supervisors, but at the same time, allow for enhanced information flows and coordination so that individual responsibilities can be carried out effectively without creating duplication or excessive burden;

- Substantial reliance by the Federal Reserve on reports filed with, or prepared by, bank, thrift, and functional regulators, as well as on publicly available information for both regulated and non-regulated subsidiaries; and

- Continued reliance on the risk-focused supervision and examination process and on market discipline.

Financial Holding Company Supervision in Practice

The supervisory activities of the Federal Reserve fall into three broad categories: information gathering, assessments and supervisory cooperation; ongoing supervision; and promotion of sound practices and improved disclosure.

Information gathering, assessments, and supervisory cooperation

To fulfill its responsibilities, the Federal Reserve needs to interact closely and exchange information with the primary bank, thrift, and functional regulators. It is also important that the Federal Reserve develop strong relationships with senior management and boards of directors of FHCs, and have access to timely information from FHCs. In order to understand how risk management and internal control policies and procedures established at the consolidated level are being implemented and assessed, these relationships will need to include heads of significant business lines and key internal audit, control, and risk management officials.

To achieve these objectives, Federal Reserve supervisory staff will:

- Regularly assess an FHC's centralized risk management and control processes. Such assessments are necessary to understand an organization's overall risk profile, to identify material contributions to core risks, and to determine how such risks are being managed and controlled on a consolidated basis.

- Perform limited targeted transaction testing, where appropriate, to verify that risk management systems of the FHC are adequately and appropriately measuring and managing areas of risk for the organization, and to confirm that laws and regulations applicable to the FHC and within the jurisdiction of the Federal Reserve are

being followed.

- Have periodic discussions with FHC senior management and boards of directors. Such discussions will enable the Federal Reserve to build relationships with key personnel and to understand changing activities and the evolving risk profile of the consolidated organization. Periodic discussions also will provide a forum for supervisory staff to present any findings or concerns related to the activities of the group as a whole or to business lines that cut across legal entities.

- Have periodic discussions with key personnel responsible for corporate management and control functions, such as heads of business lines, risk management, internal audit and internal control.

In performing the tasks described above, Federal Reserve supervisory staff, to the extent possible, should coordinate their actions with those of the primary bank, thrift, and functional regulators of the FHC's subsidiaries. For example, in order to understand the risks and risk-management systems of an FHC at the consolidated level, the Federal Reserve will need information concerning assets or liabilities booked in significant bank, thrift, and functionally regulated subsidiaries within the FHC group. The primary bank, thrift, and functional regulators of such subsidiaries also may have a need for information from the FHC, consistent with their respective statutory mandates. To assist in sharing needed information, Federal Reserve supervisory staff should:

- Have periodic meetings with the primary bank, thrift and functional regulators of an FHC's subsidiaries to develop an understanding of the risk profiles of the individual regulated legal entities and their relation to the FHC's overall risk profile. These meetings also should be used, where appropriate, to share information regarding supervisory plans and coordinate supervisory activities and follow-up, as needed.

- Review the examination findings of primary bank, thrift and functional regulators (and their self-regulatory organizations) together with other relevant information in order to develop a consolidated picture of the FHC's financial condition and risk profile, the effectiveness of risk management and internal control policies, and the

implications for the affiliated depository institutions.

- Make available to primary bank, thrift and functional regulators, to the extent permissible, pertinent information regarding the financial condition, risk management policies, and operations of an FHC that may have a material impact on individual regulated subsidiaries, as well as information concerning transactions or relationships between the regulated subsidiaries and other subsidiaries within the FHC group. This process will assist supervisors in performing their statutory and supervisory responsibilities over regulated subsidiaries.

- Participate in the sharing of information among international supervisors, consistent with applicable law, to ensure that an FHC's global activities are supervised on a consolidated basis and to minimize material gaps in supervision.

