

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10791
July 19, 1995]

SAFETY AND SOUNDNESS STANDARDS
— **Final Rules for State Member Banks, Effective August 9**
— **Comments Requested by August 24 on Proposed**
Asset Quality and Earnings Guidelines

*To All State Member Banks and Bank Holding
Companies in the Second Federal Reserve District:*

Following is the text of a statement by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued final guidelines and a final rule regarding safety and soundness standards for state member banks as required by Section 132 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

The final rule and guidelines are effective August 9, 1995.

The final guidelines and final rule reflect amendments pursuant to the Riegle Community Development and Regulatory Improvement Act of 1994 (Community Development Act), which authorized the agencies to prescribe safety and soundness standards by regulation or guideline and eliminated holding companies from the scope of Section 132.

The agencies sought comment on methods to meet the requirements of Section 132 through an advance notice of proposed rulemaking in July 1992 and a notice of proposed rulemaking in November 1993. The final guidelines take into account public comments and set forth broad, principle-based standards that establish the objectives that proper operations and management should achieve, while leaving the methods for achieving those objectives to each institution. The final rule establishes deadlines for submission and review of safety and soundness compliance plans that the agencies may require for insured depositories that fail to meet the guidelines.

The Federal Reserve also issued proposed guidelines for safety and soundness standards relating to asset quality and earnings. As amended by the Community Development Act, Section 132 no longer requires the agencies to prescribe quantitative standards in these areas, but rather, requires the agencies to prescribe standards the agencies deem appropriate. The agencies are therefore proposing asset quality and earnings standards, in guidelines form, that emphasize monitoring, reporting and preventive or corrective action.

Comments on the proposed asset quality and earnings guidelines are requested by August 24, 1995.

The Board initially approved the final rule, final guidelines and proposed guidelines on February 2, 1995. Publication of the attached joint guidelines, rule and proposal were delayed to reach interagency agreement.

Enclosed is an excerpt from the *Federal Register* of July 10, containing the standards for safety and soundness as they affect state member banks, and the proposal regarding asset quality and earnings guidelines; the standards simultaneously announced by the other Federal regulatory agencies have not been reprinted in the enclosure. Comments on the proposal should be submitted by August 24, 1995, and may be sent to the Board of Governors, as indicated in the notice, or to our Financial Examinations Function.

WILLIAM J. McDONOUGH,
President.

FRASER
Federal Reserve Bank of St. Louis

Monday
July 10, 1995

Part IV

Federal Reserve System
12 CFR Parts 208 and 263

**Standards for Safety and Soundness and
Interagency Guidelines Establishing
Standards for Safety and Soundness;
Final Rule and Proposed Rule**

[Enc. Cir. 10791]

DEPARTMENT OF THE TREASURY**Office of the Comptroller of the Currency****12 CFR Part 30**

[Docket No. 95-15]

FEDERAL RESERVE SYSTEM**12 CFR Parts 208 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**

[No. 95-113]

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: Final rule.

SUMMARY: As required by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) have adopted a final rule establishing deadlines for submission and review of safety and soundness compliance plans. The agencies may require compliance plans to be filed by an insured depository institution for failure to meet the safety and soundness standards prescribed by guideline pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act). In conjunction with this final rule, the agencies have adopted Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines). The Guidelines will appear as an appendix to each of the agencies' final rule. The agencies view the final rule and Guidelines as a realistic balance between the objectives of section 132 of FDICIA and avoiding overly burdensome regulation.

In November 1993, the agencies published in the *Federal Register* a joint notice of proposed rulemaking prescribing standards for safety and soundness, including standards for asset quality and earnings. The agencies are proposing revised asset quality and earnings standards. A document requesting comment on these standards is published elsewhere in this separate part of the *Federal Register*. The agencies intend to add asset quality and earnings standards to the Guidelines after public comments are considered and final standards are adopted.

EFFECTIVE DATE: August 9, 1995.

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 (202/874-5210), Securities and Corporate Practices Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board of Governors: 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, Managing Senior Counsel (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, Manager, Planning and Program Development (202/898-6911) or Michael D. Jenkins, Examination Specialist (202/898-6896), Division of Supervision; Lisa M. Stanley, Senior Counsel (202/898-7494) or Nancy L. Alper, Counsel (202/898-3720), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

OTS: William Magrini, Project Manager (202/906-5744), Policy Office, Cathern Smith, Regional Coordinator (202/906-6614), Regional Operations; Kevin Corcoran, Assistant Chief Counsel (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.

SUPPLEMENTARY INFORMATION:**I. Background****A. Statutory Framework**

Section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. 102-242,

added a new section 39 to the FDI Act (12 U.S.C. 1831p-1) which required each Federal banking agency to establish by regulation certain safety and soundness standards for the insured depository institutions and depository institution holding companies for which it was the primary Federal regulator. That portion of section 39 that addresses compensation was subsequently amended by section 956 of the Housing and Community Development Act of 1992, Pub. L. 102-550.

On September 23, 1994, the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), Pub. L. 103-325, was enacted. Section 318 of the CDRI Act further amended section 39 of the FDI Act: (1) To authorize the agencies to establish safety and soundness standards by regulation or by guideline for all insured depository institutions; (2) to give the agencies greater flexibility in prescribing asset quality and earnings standards; and (3) to eliminate the requirement that standards prescribed under section 39 apply to depository institution holding companies. Pursuant to section 318 of the CDRI Act, these amendments have the same effective date as section 39 of the FDI Act, as provided in section 132(c) of FDICIA.

