FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10667**
November 29, 1993]

SAFETY AND SOUNDNESS STANDARDS

Interagency Notice of Proposed Rulemaking

Comments Due January 3, 1994

To All State Member Banks, Bank Holding Companies, and Branches and Agencies of Foreign Banks, in the Second Federal Reserve District:

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System have issued joint proposals prescribing safety and soundness standards for insured depository institutions and their holding companies, as required by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

Following is the text of the statement by the Board of Governors announcing the proposal:

> The Federal Reserve Board has requested public comment on an interagency notice of proposed rulemaking prescribing safety and soundness standards required by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).
>
> Comments should be received by January 3, 1994.
>
> Section 132 of FDICIA requires each of the Federal banking agencies to prescribe safety and soundness standards for the insured depository institutions or depository institution holding companies that it regulates. The proposed rule prescribes standards specific enough to identify emerging operational and managerial problems and to require submission of a compliance plan before those problems become serious. The proposed standards generally establish the end that proper operations and management should achieve, while leaving the means to each institution.
>
> The agencies sought comment on methods to meet the requirements of section 132 through an advance notice of proposed rulemaking in July of 1992. The current proposal incorporates suggestions received in response to that advance notice, including the suggestion that the agencies prescribe general standards rather than specific item-by-item requirements.
>
> The Board initially approved the publication of a notice of proposed rulemaking under section 132 on April 21, 1993. Publication of the notice was delayed in order to reach interagency agreement.

Enclosed — for member banks, bank holding companies, and branches and agencies of foreign banks in this District — is an excerpt from the *Federal Register* of November 18, containing the interagency notice of proposed rulemaking, together with the text of the proposed amendments to Regulation H, Regulation Y, and the Rules of Practice for Hearings of the Board of Governors. Additional, single copies of the enclosure may be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor, or by calling the Circulars Division (Tel. No. 212-720-5215 or 5216).

Comments on the proposal should be submitted by January 3, 1994, and may be sent to the Board, as indicated in the notice, or to our Domestic Banking Department.

WILLIAM J. MCDONOUGH,
President.

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Proposed Rules

Federal Register
Vol. 58, No. 221
Thursday, November 18, 1993

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 30

[Docket No. 93–17]

FEDERAL RESERVE SYSTEM

12 CFR Parts 208, 225, and 263

[Docket No. R–0766]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Parts 303, 308, and 364

RIN 3064–AB13

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 570

[OTS 93–101]

RIN 1550–AA54

Standards for Safety and Soundness

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively "the agencies") solicit comments on all aspects of proposed safety and soundness standards required to be prescribed by regulation pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act)). The standards are intended to enable the agencies to address problems at banks, thrifts, and depository institution holding companies before the problems cause significant deterioration in the financial condition of the institution or holding company. Public comment is invited on all aspects of this proposal.

DATES: Written comments must be received on or before January 3, 1994.

ADDRESSES: Interested parties are invited to submit written comments to any or all of the agencies. All comments will be shared among the agencies.

OCC: Communications Division, 250 E Street SW., Washington, DC 20219, attention: Docket No. 93–17. Comments will be available for public inspection and photocopying at the same location on business days between 9 a.m. and 5 p.m.

Board: Comments, which should refer to Docket No. R–0766, may be mailed to Mr. William Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551. Comments addressed to Mr. Wiles may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room MP–500 between 9 a.m. and 5 p.m., except as provided in § 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FDIC: Hoyle L. Robinson, Executive Secretary, Attention: Room F–402, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. Comments may be hand-delivered to room F–400, 1776 F Street, NW., Washington, DC, on business days between 8:30 a.m. and 5 p.m. [FAX number (202)898–3838]. Comments will be available for inspection and photocopying in room 7118, 550 17th Street, NW., Washington, DC 20429, between 9 a.m. and 4:30 p.m. on business days.

OTS: Comments should be directed to Director, Information Services Division, Public Affairs, Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552, Attention: Docket No. 93–101. These submissions may be hand delivered to 1700 G Street, NW., from 9 a.m. to 5 p.m. on business days; they may be sent by facsimile transmission to FAX number (202) 906–7755. Submissions must be received by 5 p.m. on the day they are due in order to be considered by the OTS. Late-filed, misaddressed, or misidentified submissions will not be considered in this rulemaking. Comments will be available for inspection at 1700 G Street NW., from 1 p.m. until 4 p.m. on business days. Visitors will be escorted to and from the Public Reference Room at established intervals.

FOR FURTHER INFORMATION CONTACT:
OCC: Emily R. McNaughton, National Bank Examiner (202/874–5170), Office of the Chief National Bank Examiner; David Thede, Senior Attorney, Bank Operations and Assets Division (202/874–4460), Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: David Wright, Supervisory Financial Analyst (202/728–5854), Division of Banking Supervision and Regulation; Scott G. Alvarez, Associate General Counsel (202/452–3583), Gregory A. Baer, Senior Attorney (202/452–3236), Legal Division, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452–3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

FDIC: Robert W. Walsh, Examination Specialist (202/898–6911) or Michael D. Jenkins, Examination Specialist (202/898–6896), Division of Supervision; Lisa M. Stanley, Senior Counsel (202/898–7494), Jeffrey M. Kopchik, Counsel (compensation standards) (202/898–3872), or Nancy L. Alper, Counsel (enforcement) (202/898–3720), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: Robert Fishman, Senior Program Manager (202/906–5672), Deirdre Kvartunas, Program Analyst (202/906–7933), Policy Office, Cheryl Martin, Regional Coordinator (202/906–7869), Regional Operations; Kevin Corcoran, Assistant Chief Counsel for Business Transactions (202/906–6962), Teri M. Valocchi, Counsel (Banking and Finance) (202/906–7299), Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

[Enc. Cir. No. 10667]

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SUPPLEMENTARY INFORMATION:

I. Statutory Framework

Section 132 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), Public Law 102–242, added a new section 39 to the FDI Act (12 U.S.C. 1831p–1) which requires each agency to prescribe by regulation certain safety and soundness standards for the insured depository institutions and depository institution holding companies for which it is the primary Federal regulator. Section 39 was subsequently amended in the compensation area by section 956 of the Housing and Community Development Act of 1992, Public Law 102–550.

Three types of standards must be prescribed: (1) Operational and managerial; (2) asset quality and earnings; and (3) compensation. Stock valuation standards must be prescribed to the extent feasible.

Section 39(a) requires the agencies to prescribe by regulation operational and managerial standards relating to: (1) Internal controls, information systems, and internal audit systems, in accordance with section 36 of the FDI Act (12 U.S.C. 1831m); (2) loan documentation; (3) credit underwriting; (4) interest rate exposure; (5) asset growth; and (6) compensation, fees, and benefits, in accordance with subsection (c) of section 39.

Section 39(b) requires the agencies to prescribe by regulation standards specifying: (1) A maximum ratio of classified assets to capital; (2) minimum earnings sufficient to absorb losses without impairing capital; and (3) to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of institutions and holding companies.

If an agency determines that an institution or holding company fails to meet any standard prescribed under sections 39(a) or 39(b), the institution or company must submit to the agency an acceptable plan to achieve compliance with the standard. In the event that an institution or company 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 or company to correct the deficiency. The agency may, and in some cases must, take other supervisory actions until the deficiency has been corrected.