- Review internal audit and management reports and publicly available information (including market information on equity and debt prices of the consolidated organization), as well as reports and statistics collected by other regulators, including those of depository institution subsidiaries. To limit regulatory burden, this information should be obtained, to the fullest extent possible, from the parent organization, from primary bank, thrift, and functional regulators of the FHC's regulated subsidiaries, and from publicly available sources, such as externally audited financial statements.

Ongoing supervision

FHC structure, management, and the applications process

The Federal Reserve is responsible for understanding the consolidated organization's legal, organizational, and risk management structure, major business activities, and risk exposures and risk management systems. The Federal Reserve needs to understand the nature and degree of involvement of the board of directors at the consolidated group level in overseeing the risk management and control process of the organization. The Federal Reserve, when considering any formal application, declaration, certification, or notification process at the FHC level, will coordinate, as appropriate, with primary bank, thrift, and functional regulators.

Reporting and examination

The Federal Reserve will rely, to the fullest extent possible, on reports that an FHC or its subsidiaries are required to file with, or are prepared by, federal or state authorities (or self-regulatory organizations). The Federal Reserve will rely on routinely prepared management reports, publicly reported information, and externally audited financial statements. The Federal Reserve also will rely to the fullest extent possible on the examination of an FHC's bank and nonbank subsidiaries by their appropriate primary bank, thrift, and functional regulators (and their self-regulatory organizations).

If supervisory staff requires a specialized report from a functionally regulated subsidiary of an FHC, staff first will request it from the subsidiary's appropriate functional regulator. In the event that the report is not made available to the Federal Reserve, supervisory staff may obtain the report directly from the functionally regulated subsidiary if it is necessary to assess (i) a material risk to the FHC or any of its depository institution subsidiaries, (ii) compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the FHC or a subsidiary, or (iii) the FHC's systems for monitoring and controlling financial and operational risks that may pose a safety and soundness threat to a depository institution subsidiary.

The Federal Reserve may examine a functionally regulated subsidiary when it has reasonable cause to believe (or reasonably determines) that (i) the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution, (ii) the examination is necessary to be adequately informed about the FHC's systems for monitoring and controlling the financial and operational risks that may pose a safety and soundness risk to a depository institution subsidiary, or (iii) the subsidiary is not in compliance with any federal law that the Board has specific jurisdiction to enforce (and the Board cannot determine compliance by examining the FHC or its affiliated depository institutions). Before examining a functionally regulated subsidiary, supervisory staff should first seek to obtain the necessary information from the appropriate functional regulator. If an examination is determined to be necessary, the Federal Reserve should coordinate its actions with the appropriate functional regulator.

Consistent with current practice, the Federal Reserve will continue to rely to the fullest extent possible on the work performed by bank, thrift, and functional regulators to validate that material risks are measured and managed adequately at the regulated subsidiary level. Where necessary and appropriate, and consistent with (i) through (iii) above, the Federal Reserve may conduct or participate in reviews at banks, thrifts, or functionally regulated subsidiaries to validate that risk management and

internal control policies established at the consolidated level are being implemented effectively.

For a subsidiary of an FHC that is not supervised by a bank, thrift, or functional regulator, the Federal Reserve will obtain information from the subsidiary, as appropriate and necessary, to assess the financial condition of the FHC as a whole. In addition, the Federal Reserve will conduct examinations of such subsidiaries, if necessary, to be informed as to the nature of the subsidiary's operations and financial condition, as well as the subsidiary's financial and operational risks that may pose a threat to the safety and soundness of any depository institution subsidiary of the FHC and the systems for monitoring and controlling such risks. Under the GLB Act, the Federal Reserve may not examine any subsidiary of an FHC that is an investment company registered with the SEC and that is not itself a BHC.

Capital adequacy

The Federal Reserve is responsible for assessing consolidated capital adequacy for FHCs with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization. Capital adequacy will be assessed in relation to the risk profile of the consolidated organization. The Federal Reserve will review the FHC's internal risk assessment and related capital analysis process for determining the adequacy of its overall capital position. Such a review will include consideration of present and future economic conditions, future business development plans, possible stress scenarios, and internal risk control and audit procedures. As BHCs, FHCs are subject to the Federal Reserve's holding company capital guidelines, which set forth minimum capital ratios that serve as tripwires for additional supervisory scrutiny and corrective action. The Federal Reserve will review these requirements as they apply to FHCs and may, if warranted, adapt the manner in which they apply to FHCs that engage in a broad range of financial activities.