Section 39(a) requires the agencies to establish 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 of the FDI Act. Section 39(b) requires the agencies to establish standards relating to asset quality, earnings, and stock valuation that the agencies determine to be appropriate.

Section 39(c) requires the agencies to establish standards prohibiting as an unsafe and unsound practice any compensatory arrangement that would provide an executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits and any compensatory arrangement that could lead to material financial loss to an institution. Section 39(c) also requires that the agencies establish standards that specify when compensation is excessive. If an agency determines that an institution fails to meet any standard established by regulation under subsection (a) or (b) of section 39, the institution *must* submit to the agency an acceptable plan to achieve compliance with the standard. Under the CDRI Act

amendment to section 39, if an agency determines that an institution fails to meet any standard established by guideline under subsection (a) or (b) of section 39, the agency *may* require the institution to submit to the agency an acceptable plan to achieve compliance with the standard.

Where an agency requires submission of a plan to achieve compliance with the standards, if the institution fails to submit an acceptable plan within the time allowed by the agency or fails in any material respect to implement an accepted plan, the agency must, by order, require the institution to correct the deficiency. The agency may, and in some cases must, take other supervisory actions until the deficiency has been corrected.

B. Agencies' Proposals

On July 15, 1992, the agencies published a joint advance notice of proposed rulemaking (ANPR) in the **Federal Register**, 57 FR 31336, for a 60-day comment period. The agencies received over 400 comment letters in response to the ANPR, with some letters submitted to more than one agency. Commenters strongly recommended that the agencies propose general rather than specific standards in order to avoid regulatory micromanagement.

On November 18, 1993, the agencies published a joint notice of proposed rulemaking in the **Federal Register**, 59 FR 60802, for a 45-day comment period. Based on comments received in response to the ANPR, the agencies proposed general standards designed to identify emerging safety and soundness problems in depository institutions.

II. The Final Rule

Although section 39 of the FDI Act, as amended by the CDRI Act, allows the agencies to establish safety and soundness standards by regulation or by guideline, section 39(e) of the FDI Act continues to require the agencies to establish deadlines for submission and review of compliance plans by regulation. For this reason, although the agencies have established safety and soundness standards by guideline, the agencies have established deadlines and procedures for submission and review of compliance plans by regulation.

The agencies' final rule adopts the procedures proposed for submission of compliance plans and issuance of orders, except that, under the final rule, the agencies are authorized, rather than required, to request a compliance plan for failure to satisfy the safety and soundness standards set out in the Guidelines. The procedures for issuing orders in the final rule are modelled

after those adopted by the agencies for issuance of prompt corrective action directives pursuant to section 38 of the FDI Act.

The agencies expect that noncompliance with the standards adopted pursuant to section 39 generally will be detected during examinations of institutions. Under the final rule, an institution must file a compliance plan within 30 days of a request to do so from the institution's primary Federal regulator. An agency may extend or shorten that time, if necessary. The agency then generally has 30 days to review the plan.

Several commenters requested an extension, from 30 days to 60 days or more, of the time period within which an institution must file a compliance plan after receiving a request from the agency to do so. The agencies' proposal allowed the agencies to require that a compliance plan be filed within 30 days or within a time period specified by the agencies. The agencies believe that this provision provides sufficient flexibility to extend the time period where appropriate or necessary. Accordingly, the agencies have decided not to extend the time period within which an institution must generally file a compliance plan. Although section 39 does not provide for any prior notice or administrative review of an agency order, the agencies' final rule provides for prior notice of, and an opportunity to respond to, a proposed order.

A few commenters requested that the agencies extend from 14 to 60 days or more the time period within which an institution must respond to the agency's notice of intent to issue an order requiring the institution to correct a safety and soundness deficiency or to take or refrain from taking other actions. Under the agencies' proposal, the agencies could determine that a different time period was appropriate in light of the safety and soundness of the institution or other relevant considerations. The agencies have decided to adopt the time period set forth in the proposal because the agencies believe that time period carries out the purpose of section 39 to facilitate early identification and correction of safety and soundness deficiencies.

A compliance plan 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) (12 U.S.C. 1831p), a cease-and-desist order entered into pursuant to section 8 of the FDI Act (12 U.S.C. 1818), a formal or informal agreement, or a response to a report of examination.

In conjunction with this rulemaking, the FDIC has amended part 303 of its regulations regarding delegations of authority to act on compliance plans under section 39.

III. Interagency Guidelines Establishing Standards for Safety and Soundness

The agencies have adopted Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines) pursuant to section 39 of the FDI Act. By adopting the standards as guidelines, the agencies retain the authority to require an institution to submit an acceptable compliance plan as well as the flexibility to pursue other more appropriate or effective courses of action given the specific circumstances and severity of an institution's noncompliance with one or more standards. Failure to submit or adhere to a compliance plan will subject an institution to the sanctions under section 39.

The agencies expect to request a compliance plan from an institution whose failure to meet one or more of the standards is of such severity that it could threaten the safe and sound operation of the institution. The agencies *may* elect to rely on an existing plan or enforcement action to ensure that an institution achieves compliance with the Guidelines, rather than requiring the submission of a separate safety and soundness compliance plan.