Section 39(c) requires the agencies to prescribe by regulation standards prohibiting as an unsafe and unsound practice excessive compensation or compensation that could result in a material financial loss to an institution. This subsection also requires that the agencies prescribe standards specifying when compensation is excessive.

II. Advance Notice of Proposed Rulemaking

In July 1992, the agencies published in the **Federal Register** an advance notice of proposed rulemaking (ANPR) requesting public comments on all aspects of the safety and soundness standards to be prescribed pursuant to section 39 of the FDI Act. See 57 FR 31336, July 15, 1992. In addition, for each safety and soundness standard, the ANPR requested comment on specific questions asked by the agencies.

The agencies received over 400 comment letters in response to the ANPR, though some letters were submitted to more than one agency. The majority of comments were received from insured depository institutions. With respect to each of the three principal areas in which regulatory standards must be prescribed, commenters strongly recommended that the agencies adopt general rather than specific standards in order to avoid regulatory micromanagement of the banking and thrift industries.

The comments are discussed in further detail below in the description of the proposed rule.

III. Proposed Rule

A. Summary and Purpose

In enacting section 39, Congress sought to protect the deposit insurance funds. Section 39 requires the agencies to identify and address problems at institutions or holding companies before capital becomes impaired. The agencies have proposed standards under section 39 that they believe serve this end without dictating how institutions are to be managed and operated. The proposed standards are specific enough to identify emerging safety and soundness problems and require submission of a compliance plan before those problems become serious; however, the standards do not specify each operational and managerial procedure an institution must have in place. Where possible, the standards establish the ends that proper operations and management shall achieve, while leaving the means to each institution. Where the agencies do establish features that an institution's systems must include, these features are of a basic type.

The proposed standards do not represent a change in the agencies' policies; rather, these standards represent the fundamental standards used by the agencies to assess the operational and managerial quality of an institution. Thus, under the proposed regulations, the agencies believe that well-managed institutions generally should not find it necessary to amend their operations in order to comply with the operational and managerial standards. The agencies request comment on whether the proposed standards would require institutions to amend their operations in order to comply.

The agencies expect that violations of the standards promulgated pursuant to section 39 generally will be detected during examinations and inspections of institutions and companies. Violations of the earnings standard (and, for OTS, the classified assets to total capital ratio), however, may be detected as a result of the submission of a report of condition or thrift financial report or through off-site monitoring of the institution or company.

B. Effect on Existing Authority

Compliance with the standards required by section 39 would not preclude a finding that an institution is engaged in an unsafe or unsound practice or is in an unsafe or unsound condition. Accordingly, supervisory action may be taken against an institution or company that has not been cited for a deficiency under section 39.

Conversely, failure to comply with the safety and soundness standards established pursuant to section 39 (except for the standard prohibiting payment of excessive compensation) would not necessarily constitute an unsafe or unsound practice. An agency may request submission of a plan to achieve compliance pursuant to section 39 without taking any additional supervisory or enforcement action.

C. Operational and Managerial Standards

The proposed operational and managerial standards address an institution's general practices. The agencies believe that section 39 allows the agencies to evaluate an institution's overall practices in order to determine whether those practices are sound in principle and whether procedures are in place to ensure that they are applied in the normal course of business. Thus, for example, in the areas of credit underwriting or loan documentation, an institution would not fail one of these standards merely because it had failed to document one loan properly or had used poor underwriting standards in making a single loan. Instead, the agencies would consider each institution's performance in the aggregate.

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Recognizing that smaller institutions may require less sophisticated systems and practices given the relatively limited types of activities in which they engage, the proposal states that internal controls and information systems, internal audit systems, and credit underwriting practices shall be appropriate to the size of the institution and the nature and scope of its activities. The proposal also states that an institution shall manage its interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities.

1. Internal Controls, Information Systems, and Internal Audit Systems

The ANPR sought comment on the appropriate level of specificity for standards governing internal controls, information systems, and internal audit systems. Commenters strongly preferred that standards in this area be general, in order to enable each institution to comply with the standards by using control systems that are tailored to its individual operating environment. The proposed standards describe the functions that adequate internal controls and information systems must be able to perform.

Section 39(a)(1)(A) requires the agencies to prescribe standards relating to internal controls, information systems, and internal audit systems in accordance with section 36 of the FDI Act (12 U.S.C. 1831m). Section 36 requires certain institutions' management to submit to the agencies and to any State bank or State thrift supervisor an annual report containing a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Section 36 also requires the independent public accountant for certain institutions to attest to, and report separately on, management's assertions in the internal control report in accordance with generally accepted standards for attestation engagements.

The agencies are proposing to prescribe the functions that adequate internal controls and information systems must be able to perform, rather than providing types of controls or systems that must be present in every case. Thus, for example, internal controls must provide for effective risk assessment, though each institution may establish its own type of controls to meet this requirement. Similarly, each institution must have an organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to prescribed policies, though the institution is free to choose its own organizational structure.

The proposed regulations address internal audit systems separately. In this area, the agencies believe that there are necessary components of an adequate internal audit system. The proposed regulations require that an institution's internal audit system: (1) Provide for those performing internal audits to be qualified and independent; (2) include testing and review of internal controls and information systems; (3) adequately document the tests performed and their findings, as well as any corrective actions taken as a result of the audit; and (4) provide for the results of the audit to be reviewed and acted upon by management.

The agencies are aware that many institutions use data processing service organizations to execute and record transactions, maintain related records and process related data. The determination of whether an institution's independent auditor needs to review a service organization's operations, as they relate to the institution's internal controls, should be made in accordance with generally accepted auditing standards.

2. Loan Documentation

Commenters were strongly opposed to any item-by-item listing of requirements for loan documentation, favoring general standards instead. Commenters also felt that the standards had to be sufficiently general to allow for different treatment according to loan type and amount.

The proposed regulations do not specify in detail what loan documentation must contain. Instead, they specify what loan documentation must enable an institution to do. Thus, documentation practices at an institution will not be evaluated against a checklist of requirements but instead will be evaluated based on whether they: (1) Enable the institution to make an informed lending decision and to assess risk as necessary on an ongoing basis; (2) identify the purpose of the loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner; (3) ensure that any claim against a borrower is legally enforceable; (4) demonstrate appropriate administration and monitoring of a loan; and (5) take account of the size and complexity of a loan. The agencies believe that the proposed regulations provide a standard against which compliance can be measured, while at the same time allowing for differing approaches to loan documentation.

On March 30, 1993, the agencies issued a joint policy statement regarding documentation of small and medium-sized business and farm loans. Under that policy statement, well-managed, well or adequately capitalized institutions are allowed to establish a "basket" of small and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. Under the proposed safety and soundness regulation, the interagency policy statement would continue to apply. The OTS has amended its current loan documentation regulation to conform to the interagency policy statement.

The OTS's current loan documentation regulation at 12 CFR 563.170(c)(1)–(7) establishes detailed loan documentation requirements that may not be necessary in light of the standards proposed in this rulemaking. The OTS specifically requests comment on changes to the loan documentation rule that would be appropriate to eliminate unnecessarily detailed and burdensome regulatory requirements.

3. Credit Underwriting

Commenters overwhelmingly favored general credit underwriting standards rather than an item-by-item listing of requirements that must be met for each extension of credit.