Although the Federal Reserve is responsible for assessing the consolidated capital adequacy of FHCs, the primary bank, thrift, or functional regulators of FHC subsidiaries will continue to set and enforce applicable capital requirements for the regulated entities within their jurisdiction. Under the GLB Act, the Federal Reserve may not establish separate capital adequacy requirements for an FHC subsidiary that is in compliance with the capital requirements of its functional regulator.

Consistent with current practice, the Federal Reserve will continue to place significant reliance on the primary bank, thrift, or functional regulator's analysis of the capital adequacy of a regulated subsidiary and use that analysis as significant input in assessing an FHC's consolidated capital adequacy. This is especially true where a securities broker-dealer or

insurance company comprises a predominant part of an FHC.

When assessing consolidated capital adequacy for FHCs with functionally regulated subsidiaries, several issues take on particular prominence. Capital adequacy requirements that have been established for banking, securities, and insurance entities by their respective regulators reflect varying definitions of the elements of capital and varying approaches to asset and liability valuations. Techniques for assessing capital adequacy must be sufficiently robust to identify situations such as double or multiple leverage or double gearing, because in such cases the actual capital protection may be overstated.

Intra-group exposures and concentrations

Intra-group exposures, including servicing arrangements and risk concentrations, have the potential to threaten the condition of regulated entities. Intra-group exposures may be significant at large, complex FHCs, especially those that operate their businesses on global lines that cut across legal entities within the firm. The focus of the Federal Reserve in this area is on the potential impact of intra-group exposures and concentrations on insured depository institution subsidiaries of an FHC.

Risk concentrations can take many forms, including exposures to one or more counterparties or related entities, industry sectors, and geographic regions. For risk concentrations, the holding company supervisor is uniquely positioned to understand the combinations of exposures within an organization across all legal entities. This understanding is critical at the group level -- risk concentrations that are prudent on a legal entity basis may aggregate to an unsafe level for the consolidated organization.

The Federal Reserve will monitor intra-group exposures and risk concentrations as follows:

- The appropriate primary bank and thrift regulators will continue to monitor and enforce section 23A and 23B restrictions at the bank or thrift level. The Federal Reserve will focus on assessing whether the FHC monitors and ensures compliance with these statutory requirements. The Federal Reserve plans to begin collecting data from each depository institution subsidiary of BHCs, including FHCs, on their covered transactions with affiliates that are subject to sections 23A and 23B and will share that data with primary bank and thrift regulators.

- Functional regulators will continue to monitor and

enforce any intra-group exposure restrictions that may apply to the regulated entities under their jurisdictions.

- The Federal Reserve will focus on understanding and monitoring related-party exposures at the group level, including areas such as servicing agreements, derivatives exposures, and payments system exposures, with an important focus on the extent to which a depository institution subsidiary's risk management is dependant on transactions with affiliates.

- The Federal Reserve also will focus on management's effectiveness in monitoring and controlling intra-group exposures and risk concentrations. The Federal Reserve will consider how an organization's risk management processes measure and manage group-wide risk concentrations.

Enforcement powers

The Federal Reserve generally is authorized to take enforcement action against FHCs and their nonbank subsidiaries. The primary bank and thrift supervisors have the authority to take enforcement action against the banks and thrifts under their jurisdictions. Under the GLB Act, the Federal Reserve may take enforcement action against a functionally regulated subsidiary of an FHC, but only when such action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk either to the financial safety, soundness or stability of an affiliated depository institution, or to the domestic or international payments system. In such circumstances, the Federal Reserve may only take the action if it is not reasonably possible to protect effectively against the material risk through an action directed at or against an affiliated depository institution.