The Guidelines set out the safety and soundness standards that the agencies will use to identify and address problems at institutions before capital becomes impaired. The agencies believe that the standards adopted in the Guidelines serve this end without dictating how institutions must be managed and operated. Adoption of these Guidelines is consistent with the overwhelming majority of commenters' recommendations that the standards established under section 39 be general and flexible in nature. The agencies have decided to use the flexibility provided by the CDRI Act to propose new asset quality and earnings standards which the agencies believe are more appropriate. Therefore, the agencies have not included these standards in the final Guidelines, but are seeking comment on these standards elsewhere in this separate part of the **Federal Register**. The agencies intend to add revised asset quality and earnings standards to the Guidelines after comments are considered and final standards are adopted.

A. Holding Company Coverage

Section 318 of the CDRI Act eliminates the requirement that the

standards established pursuant to section 39 apply to depository institution holding companies. The Conference Report for the CDRI Act states, "The Conferees intend these requirements to apply only to the depository institutions." H.R. Conf. Rep. No. 652, 103rd Cong., 2d Sess. 175 (1994). Accordingly, the Guidelines do not apply to holding companies.

B. Operational and Managerial Standards

The agencies' proposed operational and managerial standards did not specify each procedure an institution must have in place. Instead, the proposed standards established the objectives that proper operations and management oversight should achieve, while leaving the methods for achieving those objectives to each institution. The proposed standards represented the fundamental standards in use by the agencies to assess the operational and managerial quality of an institution. The standards did not represent a change in any of the agencies' policies.

The majority of commenters believed that the proposed standards were sufficiently flexible and general in nature. Commenters generally viewed the standards as a realistic balance between the mandates of section 39 and the objective of avoiding overly burdensome regulation. Many commenters believed that the standards would ensure that decision-making responsibility resides with management of the institution.

A few commenters expressed concern that the agencies' examination process would, in effect, require specific standards, and they asked that more specific guidance be provided to examiners to ensure consistent interpretation of the standards. The agencies acknowledge the importance of consistent interpretation of the Guidelines and are considering issuing guidance to their examination staffs.

In response to the agencies' proposals, many commenters recommended that the agencies adopt standards that would apply according to an institution's asset size. The agencies recognize that smaller, less complex institutions may require less sophisticated systems and practices. Therefore, the standards for internal controls and information systems, internal audit systems, and credit underwriting state that these standards must be appropriate to the size of the institution and the nature and scope of its activities. In addition, the agencies' standard for interest rate exposure states that an institution must manage its interest rate risk in a manner appropriate to the size of the institution

and the complexity of its assets and liabilities.

The agencies specifically requested comment on whether the proposed standards would require institutions to modify their operations. While many commenters encouraged the agencies to exempt certain institutions from the standards based on asset size or capital category, the majority of commenters did not believe that the proposed standards would require institutions to modify their operations in order to comply. The agencies believe that well-managed institutions generally should not find it necessary to modify their operations in order to comply with the operational and managerial standards in the Guidelines.

The standards adopted by the agencies are based in large measure upon the standards proposed by the agencies. In determining whether an institution satisfies the standards, the agencies intend to consider an institution's overall practices and performance so that an institution would not fail one of the standards due to an isolated error or inconsistency.

1. Compliance With Laws and Regulations

The agencies' proposed standards for internal controls and information systems, loan documentation, credit underwriting, interest rate exposure and asset growth included a requirement for compliance with laws and regulations. Several commenters believed that this requirement was redundant and unnecessary since all institutions must comply with applicable laws and regulations and violation of a law or regulation may subject an institution to appropriate supervisory and enforcement action. The agencies believe that the express requirement to ensure compliance with applicable laws and regulations is a necessary standard for internal controls and information systems, but agree that repeating the requirement in the other standards is unnecessary. Accordingly, the requirement to ensure compliance with applicable laws and regulations has been deleted from the standards for loan documentation, credit underwriting, interest rate exposure and asset growth.

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

The agencies' proposed standards for internal controls and information systems were designed to enable each institution to comply by using control systems tailored to its individual operating environment. The majority of commenters favored these standards. Some accounting and auditing firm

commenters recommended that the agencies incorporate into the standards the guidelines prepared by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in "Internal Control: An Integrated Framework". The agencies believe that the proposed internal control standards are consistent with the COSO framework for the structure of control systems. Therefore, using the COSO framework in developing and evaluating a system of internal controls is one way an institution could meet the standards proposed by the agencies.

The agencies' proposal addressed internal audit systems separately. Internal audit systems are important to the ongoing monitoring of the effectiveness of the design and execution of any system of internal controls. The proposal required each institution to have an internal audit system that provided for adequate testing and review of internal controls and information systems among other provisions. Commenters criticized the requirement for an internal audit system because it seemed to imply that either a full-time internal auditor and staff or outside consultants would be necessary to perform an internal audit. Several commenters believed that the costs involved could not be justified for many smaller institutions.

The proposed audit standard did not explicitly require an internal audit function. The agencies believe it is management's responsibility to consider carefully the level of audit activity that will provide effective monitoring of the internal control system after taking into account the audit system's costs and benefits. For many banking organizations that have reached a certain size or complexity of operations, the benefits derived from an independent internal audit function more than outweigh its cost. However, for certain smaller institutions with few employees and less complex operations, the costs may outweigh these benefits.