In the proposal, the agencies have established the general parameters of safe and sound credit underwriting practices. The standards would require each institution to establish and maintain prudent credit underwriting practices that: (1) Are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made; (2) consider the nature of the markets in which loans will be made; (3) provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed; (4) establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors; (5) take adequate account of concentration of credit risk; and (6) are appropriate to the size of the institution and the nature and scope of its activities.

4. Interest Rate Exposure

Several commenters suggested that the standard for interest rate exposure focus on an institution's management system for controlling interest rate

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exposure. Commenters generally opposed any absolute limit on interest rate exposure under section 39, with some noting that section 305 of FDICIA already addresses that issue. Many commenters argued that the financial condition of the institution should be considered in the standards, with better capitalized institutions allowed to take greater risk. Some commenters also felt that smaller institutions should be allowed to take greater risk, as they pose a lesser risk to the deposit insurance funds and do not have the resources for sophisticated systems to manage interest rate risk.

Recognizing that many smaller institutions do not need a sophisticated system for quantifying interest rate risk, the agencies have not proposed to require such systems in all cases. Rather, institutions would be required to manage interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities. Larger institutions that are exposed to significant interest rate risk would be expected to maintain a more formal system for the measurement and management of such risk. Under section 305 of FDICIA, which requires amendment of the risk-based capital standards to take account of interest rate risk, some institutions may be required to quantify interest rate risk.

5. Asset Growth

A large number of commenters asked that the agencies rely on current policies and regulations regarding asset growth and on existing capital standards. The commenters also strongly supported reliance on existing laws and regulations regarding asset growth through merger. The agencies considered existing policies and regulations in drafting the proposed regulations.

The agencies have not proposed a quantitative limit on asset growth. A quantitative limit for all institutions regardless of size and financial condition would be overly restrictive and inconsistent with safety and soundness. Further, the agencies do not believe that it would be feasible to establish a separate quantitative limit for each distinguishable class of institution. Moreover, asset growth does not necessarily cause safety and soundness problems; rather, unplanned or poorly managed asset growth is cause for concern.

Under the proposal, an institution would be required to base its asset growth on a plan that reflects consideration of (1) the source, volatility and use of the funds that support asset growth; (2) any increase in credit risk or interest rate risk as a result of growth; and (3) the effect of growth on the institution's capital. Asset growth by an institution would be evaluated against the institution's plan.

6. Compensation, Fees and Benefits

Subsection (a) of section 39 requires the agencies to establish operational and managerial standards relating to compensation, fees and benefits. This mandate is distinguishable from that of subsection (c) of section 39, which requires the agencies to prohibit as an unsafe and unsound practice any compensation that is excessive or could lead to a material financial loss to an institution.

The proposed regulations would require that each institution maintain safeguards to prevent the payment of compensation, fees, or benefits that are excessive or could lead to material financial loss. Because section 39(a) provides that operational and managerial standards in the compensation area are to be prescribed in accordance with section 39(c), the agencies' proposed operational and managerial standard is tailored to prevent the payment of compensation, fees, and benefits prohibited under section 39(c). The agencies do not believe that it would be appropriate to define how institutions are to set compensation. Instead, the proposal would require that the method selected be designed to prevent payment of compensation, fees, or benefits that are excessive or could lead to material financial loss.

D. Asset Quality, Earnings, and Stock Valuation Standards

Section 39(b) requires the agencies to establish a maximum ratio of classified assets to capital, to require minimum earnings sufficient to absorb losses without impairing capital, and to establish, to the extent feasible, a minimum ratio of market to book value. These quantitative standards are somewhat different from the operational and managerial standards because they are designed to detect a deterioration in the overall financial condition of an institution or holding company rather than the existence of operational or managerial deficiencies. Specifically, these standards are meant to alert institutions and the agencies to developing conditions that warrant submission of a compliance plan to the appropriate agency for evaluation. The proposed quantitative standards are meant to supplement, rather than replace, the detailed analyses of these areas that occur during the examination. Therefore, institutions that meet these standards may still be advised at the end of an examination that earnings or asset quality are not adequate and that problems need to be addressed.

1. Maximum Ratio of Classified Assets to Capital

In the ANPR, the agencies sought comment on various aspects of the maximum ratio of classified assets to capital required by section 39, including what types of capital should be included in the ratio and whether classified assets should be weighted for purposes of calculating the ratio. Commenters strongly favored use of existing measures so as to reduce complexity. Some commenters also favored weighting the classified assets according to their probability of loss. With regard to the denominator of the ratio, commenters stressed that the allowance for loan and lease losses, which is currently excluded from tier 1 capital (core capital for OTS), should be included in order to capture capital set aside for losses inherent in the loan portfolio.

The agencies are proposing a maximum ratio whose numerator includes all classified assets on a non-weighted basis and whose denominator includes total capital plus any allowance for loan and lease losses (general valuation allowance for thrifts) otherwise excluded from total capital. The required maximum ratio would be 1.0. Although the agencies are proposing a maximum ratio of 1.0, the agencies have considered other ratios including 0.50 and 0.75. The agencies are particularly interested in receiving comment on the appropriate maximum ratio.

Under this proposed ratio, the numerator should include only assets classified as substandard and doubtful. Assets classified as loss are considered only to the extent that related losses have not been recognized.

The agencies have decided not to propose a weighted measure of classified assets. In trials of ratios using both weighted and non-weighted classified assets, the agencies found that substantially the same institutions were identified under each approach. Because both approaches yield similar results, the agencies have proposed the simpler, non-weighted ratio, which should be less burdensome for institutions to calculate and monitor. However, the agencies seek comment on the relative accuracy of the two measures.

The agencies emphasize that section 39(b) requires the agencies to prescribe a *maximum* ratio of classified assets to

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capital. Because it is a maximum ratio, institutions should generally strive to operate at ratios well below the maximum ratio. Regardless of the ratio adopted by the agencies, the agencies will continue to exercise supervisory judgment and to require corrective action through existing supervisory and enforcement means, as appropriate.

The agencies further emphasize that this ratio is only one of many factors considered in determining the overall financial condition of an institution. Thus, the agencies may require an institution to take steps to reduce its ratio of classified assets to capital even though the institution is operating with a ratio that is less than the maximum ratio that is ultimately required in the agencies' final regulations. In order to clarify this point, the proposed standard expressly preserves the agencies' existing authority to require an institution to maintain a ratio of classified assets to capital that is less than the maximum required under section 39.

2. Minimum Earnings Standard

In the ANPR, the agencies sought comment on various aspects of the minimum earnings standard required by section 39, including the appropriate measure for earnings and the time period for determining whether minimum earnings have been achieved. Commenters suggested various definitions of "earnings," including average return on equity, earnings or losses prior to taxes, retained earnings, and net income after dividends. There was no consensus on a time period for measuring earnings, and recommendations included one, two, three and five year periods.

The proposed standard requires that an institution continue to meet minimum capital standards assuming that any losses experienced over the past four quarters were to continue over the next four quarters. Specifically, if an institution has an aggregate net loss over the past four quarters, the institution's capital ratios would be recalculated under the assumption that those losses will continue over the next four quarters.

The agencies believe that this standard would identify institutions that are currently operating above minimum capital standards but whose earnings are not sufficient to avoid impairing capital. The agencies also believe that this standard is relatively simple to calculate and administer.