Under any circumstances, the Board may take enforcement action against a functionally regulated subsidiary to enforce compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the subsidiary. In the event the Federal Reserve believes that an enforcement action by the Federal Reserve against a functionally regulated entity is necessary, the Federal Reserve will notify the entity's appropriate functional regulator and will coordinate such an action with any taken by the functional regulator wherever practical. It is expected that the Federal Reserve will not take an enforcement action against a functionally regulated subsidiary (or a person associated with the subsidiary) if the problem involves factors and statutes that are the primary responsibility of the functional regulator.

Under the existing bank holding company framework, the Federal Reserve coordinates enforcement actions with the primary bank and thrift regulators, possibly with some adaptation of the action for the holding company context (such as limitations on parent company debt or dividends). The Federal Reserve will continue to coordinate enforcement actions with those regulators. In a similar fashion, the Federal Reserve will coordinate with functional regulators when formulating and issuing enforcement actions that involve or may have an impact on functionally regulated subsidiaries.

Promotion of sound practices and improved disclosure

The Federal Reserve can promote sound practices in a number of ways, such as by monitoring trends in risk exposures and risk management practices across the FHC population through a combination of efforts. These include regular discussions, centered on specific issues and emerging risks, with FHC management; regular meetings with primary bank, thrift, and functional regulators to explore and discuss issues of mutual interest and/or concern; interagency working groups or specialty teams to gain early insight into risks that cut across the various entities of a conglomerate or groups of conglomerates; and industry conferences on relevant topics of interest.

These initiatives will contribute to the development of sound practices that the Federal Reserve and other primary bank, thrift, and functional regulators can communicate to the senior management and board of directors of the FHCs, as well as to the senior management of their bank and nonbank subsidiaries.

Improved transparency and public disclosure can meaningfully supplement the efforts of supervisors to monitor the increasingly complex and global activities of diversified banking organizations. The Federal Reserve will, consistent with sound accounting principles and practices, and with considerations of depository institution safety and soundness, participate in efforts to enhance disclosures that illuminate group-wide activities, risk exposures, risk management, controls, and intra-group exposures.

Ongoing challenges

Most of the concepts discussed in this framework are already being applied by the Federal Reserve in the context of the consolidated supervision of BHCs.[1] Examples include greater reliance on risk-focused supervision; strengthening relationships with senior management; improving coordination with other federal, state and international regulatory and supervisory authorities; greater reliance on specialty teams, sound practices papers and public disclosures; and simplification of the applications process.

Still, supervision of more diversified FHCs presents new challenges. To address these challenges, the Federal Reserve will continue its efforts to strengthen (i) cooperative arrangements with bank and thrift regulators, the SEC, CFTC, state insurance and securities regulators, and foreign supervisors; (ii) relationships with FHC management and personnel responsible for significant risk management functions and, where necessary, the management of the organization's nonbank subsidiaries; (iii) information flows that provide supervisors with relevant, up-to-date information without imposing unwarranted burden on financial organizations; (iv) techniques for evaluating capital adequacy for FHCs engaged in an expanded range of nonbank financial activities; (v) public disclosures and market discipline; (vi) techniques for assessing the overall risk profile of FHCs and the implications for affiliated depository institutions; and (vii) incentives for FHCs to continually review and improve their risk management processes, internal controls, and audit practices.

The Federal Reserve is committed to continuing to work in a constructive and cooperative fashion with all regulators involved in overseeing the activities of FHCs and their bank and nonbank subsidiaries.

Reserve Banks are asked to distribute this SR letter to FHCs as well as to the state banking agencies and functional regulators in their districts. Questions pertaining to this framework should be directed to Roger Cole, Associate Director, at (202) 452-2618, Michael Martinson, Deputy Associate Director, at (202) 452-3640, or Barbara Bouchard, Manager, Policy Development, at (202) 452-3072.

Richard Spillenkothen
Director

Cross Reference: SR 99-15

Notes:

1. The Federal Reserve's framework for supervising large complex banking organizations (LCBOs) is described in SR letter 99-15.