Several commenters recommended that the agencies clarify how an institution, especially a small institution without an internal auditor, can ensure that its internal audit system provides for the "independence and objectivity" of those performing internal audits. The agencies believe that this standard can be met by ensuring that the person conducting the review, whether the auditor and/or another employee, is independent from the function under review and is able to report findings directly to the board of directors or to a designated directors' audit committee. The Guidelines adopted by the agencies clarify the appropriate role of a system

of independent reviews in an internal audit system.

A few commenters noted that the proposed standard providing for "verification and review of management actions to address identified weaknesses" seemed unnecessarily broad and potentially burdensome if the standard was interpreted to mean that every weakness, including minor, technical weaknesses, had to be specifically addressed by management in a report to the board of directors. To clarify this standard and to ensure that management's attention is focused on areas of concern, the agencies have changed "identified weaknesses" to "material weaknesses".

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.

3. Loan Documentation

The agencies' proposal specified what an institution's loan documentation practices must enable the institution to do, instead of specifying an item-by-item listing of loan documentation requirements.¹ An overwhelming majority of commenters strongly favored general loan documentation standards. Commenters believed that the proposed standards were sufficiently general to allow for different treatment according to loan type and amount.

In response to numerous comments, the agencies wish to emphasize that in evaluating an institution's loan documentation practices, they do not expect an institution to obtain an opinion of legal counsel for the purpose of demonstrating that a claim against a borrower is legally enforceable. Rather, an institution must establish loan documentation practices that provide for proper recording or perfection of the security interest.

The Guidelines adopt the agencies' standards on loan documentation as proposed. The agencies believe that the loan documentation standards provide a gauge against which compliance can be measured, while at the same time allowing for differing approaches to loan documentation.

¹ The current regulation establishing detailed loan documentation requirements at 12 CFR 563.170(c) remains in effect for all savings associations regulated by the OTS.

Under the Interagency Policy Statement Regarding Documentation of Small and Medium-sized Business and Farm Loans, (March 30, 1993), well-managed, well- or adequately capitalized institutions are permitted to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. The agencies' Guidelines do not affect the application of this interagency policy statement.

4. Credit Underwriting

The agencies' proposed standards for credit underwriting established general parameters of safe and sound credit underwriting practices. Commenters overwhelmingly favored general credit underwriting standards rather than a detailed listing of requirements that must be met for each extension of credit. Based on the comments received, the agencies have adopted the credit underwriting standards as proposed, in guideline form.

5. Interest Rate Exposure

The agencies proposed to require an institution to manage interest rate risk in a manner appropriate to the size of the institution and the complexity of its assets and liabilities and to provide for periodic reporting to management and the board of directors regarding interest rate risk. A majority of commenters supported this standard. Based on these comments, the agencies' Guidelines adopt this standard without change.

Section 305 of FDICIA requires amendment of the agencies' risk-based capital standards to take account of interest rate risk. The final regulation implementing section 305 may require some institutions to quantify interest rate risk.²

6. Asset Growth

The agencies' proposal required an institution to base its asset growth on a plan that fully considered the source of the institution's growth, the risks presented by such growth, and the effect of growth on the institution's capital. Commenters overwhelmingly favored this approach rather than a quantitative limit on asset growth which the commenters believed would be overly restrictive and inconsistent with safety and soundness. The agencies do not believe that asset growth necessarily causes safety and soundness problems. The agencies, however, do find that

² The OTS regulation implementing section 305 requires additional capital from institutions that have "above normal" interest rate risk. See 58 FR 45299 (August 31, 1993).

unplanned or poorly managed asset growth can be a cause for concern.

Based on the comments received, the agencies' Guidelines adopt the asset growth standard as proposed. The agencies will evaluate asset growth against an institution's overall strategic plan for growth.

7. Compensation, Fees and Benefits

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

The agencies' proposal required each institution to maintain safeguards to prevent the payment of compensation, fees, or benefits that are excessive or that could lead to material financial loss. A majority of commenters supported the agencies' proposed rules, although many commenters recommended that the rules exempt healthy institutions from the compensation standards.

Section 39 does not allow for any exemptions from this standard. Moreover, the agencies do not believe that exemptions are necessary in view of the flexibility of this standard. For these reasons and based on the comments received, the agencies' Guidelines incorporate the proposed operational and managerial standards relating to compensation, fees and benefits without change.

C. Standards Relating to Stock Valuation

The agencies believe that establishing stock valuation standards for publicly traded institutions is not appropriate. As indicated in the agencies' proposal, in the long run the market value of an organization is dependent on an institution's financial condition and performance, but over shorter and more operationally relevant time horizons, market value is also affected by factors such as the attractiveness of financial institution stocks relative to other competitors and industries, the performance of the general stock market, industry conditions and random fluctuations. Therefore, over any practical period of time, institutions do not have direct control over the marketplace's evaluation of their stock's value. An additional consideration is the appropriateness of applying a standard that affects only a subset of banking and thrift organizations and

could operate to discourage depository institutions from becoming publicly traded. The agencies intend to continue their existing policy of augmenting their overall examinations and ongoing monitoring of publicly-traded institutions through the review of stock price changes, market price to book value ratios, bond ratings and other indicators of the market's assessment of an institution's performance. To the extent that an institution's market to book ratio appears to significantly contradict the agencies' assessment of its condition, the agencies intend to continue to scrutinize carefully such institutions for developing problems.