The agencies recognize that some institutions may not meet this standard due to accounting losses that are one-time events unlikely to recur, such as charges to earnings for retiree health benefits. In such instances, an institution's compliance plan could consist of an explanation of the circumstances surrounding the event, and in general no further action would be required.

3. Minimum Ratio of Market Value to Book Value

In the ANPR, the agencies requested comment on whether a minimum ratio of market value to book value for publicly traded institutions was feasible. The commenters concluded in overwhelming numbers that such a minimum ratio was not feasible, setting forth a variety of practical and theoretical problems with such a ratio.

Clearly, a minimum market value to book value ratio is technically possible, but the agencies do not believe that technical possibility is what Congress had in mind in directing the agencies to establish such a ratio "if feasible." Accordingly, the agencies view the statutory language as a directive to consider whether adoption of such a ratio is a reasonable means to advance the objectives sought by Congress.

In light of the comments and their own experience, and for the reasons set forth below, the agencies believe that establishing a minimum market value to book value ratio for publicly traded institutions is not a feasible means to the end desired by Congress: Identifying problems at insured depository institutions and holding companies in their early stages and correcting such problems through a compliance plan. Therefore, no such ratio is included in the proposed regulations.

The agencies believe that a market-to-book ratio would not be an operationally reliable indicator of safety and soundness. In the long run, the market value of an institution or holding company is dependent on financial condition and performance. However, in the short run, market value may also be affected by factors unrelated to the institution's or holding company's condition and performance. These include the attractiveness of institution or holding company stocks relative to other competitors and industries; the performance of the general stock market; industry conditions; random fluctuations; an institution's perceived potential for takeover; merger, acquisition or other rumors; international factors; weakness in the dollar; or the regional economic outlook. Thus, a safe and sound institution could well be found in violation of a minimum market-to-book ratio as a result of factors that are not necessarily indicative of an institution's condition.

A requirement that an institution submit a compliance plan if it fails to meet the ratio would also not be feasible. A publicly traded institution or holding company does not have direct control over the market's evaluation of its stock's value. This is especially true for distressed institutions or holding companies that may not be able in the short run to persuade investors to bid higher for shares or to purchase newly issued stock. Moreover, in an attempt to gain compliance, some institutions might take "quick fix" actions such as asset sales that could erode the institution's long-term value.

The agencies believe that implementation of a minimum market value to book value ratio could have unintended consequences that could actually reduce the safety and soundness of the banking and thrift industries.

- Such a ratio might be considered a "penalty" and therefore discourage mutual institutions from converting to a stock form of ownership and discourage closely held institutions from exposing their stock to the public market. This would give non-public companies a perceived advantage over public companies because they would not have to meet the minimum ratio.
- Market speculators might take advantage of the standard by short selling distressed company stocks, especially those with thinner markets. Market manipulators could attempt to push an institution's stock price below the regulatory standard and expect the market to respond by pushing the price down even further, to the speculator's advantage. The agencies believe such speculative actions could adversely affect an institution's safety and soundness by limiting its access to liquidity and the capital markets.
- A sharp decline in the stock market might cause numerous institutions to fail to meet the standard, which could hinder institutions from providing liquidity to the market when it was needed.

During examinations and off-site monitoring of publicly traded institutions, the agencies currently consider stock price changes, market price to book value ratios, bond ratings and other indicators of the market's assessment of an institution's performance. Although the agencies believe that a minimum market to book ratio is not feasible to implement as a regulatory standard, they will continue to consider these factors.

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E. Compensation That Is Excessive or That Could Lead to Material Financial Loss

Commenters strongly supported the use of the factors set forth in section 39(c) as the sole standard in defining excessive compensation. Commenters felt that regulations specifying in more detail when compensation would be considered excessive would constitute micro-management of an institution's management practices. The agencies have relied upon the statutory language in formulating the standard under this section.

Under the proposal, compensation would be considered excessive if it were unreasonable or disproportionate to the services actually performed by the individual being compensated. In making that determination, the agencies will consider all relevant factors, including those set out in section 39(c)—(1) the compensation history of the individual and other individuals with comparable expertise at the institution, (2) the financial condition of the institution, (3) comparable compensation practices at comparable institutions, and (4) any connection between the individual and any wrongdoing at the institution.

F. Coverage of Holding Companies

Section 39(a) requires the appropriate Federal banking agency to establish operational and managerial standards for depository institution holding companies as well as depository institutions. Section 39(b) requires that a maximum ratio of classified assets to capital, minimum earnings sufficient to avoid impairing capital, and a minimum ratio of market to book value (to the extent feasible) be prescribed for depository institution holding companies. Section 39(c), governing compensation, does not apply to holding companies, and commenters strongly opposed the establishment of compensation standards for depository institution holding companies.

1. Bank Holding Companies

As the appropriate Federal banking agency for bank holding companies, the Board is proposing regulations to apply section 39 (a) and (b) to those companies. First, the Board is proposing to require that each bank holding company ensure that each of its subsidiary insured depository institutions is in compliance with the applicable safety and soundness standards adopted pursuant to section 39. Second, rather than adopt a separate set of operational and managerial standards for bank holding companies, the Board's proposal applies to bank holding companies the same standards regarding internal controls, information systems, internal audit systems, interest rate exposure, asset growth, and compensation, fees, and benefits that it is proposing to apply to state member banks. In doing so, the Board is proposing to apply such standards only when relevant to the operations of the holding company and thereby avoid imposing an unnecessary burden on small and shell bank holding companies.

Two of the operational and managerial standards required to be established by section 39(a)—those regarding credit underwriting and loan documentation—may not apply to all bank holding companies. The Board's proposed regulation makes clear that if a bank holding company does not extend credit at the holding company level, then the credit underwriting and loan documentation standards are not applicable to the holding company, and the holding company will not be expected to have practices or policies in these areas.

For the same reason that the agencies have determined that establishing a maximum ratio of market value to book value for depository institutions would not be feasible, the Board believes that such a ratio would not be feasible for bank holding companies. The Board is proposing to apply the same maximum ratio of total classified assets to total capital and the requirement of minimum earnings sufficient to avoid impairing capital to both bank holding companies and state member banks. For purposes of calculation of those ratios, the Board will examine a bank holding company on a consolidated basis. The Board believes that applying those ratios only at the holding company level could paint a false picture of the safety and soundness of the holding company and create perverse financial incentives, such as an incentive to leave classified assets at an insured depository institution rather than upstreaming them to the holding company, where the deposit insurance fund is not at risk.

Bank holding companies with less than $150 million in assets that meet the requirements of the Federal Reserve's reporting exemption do not report consolidated capital or earnings figures. Thus, applying to these companies the standards for minimum earnings and maximum classified assets applicable to insured depository institutions would require the imposition of consolidated reporting. In order to avoid imposing such a significant reporting burden on these companies, and because, in the case of small bank holding companies, substantially all of the consolidated institution's classified assets and earnings are derived from their subsidiary institutions, the Board is proposing a different standard for them: if any subsidiary depository institution of a bank holding company with less than $150 million in assets is in violation of the quantitative standards, then the bank holding company will be found to be in violation. The Board believes that this standard would identify bank holding companies with insufficient earnings or an excess of classified assets.

In applying section 39 to bank holding companies, the Board does not propose to apply safety and soundness standards to the non-U.S. operations of bank holding companies that are foreign banks, companies that own foreign banks, or non-U.S. subsidiaries of foreign banks. The operations of foreign banks would be covered by the proposed rule to the extent that they are conducted through a U.S.-incorporated company that owns an insured bank. The Board seeks comment on this issue.