D. Prohibition on Compensation That is Excessive or That Could Lead to Material Financial Loss

Section 39(c) of the FDI Act, as amended by the CDRI Act, continues to require the agencies to establish standards (1) prohibiting as an unsafe and unsound practice the payment of excessive compensation or compensation that could lead to material financial loss to an institution; and (2) specifying when compensation, fees, or benefits are excessive.

The agencies' joint proposal relied upon the statutory language in formulating the standards required under section 39(c). Commenters strongly supported the use of the factors set forth in section 39(c) as the sole standard in defining excessive compensation. Commenters believed that more detailed standards would constitute micro-management of an institution's management practices. Accordingly, the agencies' Guidelines include the compensation standards as proposed.

In the Guidelines, as under the proposal, compensation is considered excessive if it is unreasonable or disproportionate to the services actually performed by the executive officer, employee, director, or principal shareholder being compensated. In making that determination, the agencies will consider all relevant factors, including those set out in section 39(c).

E. Effect on Agencies' Existing Authority

Compliance with the standards set out in the Guidelines does not preclude the agencies from finding that an institution is engaged in an unsafe and unsound practice or is in an unsafe and unsound condition. Conversely, failure to comply with the standards set out in the Guidelines does not necessarily constitute an unsafe or unsound practice or an unsafe and unsound condition, except for failure to comply with the standard prohibiting payment

of excessive compensation or compensation that could lead to material financial loss.

The agencies may take supervisory action against an institution that has not been requested to submit a safety and soundness compliance plan. In addition, the agencies may request submission of a compliance plan without taking any other supervisory or enforcement action.

IV. Regulatory Flexibility Act

The agencies have concluded that the final rule will not impose a significant economic hardship on small institutions. The rule establishes deadlines for submission and review of compliance plans requested by the agencies of any insured depository institution which fails to meet the standards adopted by the agencies in the Interagency Guidelines Establishing Standards for Safety and Soundness. The impact of the final rule on small institutions should be proportionate to its impact on larger institutions. Accordingly, pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b), the agencies hereby certify that the final rule will not have a significant economic impact on a substantial number of small entities.

V. OCC and OTS: Unfunded Mandates Reform Act of 1995 Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) (signed into law on March 22, 1995) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, the final rule establishes deadlines and procedures for submission and review of safety and soundness plans and establishes standards for safety and soundness, as prescribed by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242. The standards represent the fundamental standards in use by the agencies, represent no change in the agencies' policies and impose minimal new Federal requirements. Thus, no additional costs to State, local or tribal governments or to the private sector of \$100 million or more in any one year

result from this rule. Accordingly, the OCC and OTS have not prepared a budgetary impact statement nor specifically addressed any regulatory alternatives.

VI. Effective Date

The agencies have determined that pursuant to section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI), Pub. L. 104-4, there is good cause for the final rule on safety and soundness to be effective 30 days after publication in the **Federal Register**. The implementation of this final regulation has been delayed because of changes required due to changes in the statute. CDRI amended 12 U.S.C. 1831p-1 to allow the agencies to implement the standards for safety and soundness by guideline rather than regulation. Under the guidelines the agencies may require an institution that fails to meet the standards to file a compliance plan. However, that action would be taken on a case-by-case basis after adequate notice to the institution. Therefore, the agencies believe that further delay is unnecessary.

VII. Executive Order 12866

The OCC and the OTS have determined that this final rule is not a "significant regulatory action" for purposes of Executive Order 12866.

Text of Final Common Rule

The text of the agencies' final common rule appears below:

Appendix ____ to Part ____—Interagency Guidelines Establishing Standards for Safety and Soundness

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I. Introduction

i. Section 39 of the Federal Deposit Insurance Act¹ (FDI Act) requires each Federal banking agency (collectively, the agencies) to establish certain safety and soundness standards by regulation or by guideline for all insured depository institutions. Under section 39, the agencies must establish three types of standards: (1) Operational and managerial standards; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.

ii. Section 39(a) requires the agencies to establish 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 establish standards relating to asset quality, earnings, and stock valuation that the agencies determine to be appropriate.

iii. Section 39(c) requires the agencies to establish standards prohibiting as an unsafe and unsound practice any compensatory arrangement that would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits and any compensatory arrangement that could lead to material financial loss to an institution. Section 39(c) also requires that the agencies establish standards that specify when compensation is excessive.

iv. If an agency determines that an institution fails to meet any standard established by guideline under subsection (a) or (b) of section 39, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. In the event that an institution fails to submit an acceptable plan within the time allowed by the agency or fails in any material respect to implement an accepted plan, the agency must, by order, require the institution to correct the deficiency. The agency may, and in some cases must, take other supervisory actions until the deficiency has been corrected.

v. The agencies have adopted amendments to their rules and regulations to establish deadlines for submission and review of compliance plans.²

¹ Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1) was added by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. 102-242, 105 Stat. 2236 (1991), and amended by section 956 of the Housing and Community Development Act of 1992, Pub. L. 102-550, 106 Stat. 3895 (1992) and section 318 of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, 108 Stat. 2160 (1994).

² For the Office of the Comptroller of the Currency, these regulations appear at 12 CFR Part 30; for the Board of Governors of the Federal Reserve System, these regulations appear at 12 CFR Part 263; for the Federal Deposit Insurance Corporation, these regulations appear at 12 CFR Part 308, subpart R, and for the Office of Thrift

vi. The following Guidelines set out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The agencies believe that the standards adopted in these Guidelines serve this end without dictating how institutions must be managed and operated. 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.

A. Preservation of Existing Authority

Neither section 39 nor these Guidelines in any way limits the authority of the agencies to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. Action under section 39 and these Guidelines may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the agencies. Nothing in these Guidelines limits the authority of the FDIC pursuant to section 38(i)(2)(F) of the FDI Act (12 U.S.C. 1831(o)) and Part 325 of Title 12 of the Code of Federal Regulations.

B. Definitions

1. *In general.* For purposes of these Guidelines, except as modified in the Guidelines 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).
2. *Board of directors*, in the case of a state-licensed insured branch of a foreign bank and in the case of a federal branch of a foreign bank, means the managing official in charge of the insured foreign branch.
3. *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.
4. *Director* shall have the meaning described in 12 CFR 215.2(c).³
5. *Executive officer* shall have the meaning described in 12 CFR 215.2(d).⁴
6. *Principal shareholder* shall have the meaning described in 12 CFR 215.2(f).⁵

II. Operational and Managerial Standards

A. *Internal controls and information systems.* An institution should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:

1. An organizational structure that establishes clear lines of authority and

Supervision, these regulations appear at 12 CFR Part 570.

³ In applying these definitions for savings associations, pursuant to 12 U.S.C. 1464, savings associations shall use the terms "savings association" and "insured savings association" in place of the terms "member bank" and "insured bank".

⁴ See footnote 3 in section I.B.4. of this appendix.

⁵ See footnote 3 in section I.B.4. of this appendix.

responsibility for monitoring adherence to established 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.* An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for:

1. Adequate monitoring of the system of internal controls through an internal audit function. For an institution whose size, complexity or scope of operations does not warrant a full scale internal audit function, a system of independent reviews of key internal controls may be used;
2. Independence and objectivity;
3. Qualified persons;
4. Adequate testing and review of information systems;
5. Adequate documentation of tests and findings and any corrective actions;
6. Verification and review of management actions to address material weaknesses; and
7. Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

C. *Loan documentation.* An institution should establish and maintain loan documentation practices that:

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 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; and
5. Take account of the size and complexity of a loan.

D. *Credit underwriting.* An institution should 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 and 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.

E. *Interest rate exposure.* An institution should:

1. Manage interest rate risk in a manner that is appropriate to the size of the

institution and the complexity of its assets and liabilities; and

2. Provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk.

F. Asset growth. An institution's asset growth should be prudent and consider:

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.

G. [Reserved].

H. [Reserved].

I. Compensation, fees and benefits. An institution should maintain safeguards to prevent the payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the institution.

III. 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 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 institution;
3. The financial condition of the institution;
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 institution;
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 institution; and
7. Any other factors the agencies determine to be relevant.

B. Compensation Leading to Material Financial Loss

Compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.

Adoption of Final Common Rule

The agency specific adoption of the final common rule, which appears at the end of the common preamble, appears below.

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, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Safety and soundness, Securities.

12 CFR Part 263

Administrative practice and procedure, Claims, Crime, Equal Access to justice, Federal Reserve System, Lawyers, Penalties.

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, Crime, Equal access to justice, Investigations, Lawyers, Penalties.

12 CFR Part 364

Administrative practice and procedure, Bank deposit insurance, Banks, banking, Reporting and recordkeeping requirements, 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.

FEDERAL RESERVE SYSTEM

12 CFR Chapter II

For the reasons outlined in the preamble, the Board hereby amends 12 CFR parts 208 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, is added to part 208 to read as follows:

Subpart D—Standards for Safety and Soundness

§ 208.60 Standards for safety and soundness.

The Interagency Guidelines Establishing Standards for Safety and Soundness prescribed pursuant to section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p–1), as set forth as appendix D to this part apply to all state member banks.

3. A new appendix D is added to part 208 as set forth at the end of the common preamble:

Appendix D to Part 208—Interagency Guidelines Establishing Standards for Safety and Soundness

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:

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 and notification 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 that are subject to the provisions of section 39 of the Federal Deposit Insurance Act (section 39) (12 U.S.C. 1831p–1).

§ 263.301 Purpose.

Section 39 of the FDI Act requires the Board to establish safety and soundness standards. Pursuant to section 39, a bank may be required to submit a compliance plan if it is not in compliance with a safety and soundness standard established by guideline 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 established under section 39, the bank fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted plan. This subpart establishes procedures for requiring submission of a compliance plan and issuing an enforceable order pursuant to section 39.

§ 263.302 Determination and notification 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 has failed to satisfy the safety and

soundness standards contained in the Interagency Guidelines Establishing Standards for Safety and Soundness set out in appendix D to part 208 of this chapter.

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

§ 263.303 Filing of safety and soundness compliance plan.

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

(2) *Other plans.* If a State member bank is obligated to file, or is currently operating under, a capital restoration plan submitted pursuant to section 38 of the FDI Act (12 U.S.C. 1831o), 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 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 of whether the plan has been approved or seek additional information from the bank 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 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 to correct the deficiency and may take further actions

provided in section 39(e)(2)(B).

Pursuant to section 39(e)(3), the Board may 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 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 Merger Act (12 U.S.C. 1828(c)) will be excluded.