2. Savings and Loan Holding Companies

As the appropriate Federal banking agency for savings and loan holding companies, the OTS is proposing regulations for savings and loan holding companies that focus on savings and loan holding company activities most likely to cause losses at a holding company's subsidiary savings association.

In the view of the OTS, the safety and soundness standards developed for savings and loan holding companies under section 39 should be consistent with the current statutory framework that defines savings and loan holding company regulation. Many of the areas listed in section 39, while readily applicable to depository institutions, have no meaningful applicability to savings and loan holding companies. For example, neither the Savings and Loan Holding Company Act (SLHCA) nor any other statute has ever established a framework for capital requirements for savings and loan holding companies. Nor is there a legislative framework to subject the assets of savings and loan holding companies to classification or to regulate the loan documentation, credit underwriting, interest rate risk exposure or asset growth of savings and loan holding companies.

Given the ability of savings and loan holding companies to conduct a broader range of activities than bank holding companies, such standards would be impractical, if not impossible, to apply and would not effectively focus on

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reducing risk to the deposit insurance funds.

The OTS is proposing that each savings and loan holding company shall: (1) Ensure that transactions and relationships between the holding company and its subsidiary savings association satisfy applicable fiduciary standards and do not have a detrimental effect on the savings association's safe and sound operation; (2) not engage in any activity, or cause its subsidiary savings association to engage in any activity, that might create a serious risk that the liabilities of the holding company and its other affiliates may be imposed on the savings association; (3) not take any action that would impede the ability of its subsidiary savings association to comply with the requirements of section 39 or fully implement any safety and soundness compliance plan required of the savings association; and (4) take any corporate actions necessary to enable the subsidiary savings association to take actions required by a safety and soundness compliance plan.

The OTS believes these standards are consistent with the objectives of section 39 and the statutory framework for savings and loan holding company regulation, and further the goal of resolving problems of insured depository institutions at the lowest possible long-term loss to the deposit insurance funds. Commenters are specifically requested to address whether other standards, consistent with the requirements of section 39, would better accomplish these goals.

G. Procedures for Submission of Compliance Plans and Issuance of Orders

Section 39(e) of the FDI Act requires that the agencies establish deadlines for submission and review of compliance plans. The deadlines must provide institutions and companies with reasonable time to submit compliance plans in the event that a deficiency is detected under the operational and managerial standards or asset quality and earnings standards. The deadlines must also require the agencies to act on such plans expeditiously. The proposed regulations provide for an institution or company to file a compliance plan within 30 days of such plan being requested by the appropriate Federal banking agency, although the agency may extend or shorten the time for filing. The agency would then generally have 30 days to review the plan. The proposed regulations provide that a compliance plan under section 39 may, with the permission of the agency, be part of a capital restoration plan submitted pursuant to section 38 of the FDI Act (prompt corrective action), a cease-and-desist order entered into pursuant to section 8 of the FDI Act, a formal or informal agreement, or a response to a report of examination or report of inspection.

In the event that an institution or company fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted compliance plan within the time allowed by the agency, section 39 provides that the agency must order the institution or company to correct the deficiency and may: (1) Restrict asset growth; (2) require the institution or company to increase its ratio of tangible equity to assets; (3) restrict the rates of interest that the institution or company may pay; or (4) take any other action that would better carry out the purpose of prompt corrective action. In certain cases, the agency is required to take one or more actions.[1] Orders issued pursuant to section 39 are enforceable under section 8 of the FDI Act.

Section 39 does not provide for any prior notice or administrative review of an agency order. However, given the potential effect of such an order on the institution or company subject to the order, the agencies are proposing to give the institutions and companies prior notice of, and an opportunity to respond to, a proposed order.

The proposed procedures are modelled after those adopted by the agencies for issuance of prompt corrective action directives pursuant to section 38 of the FDI Act. Under the proposed procedures, the appropriate agency generally must provide written notice to an institution or company prior to issuing an order. The notice would describe the action contemplated by the agency. The institution or company would then be provided at least 14 calendar days to submit written arguments and evidence in response to the proposed order. Failure to file a timely response would constitute consent to issuance of the order and a waiver of the opportunity to appeal. The agency would consider the submission in determining whether to issue the order.

Under the proposed rules, the agencies would reserve the right to issue orders that are effective immediately. In these cases, the institution would have an opportunity to seek modification or rescission of the order on an expedited basis. An institution or company that appeals an immediately effective order would be required to file a written appeal within 14 calendar days of receiving the notice, and the agency would be required to consider the appeal within 60 days of its receipt.

The agencies intend to establish appropriate delegations in accordance with their own procedures. In connection with this proposal, the FDIC is proposing to revise its regulation governing delegations of authority.

H. Other Issues

1. Implementation at Holding Company Level

The ANPR sought comment on the extent to which a multi-bank or thrift holding company may establish safety and soundness standards for its subsidiary institutions so long as the standards are affirmed by the boards of the subsidiary institutions. Almost all of the commenters responding to this question supported the procedure based on the reasoning that such a procedure would allow, but not require, the holding company to establish some or all of the required standards at the holding company level, thereby creating uniformity when desired and avoiding duplication among subsidiary institutions.

Commenters also suggested allowing a bank holding company to implement section 39 at the bank holding company level in exchange for an enforceable commitment to serve as a source of strength for its depository institution subsidiaries and a reaffirmation of the liability of each of its subsidiary depository institutions pursuant to section 5(e) of the FDI Act.

Under the proposed regulation, a holding company could establish policies and practices for the entire organization, with each of the subsidiary depository institutions affirming those policies and practices. Furthermore, once a safety and soundness deficiency is detected at an institution—particularly with regard to asset quality and earnings standards—an acceptable compliance plan submitted or affirmed by the institution could include a commitment by the institution's holding company to take action to ensure that the deficiency is remedied.

[1] One such case where section 39 requires supervisory action is where the institution has, during the prior 18-month period, experienced extraordinary growth, as defined by the appropriate agency. The Board, the OCC, and the FDIC are proposing a regulatory definition of extraordinary growth, while the OTS expects to rely on existing guidance. The OTS' Regulatory Bulletin 3a–1 "Policy Statement on Growth for Insured Institutions" states that the OTS determines whether an institution has undergone excessive growth on the basis of the institution's management and asset quality, capital adequacy, interest rate risk profile and operating controls and procedures.

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Some commenters also suggested that a bank holding company be allowed to implement, and be held responsible for, the practices and policies that comply with the standards prescribed under section 39. The agencies note that under such a scenario the primary regulator of the depository institution would still be required to review and act on any compliance plan. The agencies seek comment on how a holding company might ensure, and be held responsible for, compliance with the standards in section 39—in particular, what parts of section 39 could be covered and how compliance could be monitored and enforced.

2. Incorporation by Reference

The ANPR also sought comment on the issue of whether existing guidelines, opinions, advisories and other literature should be incorporated into certain operational and managerial standards. Commenters were divided on the extent to which existing guidance should be incorporated. In establishing standards in the proposed regulations, the agencies have reviewed existing guidance as well as the comments. The proposal does not incorporate existing guidance by reference, as the agencies believe that subsequent changes to existing guidance would then require notice and comment, greatly complicating the administration of that guidance. However, the agencies will use existing and future supplemental supervisory guidance in this area where appropriate. The agencies have also proposed in their operational and managerial standards that institutions ensure compliance with applicable laws and regulations.