(e) *Amendment of compliance plan.* A State member bank 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 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 prior written notice of the Board's intention to issue an order requiring the bank 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 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 immediately to take actions to correct a safety and soundness deficiency or take or refrain from taking other actions pursuant to section 39. A State member bank 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 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 intent to issue an order shall include:

- (1) A statement of the safety and soundness deficiency or deficiencies that have been identified at the bank;
- (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 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 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) *Contents 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 regarding the proposed order.

(d) *Agency 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
- (3) Seek additional information or clarification of the response from the bank, or any other relevant source.

(e) *Failure to file response.* Failure by a bank 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 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 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) *Failure to comply with order.* Pursuant to section 8(i)(2)(A) of the FDI Act, the Board may assess a civil money penalty against any State member bank 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.

By Order of the Board of Governors of the Federal Reserve System, June 6, 1995.

William W. Wiles,
Secretary of the Board.

DEPARTMENT OF THE TREASURY**Office of the Comptroller of the Currency****12 CFR Part 30**

[Docket No. 95-15]

FEDERAL RESERVE SYSTEM**12 CFR Part 208**

[Docket No. R-0766]

FEDERAL DEPOSIT INSURANCE CORPORATION**12 CFR Part 364**

RIN 3064-AB13

DEPARTMENT OF THE TREASURY**Office of Thrift Supervision****12 CFR Part 570**

[No. 95-114]

RIN 1550-AA54

Interagency Guidelines Establishing 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: Proposed guidelines.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are proposing asset quality and earnings standards to be added to the Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines) adopted pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) and appearing as an appendix to each of the agencies' standard for safety and soundness final rule published elsewhere in this separate part of the *Federal Register*. The agencies may require an insured depository institution to file a compliance plan for failure to meet these asset quality and earnings standards when adopted in final form.

DATES: Comments must be submitted by August 24, 1995.

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. 95-15. 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 of Governors: 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: Robert E. Feldman, Acting 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]; Internet E-mail comments @fdic.gov. 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: Send comments to Chief, Dissemination Branch Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention Docket No. 95-114. 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. Comments will be available for inspection at 1700 G Street, NW., from 1 p.m. until 4 p.m. on business days.

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, (202/874-5210) Securities and Corporate Practices Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board of Governors: 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, Managing Senior Counsel (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, Manager, Planning and Program Development (202/898-6911) or Michael D. Jenkins, Examination Specialist (202/898-6896), Division of Supervision; Lisa M. Stanley, Senior Counsel (202/898-7494), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: William Magrini, Project Manager (202/906-5744), Cathern Smith, Regional Coordinator (202/906-6614), Supervision; Kevin Corcoran, Assistant Chief Counsel (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.

SUPPLEMENTARY INFORMATION:**I. Background****A. Statutory Framework**

Section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), added a new section 39 to the FDI Act which required each Federal banking agency to establish by regulation certain safety and soundness standards for the insured depository institutions and depository institution holding companies for which it was the primary Federal regulator. As enacted in FDICIA, section 39(b) of the FDI Act required the agencies to establish standards by regulation specifying a maximum ratio of classified assets to capital and minimum earnings sufficient to absorb losses without impairing capital.

On September 23, 1994 the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act) was enacted. Section 318(a) of the CDRI Act eliminated the requirement that standards prescribed under section 39 apply to depository institution holding companies and replaced the requirement that the agencies establish quantitative asset quality and earnings standards with a requirement that the agencies establish standards, by regulation or by guideline, relating to asset quality and earnings that the agencies determine to be

appropriate. Pursuant to section 318 of the CDRI Act, these amendments have the same effective date as section 39 of the FDI Act, as provided in section 132(c) of FDICIA.

B. Agencies' Proposals

The agencies published a joint advance notice of proposed rulemaking in the *Federal Register*, 57 FR 31336 (July 15, 1992). The agencies received over 400 comment letters in response to the ANPR, with some letters submitted to more than one agency. The agencies' proposal requested comment on all aspects of the safety and soundness standards required to be prescribed pursuant to section 39 of the FDI Act, as enacted in FDICIA. Commenters strongly recommended that the agencies adopt general rather than specific standards. The agencies published a joint notice of proposed rulemaking in the *Federal Register* on November 18, 1993, 59 FR 60802. The agencies proposed quantitative asset quality and earnings standards in accordance with the statutory mandate set forth in FDICIA.

C. Final Rule and Interagency Guidelines Establishing Standards for Safety and Soundness

Each of the agencies has adopted a final rule (Final Rule) and Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines). The agencies' Final Rule establishes deadlines for submission and review of safety and soundness compliance plans which may be required for failure to meet one or more of the safety and soundness standards adopted in the Guidelines. The agencies' Final Rule and Guidelines are published elsewhere in this separate part of the *Federal Register*. The Guidelines will appear as appendices to each of the agencies' Final Rule.¹

If adopted in final form, the agencies intend to incorporate these asset quality and earnings standards into the Guidelines. Thus, if adopted in final form, the agencies may require submission of a compliance plan for failure to meet the asset quality and earnings standards.

II. Request for Comment on Proposed Asset Quality and Earnings Standards

As enacted in FDICIA, section 39(b) of the FDI Act required the agencies to establish standards specifying a

maximum ratio of classified assets to capital and minimum earnings sufficient to absorb losses without impairing capital. As amended by the CDRI Act, section 39(b) no longer requires the agencies to establish quantitative standards. Instead, the agencies are required to establish such standards relating to asset quality and earnings that the agencies determine to be appropriate.