3. Recordkeeping and Reporting

The agencies request comment on whether the proposed standards, if adopted, would increase the recordkeeping or reporting requirements imposed on depository institutions and depository institution holding companies by the agencies.

IV. Regulatory Flexibility Act

Each agency has concluded after reviewing its proposed regulation that the regulation, if adopted, will not impose a significant economic hardship on small institutions. The proposal does not necessitate the development of sophisticated recordkeeping or reporting systems by small institutions; nor will small institutions need to seek out the expertise of specialized accountants, lawyers, or managers in order to comply with the regulations. The agencies therefore hereby certify pursuant to section 605(a) of the Regulatory Flexibility Act (5 U.S.C. 605) that the proposal, if adopted, will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et. seq.*).

V. Executive Order 12866

The OCC and the OTS have determined that their final regulations do not constitute "significant regulatory actions."

List of Subjects

OCC

12 CFR Part 30

Administrative practice and procedure, National banks, Reporting and recordkeeping requirements, Safety and soundness.

Board

12 CFR Part 208

Accounting, Agriculture, Banks, Banking, Confidential business information, Currency, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, Banking, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 263

Administrative practice and procedure.

FDIC

12 CFR Part 303

Administrative practice and procedure, Authority delegations (Government agencies), Bank deposit insurance, Banks, Banking, Reporting and recordkeeping requirements, Savings associations.

12 CFR Part 308

Administrative practice and procedure, Claims, Equal access to justice, Lawyers, Penalties.

12 CFR Part 364

Banks, Banking, Safety and soundness.

OTS

12 CFR Part 570

Accounting, Administrative practices and procedures, Bank deposit insurance, Holding companies, Reporting and recordkeeping requirements, Savings associations, Safety and soundness.

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Federal Reserve System
12 CFR Chapter II

For the reasons outlined in the preamble, the Board proposes to amend 12 CFR parts 208, 225, and 263 as set forth below:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for 12 CFR part 208 is revised to read as follows:

Authority: 12 U.S.C. 36, 248 (a) and (c), 321–338, 461, 481–486, 601, and 611, 1814, 1823(j), 1831o, 1831p–1, 3906–3909, 3310, 3331–3351; 15 U.S.C. 78b, 78o–4(c)(5), 78q, 78q–1, 78w, 781(b), 781(i), and 1781(g).

2. A new Subpart D, comprising §§ 208.60 through 208.64, is added to part 208 to read as follows:

Subpart D—Safety and Soundness Standards

Sec.
§ 208.60 Authority, purpose, scope and preservation of existing authority.
§ 208.61 Definitions.
§ 208.62 Operational and managerial standards.
§ 208.63 Asset quality and earnings standards.
§ 208.64 Prohibition on compensation that constitutes an unsafe and unsound practice.

Subpart D—Safety and Soundness Standards

§ 208.60 Authority, purpose, scope and preservation of existing authority.

(a) *Authority.* This part is issued by the Board pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831p–1) as added by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (Pub. L. 102–242, 105 Stat. 2236 (1991)), and as amended by section 956 of the Housing and Community Development Act of 1992 (Pub. L. 102–550, 106 Stat. 3895 (1992)).

(b) *Purpose and scope.* This part establishes operational, managerial,

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asset quality and earnings standards for all state member banks, and standards that prohibit as an unsafe and unsound practice the payment of compensation that is excessive or could lead to material financial loss to a bank. These standards are designed to identify potential safety and soundness concerns and ensure that action is taken to address those concerns before they pose a risk to the deposit insurance funds.

(c) *Preservation of existing authority.* Neither section 39 nor this subpart in any way limits the authority of the Board to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. Action under section 39 and this subpart may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the Board.

§ 208.61 Definitions.

(a) *In general.* For purposes of this part, except as modified in this section or unless the context otherwise requires, the terms used have the same meanings as set forth in sections 3 and 39 of the FDI Act (12 U.S.C. 1813 and 1831p–1).

(b) *Classified assets* means assets classified, in the most recent Federal examination or State examination that is acceptable to the Board pursuant to section 10(d)(3) of the FDI Act, as substandard or doubtful and assets classified as loss to the extent the loss amount has not been deducted from total capital or allowance.

(c) *Compensation* means all direct and indirect payments or benefits, both cash and non-cash, granted to or for the benefit of any executive officer, employee, director, or principal shareholder, including but not limited to payments or benefits derived from an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

(d) *Director* shall have the meaning described in 12 CFR 215.2(c).

(e) *Executive officer* shall have the meaning described in 12 CFR 215.2(d).

(f) *Ineligible allowance* means any allowance for loan and lease losses not eligible for inclusion in total capital for purposes of the calculation of risk-based capital under 12 CFR part 208, appendix A.

(g) *Net income or loss* means net income or net loss as reported in the quarterly report of condition.

(h) *Principal shareholder* shall have the meaning described in 12 CFR 215.2(j).

(i) *Tier 1 capital* means the amount of Tier 1 capital as defined in 12 CFR part 208, appendix A, and as reported in the most recent quarterly report of condition.

(j) *Total assets* means the amount of total assets as defined in 12 CFR part 208, appendix A, and as reported in the most recent quarterly report of condition.

(k) *Total capital* means the amount of total capital as defined in 12 CFR part 208, appendix A, as reported in the most recent quarterly report of condition.

§ 208.62 Operational and managerial standards.

(a) *Internal controls and information systems.* A State member bank shall have internal controls and information systems that are appropriate to the size of the bank and the nature and scope of its activities, and that provide for:

(1) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to prescribed policies;

(2) Effective risk assessment;

(3) Timely and accurate financial, operational and regulatory reports;

(4) Adequate procedures to safeguard and manage assets; and

(5) Compliance with applicable laws and regulations.

(b) *Internal audit system.* A state member bank shall have an internal audit system that is appropriate to the size of the bank and the nature and scope of its activities, and that provides for:

(1) Independence and objectivity;

(2) Qualified persons to perform internal audits;

(3) Adequate testing and review of internal controls and information systems;

(4) Adequate documentation of audit tests and findings and any corrective actions;

(5) Verification and review of management actions to address identified weaknesses; and

(6) Review by the bank's audit committee or board of directors of the effectiveness of the internal audit system.

(c) *Loan documentation.* A State member bank shall establish and maintain loan documentation practices that:

(1) Enable the bank to make an informed lending decision and to assess risk as necessary on an ongoing basis;

(2) Identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;

(3) Ensure that any claim against a borrower is legally enforceable;

(4) Demonstrate appropriate administration and monitoring of a loan;

(5) Take account of the size and complexity of a loan; and

(6) Ensure compliance with applicable laws and regulations.

(d) *Credit underwriting.* A State member bank shall establish and maintain prudent credit underwriting practices that:

(1) Are commensurate with the types of loans the bank will make and consider the terms and conditions under which they will be made;

(2) Consider the nature of the markets in which loans will be made;

(3) Provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;

(4) Establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;

(5) Take adequate account of concentration of credit risk;

(6) Are appropriate to the size of the bank and the nature and scope of its activities; and

(7) Ensure compliance with applicable laws and regulations.