Although commenters generally found the agencies' proposed quantitative standards acceptable, some commenters criticized the proposed standards as inflexible and simplistic. While the agencies believe that the standards as proposed are acceptable, they also believe that more comprehensive standards in these areas, as allowed under section 39(b), as amended, would be more useful and appropriate. Therefore, the agencies are proposing new standards for asset quality and earnings that emphasize monitoring, reporting and preventive or corrective action appropriate to the size of the institution and the nature and scope of its activities. These standards would be adopted by guideline.

The agencies believe the proposed standards are more likely to aid in the identification and resolution of emerging problems than setting minimum or maximum ratios. The agencies intend to continue to perform independent analyses that may include asset quality and earnings ratio analysis and will focus on an institution's oversight, reporting and corrective actions in these areas. The agencies believe that well-managed institutions should not find it necessary to modify their operations to comply with the proposed guidelines.

A. Standards Relating to Asset Quality

The agencies are proposing asset quality standards requiring monitoring and reporting systems to identify emerging problems and corrective actions to resolve them. The standards provide for institutions to identify problem assets and estimate inherent losses. Institutions would also be required to: (1) Consider the size and potential risks of material concentrations of credit risk, (2) compare the level of problem assets to the level of capital and establish reserves sufficient to absorb anticipated losses on those and other assets, (3) take appropriate corrective action to resolve problem assets; and (4) provide periodic asset quality reports to the board of directors to assess the level of asset risk.

The complexity and sophistication of an institution's monitoring, reporting systems and corrective actions should

be commensurate with the size, nature and scope of the institution's operations. The agencies believe that the proposed asset quality standards are consistent with the practices of well-managed institutions and represent the long-standing and established expectations of the agencies.

B. Standards Relating to Earnings

The agencies are proposing earnings standards requiring monitoring and reporting systems similar to the standards for asset quality. The standards are intended to ensure prompt remedial actions to enhance early identification and resolution of problems. The standards require institutions to compare their earnings trends, relative to equity, assets and other common benchmarks with their historical experience and with their peers. The standards also provide that institutions should: (1) evaluate the adequacy of earnings given the institution's size, and complexity, and the risk profile of the institution's assets and operations, (2) assess the source, volatility and sustainability of earnings, (3) evaluate the effect of nonrecurring or extraordinary income or expense, (4) take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and the institution's rate of growth, and (5) provide periodic reports with enough information for management and the board of directors to assess earnings performance.

As with the asset quality standards, the institution's monitoring, reporting systems and corrective actions should be commensurate with the size, nature and scope of the institution's operations. Once again, the agencies believe that these earnings standards are consistent with the practices of well-managed institutions and represent the long-standing and established expectations of the agencies.

The agencies propose to add to the Interagency Guidelines Establishing Standards for Safety and Soundness standards relating to asset quality and earnings as set forth below. The agencies request comment on all aspects of the proposed standards.

Regulatory Flexibility Act

Pursuant to Section 605(b) of the Regulatory Flexibility Act, the agencies certify that the proposal will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This proposal adds asset quality and earnings standards to the Interagency Guidelines

¹ For the OCC, these Guidelines appear as Appendix A to Part 30; for the Board of Governors, these Guidelines appear as Appendix D to Part 208; for the FDIC, these Guidelines appear as Appendix A to Part 364; and for the OTS, these Guidelines appear as Appendix A to Part 570.

Establishing Standards for Safety and Soundness.

Executive Order 12866

The OCC and the OTS have determined that this proposal is not a "significant regulatory action" for purposes of Executive Order 12866.

The proposed new paragraphs G and H of Section II of the Interagency Guidelines Establishing Standards for Safety and Soundness are as follows:

Asset Quality and Earnings Standards

G. Asset Quality. An insured depository institution should establish and maintain a system to identify problem assets and prevent deterioration in those assets in a manner commensurate with its size and the nature and scope of its operations. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets and estimate the inherent losses in those assets;

2. Consider the size and potential risks of material asset concentrations;

3. Compare problem asset totals to capital and establish reserves that are sufficient to absorb estimated losses;

4. Take appropriate corrective action to resolve problem assets;

5. Provide periodic asset quality reports with adequate information for management and the board of directors to assess the level of asset quality risk.

H. Earnings. An insured depository institution should establish and maintain a system to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves in a manner commensurate with its size and the nature and scope of its operations. The institution should:

1. Compare recent earnings trends relative to equity, assets or other commonly used benchmarks to the institution's historical results and those of its peers;

2. Evaluate the adequacy of earnings given the size, complexity and risk profile of the institution's assets and operations;

3. Assess the source, volatility and sustainability of earnings;

4. Evaluate the effect of nonrecurring or extraordinary income or expense;

5. Take steps to ensure that earnings are sufficient to maintain adequate

capital and reserves after considering the institution's asset quality and growth rate; and

6. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

Dated: April 13, 1995.

Eugene A. Ludwig,

Comptroller of the Currency.

By Order of the Board of Governors of the Federal Reserve System, June 6, 1995.

William W. Wiles,

Secretary of the Board.

By order of the Board of Directors.

Dated at Washington, D.C., this 21st day of March, 1995.

Federal Deposit Insurance Corporation

Robert E. Feldman,

Deputy Executive Secretary.

Dated: May 25, 1995.

By the Office of Thrift Supervision.

Jonathan L. Fiechter,

Acting Director.

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