(e) *Interest rate exposure.* A State member bank shall:

(1) Manage interest rate risk in a manner that is appropriate to the size of the bank and the complexity of its assets and liabilities;

(2) Provide for periodic reporting to management and the board of directors regarding interest rate risk; and

(3) Ensure compliance with applicable laws and regulations.

(f) *Asset growth.* A State member bank's asset growth shall be based on a plan that:

(1) Reflects consideration of:

(i) The source, volatility and use of the funds that support asset growth;

(ii) Any increase in credit risk or interest rate risk as a result of growth; and

(iii) The effect of growth on the bank's capital; and

(2) Ensures compliance with applicable laws and regulations.

(g) *Compensation, fees and benefits.* A State member bank shall maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or could lead to material financial loss to the bank, in accordance with § 208.64 of this part.

§ 208.63 Asset quality and earnings standards.

(a) *Maximum ratio of classified assets to capital*—(1) *In general.* A State

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member bank shall maintain a ratio of classified assets to total capital and ineligible allowances that is no greater than 1.0.

(2) *Preservation of authority.* Nothing in section 39 or this part shall limit the authority of the Board to require a bank to maintain a ratio of classified assets to total capital and ineligible allowances that is less than 1.0.

(b) *Minimum earnings sufficient to absorb losses without impairing capital.* A State member bank shall have minimum earnings sufficient to absorb losses without impairing capital. A State member bank has minimum earnings sufficient to absorb losses without impairing capital if:

(1) The bank is in compliance with the minimum capital requirements established in 12 CFR part 208, appendix A; and

(2) The bank would, if its net income or loss over the last four quarters continued over the next four quarters, remain in compliance with minimum capital requirements. For purposes of calculating whether a bank would remain in compliance with minimum capital requirements under this paragraph (b)(2), the Board will deduct the dollar amount of any net loss experienced by the bank over the most recent four quarters from the bank's Tier 1 capital and total assets and calculate the bank's capital ratios.

§ 208.64 Prohibition on compensation that constitutes an unsafe and unsound practice.

(a) *Excessive compensation.* Excessive compensation is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder, considering the following:

(1) The combined value of all cash and non-cash benefits provided to the individual;

(2) The compensation history of the individual and other individuals with comparable expertise at the bank;

(3) The financial condition of the bank;

(4) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;

(5) For postemployment benefits, the projected total cost and benefit to the bank;

(6) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the bank; and

(7) Any other factors the Board determines to be relevant.

(b) *Compensation leading to material financial loss.* Compensation that could lead to material financial loss to a State member bank is prohibited as an unsafe and unsound practice.

(c) *Preservation of existing authority.* Nothing in this section shall limit the authority of the FDIC under section 38(i)(2)(F) of the FDI Act (12 U.S.C. 1831o(i)(2)(F)) and part 325 of this title.

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for 12 CFR part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3907, 3909, 3310, and 3331–3351.

2. A new Subpart I, comprising § 225.81, is added to part 225 to read as follows:

Subpart I—Safety and Soundness Standards

Sec.
§ 225.81 Safety and soundness standards.

Subpart I—Safety and Soundness Standards

§ 225.81 Safety and soundness standards.

(a) *Obligation to ensure compliance.* If a safety and soundness deficiency is detected pursuant to section 39 of the FDI Act at one of its subsidiary insured depository institutions, a bank holding company shall ensure that the subsidiary insured depository institution returns to compliance with the safety and soundness standards.

(b) *Applicability of operational and managerial standards to holding companies*—(1) In general. The standards for safety and soundness regarding internal controls, information systems, internal audit systems, interest rate exposure, asset growth, and compensation, fees, and benefits prescribed pursuant to section 39(a) of the FDI Act for state member banks and § 208.62 of this chapter shall apply to a bank holding company in the same manner and to the same extent as a State member bank.

(2) Standards relating to credits. The standards for safety and soundness regarding credit underwriting and loan documentation prescribed pursuant to section 39(a) of the FDI Act for State member banks pursuant to §§ 208.62 (c) and (d) of this chapter shall apply to a bank holding company in the same manner as a State member bank to the extent that the holding company engages in credit underwriting at the holding company level.

(3) Standards for asset quality and earnings—(i) *Applicability.* Except as provided in paragraph (b)(3)(iii) of this section, the maximum ratio of total classified assets to total capital and the requirement of minimum earnings sufficient to avoid impairing capital prescribed pursuant to section 39(a) of the FDI Act for State member banks and §§ 208.63 (a) and (b) of this chapter shall apply to a bank holding company in the same manner and to the extent as a State member bank.

(ii) *Measurement.* For purposes of paragraph (b)(3)(i) of this section, total classified assets, total capital, Tier 1 capital, and net income (loss) shall be measured on a consolidated basis.

(iii) *Standard for bank holding companies with assets under $150 million.* For a bank holding company with assets of less than $150 million:

(A) *Asset quality.* The holding company shall be found to have exceeded the maximum ratio of classified assets to capital if any of its subsidiary depository institutions exceeds the maximum ratio of classified assets to capital applicable to that institution; and

(B) *Earnings.* The holding company shall be found to have violated the requirement of minimum earnings sufficient to avoid impairing capital if any of its subsidiary depository institutions is in violation of the minimum earnings requirement applicable to that institution.

(c) *Procedures for correcting a deficiency.* In taking any action under section 39 that is within the Board's discretion to take in connection with a bank holding company, the Board shall follow the procedures for requesting a safety and soundness compliance plan, ordering correction of a safety and soundness deficiency, and taking corrective action based on the failure to submit and implement a compliance plan that are prescribed under subpart I of part 263 of this chapter.

PART 263—RULES OF PRACTICE FOR HEARINGS

1. The authority citation for 12 CFR part 263 is revised to read as follows:

Authority: 5 U.S.C. 504; 12 U.S.C. 248, 324, 504, 505, 1817(j), 1818, 1828(c), 1831o, 1831p–1, 1847(b), 1847(d), 1884(b), 1972(2)(F), 3105, 3107, 3108, 3907, 3909; 15 U.S.C. 21, 78o–4, 78o–5, and 78u–2.

2. A new Subpart I, comprising §§ 263.300 through 263.305, is added to part 263 to read as follows:

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Subpart I—Submission and Review of Safety and Soundness Compliance Plans and Issuance of Orders to Correct Safety and Soundness Deficiencies

Sec.
263.300 Scope.
263.301 Purpose.
263.302 Determination of failure to meet safety and soundness standard and request for compliance plan.
263.303 Filing of safety and soundness compliance plan.
263.304 Issuance of orders to correct deficiencies and to take or refrain from taking other actions.
263.305 Enforcement of orders.

Subpart I—Submission and Review of Safety and Soundness Compliance Plans and Issuance of Orders to Correct Safety and Soundness Deficiencies

§ 263.300 Scope.

The rules and procedures set forth in this subpart apply to State member banks and bank holding companies that are subject to the provisions of section 39 of the FDI Act.

§ 263.301 Purpose.

Section 39 of the FDI Act requires the Board to establish safety and soundness standards. Pursuant to section 39, a bank or company must submit a compliance plan if it violates a safety and soundness standard under section 39(a) or (b). An enforceable order under section 8 may be issued if, after being notified that it is in violation of a safety and soundness standard prescribed under section 39, a bank or company fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted plan. This subpart establishes procedures for requesting submission of a compliance plan and issuing enforceable orders pursuant to section 39.

§ 263.302 Determination of failure to meet safety and soundness standard and request for compliance plan.

(a) *Determination.* The Board may, based upon an examination, inspection, or any other information that becomes available to the Board, determine that a bank or bank holding company has failed to satisfy the safety and soundness standards set out in part 208, subpart D, and part 225, subpart I of this chapter.

(b) *Request for compliance plan.* If the Board determines that a State member bank or bank holding company has failed a safety and soundness standard pursuant to paragraph (a) of this section, the Board shall request by letter or through a report of examination or report of inspection the submission of a compliance plan, and the bank or bank holding company shall be deemed to have notice of the deficiency three days after mailing of the letter by the Board or delivery of the report of examination or report of inspection.

§ 263.303 Filing of safety and soundness compliance plan.

(a) *Schedule for filing compliance plan*—(1) *In general.* A State member bank or bank holding company shall file a written safety and soundness compliance plan with the Board within 30 calendar days of receiving a request for a plan pursuant to § 263.302(b) of this part, unless the Board notifies the bank or bank holding company in writing that the plan is to be filed within a different period.

(2) *Other plans.* If a State member bank or bank holding company is obligated to file, or is currently operating under, a capital restoration plan submitted pursuant to section 38 of the FDI Act, a cease-and-desist order entered into pursuant to section 8 of the FDI Act, a formal or informal agreement, or a response to a report of examination or report of inspection, it may, with the permission of the Board, submit a compliance plan under this section as part of that plan, order, agreement, or response, subject to the deadline provided in paragraph (a)(1) of this section.

(b) *Contents of plan.* The compliance plan shall include a description of the steps the State member bank or bank holding company will take to correct the deficiency and the time within which those steps will be taken.

(c) *Review of safety and soundness compliance plans.* Within 30 days after receiving a safety and soundness compliance plan under this subpart, the Board shall provide written notice to the bank or bank holding company of whether the plan has been approved or seek additional information from the bank or bank holding company regarding the plan. The Board may extend the time within which notice regarding approval of a plan will be provided.

(d) *Failure to submit or implement a compliance plan*—

(1) *Supervisory actions.* If a State member bank or bank holding company fails to submit an acceptable plan within the time specified by the Board or fails in any material respect to implement a compliance plan, then the Board shall, by order, require the bank or bank holding company to correct the deficiency and may take further actions provided in section 39(e)(2)(B) of the FDI Act. Pursuant to section 39(e)(3) of the FDI Act, the Board may also be required to take certain actions if the bank commenced operations or experienced a change in control within the previous 24-month period, or the bank experienced extraordinary growth during the previous 18-month period.

(2) *Extraordinary growth.* For purposes of paragraph (d)(1) of this section, *extraordinary growth* means an increase in assets of more than 7.5 percent during any calendar quarter within the 18-month period preceding the issuance of a request for submission of a compliance plan, by a bank that is not well capitalized for purposes of section 38 of the FDI Act. For purposes of calculating an increase in assets, assets acquired through merger or acquisition approved pursuant to the Bank Holding Company Act, Bank Merger Act, National Bank Act, or Federal Reserve Act will be excluded.

(e) *Amendment of compliance plan.* A State member bank or bank holding company that has filed an approved compliance plan may, after prior written notice to and approval by the Board, amend the plan to reflect a change in circumstance. Until such time as a proposed amendment has been approved, the bank or bank holding company shall implement the compliance plan as previously approved.

§ 263.304 Issuance of orders to correct deficiencies and to take or refrain from taking other actions.

(a) *Notice of intent to issue order*—(1) *In general.* The Board shall provide a bank or bank holding company prior written notice of the Board's intention to issue an order requiring such bank or bank holding company to correct a safety and soundness deficiency or to take or refrain from taking other actions pursuant to section 39 of the FDI Act. The bank or bank holding company shall have such time to respond to a proposed order as provided by the Board under paragraph (c) of this section.

(2) *Immediate issuance of final order.* If the Board finds it necessary in order to carry out the purposes of section 39 of the FDI Act, the Board may, without providing the notice prescribed in paragraph (a)(1) of this section, issue an order requiring a bank or bank holding company immediately to take actions to correct a safety and soundness deficiency or to take or refrain from taking other actions pursuant to section 39. A State member bank or bank holding company that is subject to such an immediately effective order may submit a written appeal of the order to the Board. Such an appeal must be received by the Board within 14 calendar days of the issuance of the

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order, unless the Board permits a longer period. The Board shall consider any such appeal, if filed in a timely matter, within 60 days of receiving the appeal. During such period of review, the order shall remain in effect unless the Board, in its sole discretion, stays the effectiveness of the order.

(b) *Contents of notice.* A notice of intention to issue an order shall include:

(1) A statement of the safety and soundness deficiency or deficiencies that have been identified at the bank or bank holding company;

(2) A description of any restrictions, prohibitions, or affirmative actions that the Board proposes to impose or require;

(3) The proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of any required action; and

(4) The date by which the bank or bank holding company subject to the order may file with the Board a written response to the notice.

(c) *Response to notice*—(1) *Time for response.* A bank or bank holding company may file a written response to a notice of intent to issue an order within the time period set by the Board. Such a response must be received by the Board within 14 calendar days from the date of the notice unless the Board determines that a different period is appropriate in light of the safety and soundness of the bank or other relevant circumstances.

(2) *Content of response.* The response should include:

(i) An explanation why the action proposed by the Board is not an appropriate exercise of discretion under section 39;

(ii) Any recommended modification of the proposed order; and

(iii) Any other relevant information, mitigating circumstances, documentation, or other evidence in support of the position of the bank or bank holding company regarding the proposed order.

(d) *Consideration of response.* After considering the response, the Board may:

(1) Issue the order as proposed or in modified form;

(2) Determine not to issue the order and so notify the bank or bank holding company; or

(3) Seek additional information or clarification of the response from the bank or bank holding company, or any other relevant source.

(e) *Failure to file response.* Failure by a bank or bank holding company to file with the Board, within the specified time period, a written response to a proposed order shall constitute a waiver of the opportunity to respond and shall constitute consent to the issuance of the order.

(f) *Request for modification or rescission of order.* Any bank or bank holding company that is subject to an order under this subpart may, upon a change in circumstances, request in writing that the Board reconsider the terms of the order, and may propose that the order be rescinded or modified. Unless otherwise ordered by the Board, the order shall continue in place while such request is pending before the Board.

§ 263.305 Enforcement of orders.

(a) *Judicial remedies.* Whenever a State member bank or bank holding company fails to comply with an order issued under section 39, the Board may seek enforcement of the order in the appropriate United States district court pursuant to section 8(i)(1) of the FDI Act.

(b) *Administrative remedies.* Pursuant to section 8(i)(2)(A) of the FDI Act, the Board may assess a civil money penalty against any State member bank or bank holding company that violates or otherwise fails to comply with any final order issued under section 39 and against any institution-affiliated party who participates in such violation or noncompliance.

(c) *Other enforcement action.* In addition to the actions described in paragraphs (a) and (b) of this section, the Board may seek enforcement of the provisions of section 39 or this part through any other judicial or administrative proceeding authorized by law.

Dated: November 4, 1993.

William W. Wiles,

Secretary to the Board of Governors of the Federal Reserve System.

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