

## **FEDERAL RESERVE BOARD**

**Docket No. OP - 1416**

### **Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies**

**AGENCY:** Board of Governors of the Federal Reserve System

**ACTION:** Notice

**SUMMARY:** The Board of Governors of the Federal Reserve System (“Board”) invites comment on its intention to apply certain elements of its consolidated supervisory program currently applicable to bank holding companies to savings and loan holding companies (“SLHCs”) after assuming supervisory responsibility for SLHCs in July 2011. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 transfers supervisory functions related to SLHCs and their non-depository subsidiaries to the Board on July 21, 2011.

**DATES:** Comments must be submitted on or before May 23, 2011.

**ADDRESSES:** You may submit comments by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board’s web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board’s Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

**FOR FURTHER INFORMATION CONTACT:** Kathleen O’Day, Deputy General Counsel, (202-452-3786), or Amanda K. Alexon, Counsel, (202) 452-3818, Legal Division; Anna Lee Hewko, Assistant Director, (202) 530-6260, T. Kirk Odeward, Manager, (202) 530-6225, or Kristin B. Bryant, Supervisory Financial Analyst, (202)

452-3670, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551. Telecommunications Device for the Deaf (TDD) users may contact (202-263-4869).

## **SUPPLEMENTAL INFORMATION:**

### **Background**

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) was enacted into law on July 21, 2010. Title III of the Dodd-Frank Act abolishes the Office of Thrift Supervision (“OTS”) effective July 21, 2011, and transfers supervisory functions (including rulemaking) related to SLHCs and their non-depository subsidiaries to the Board. The Board will become responsible for the supervision of SLHCs beginning July 21, 2011 (“transfer date”).

The Board believes that it is important that any company that owns and operates a depository institution be held to appropriate standards of capitalization, liquidity, and risk management consistent with the principles of safety and soundness. As a result, it is the Board’s intention, to the greatest extent possible taking into account any unique characteristics of SLHCs and the requirements of the Home Owners Loan Act (“HOLA”), to assess the condition, performance, and activities of SLHCs on a consolidated risk-based basis in a manner that is consistent with the Board’s established approach regarding bank holding company (“BHC”) supervision. As with BHCs, our objective will be to ensure that the SLHC and its nondepository subsidiaries are effectively supervised and can serve as a source of strength for, and do not threaten the soundness of, its subsidiary depository institutions.

The Board has identified three elements of its current supervisory program that are particularly critical to the effective evaluation of the consolidated condition of holding companies: (i) the Board’s consolidated supervision program for large and regional holding companies; (ii) the Board’s supervisory program for small, noncomplex holding companies; and (iii) the Board’s holding company rating system. The Board believes that these programs aid in the effective supervision of BHCs and that they would be equally effective for the supervision of SLHCs.

It is the Board’s intention that, after the transfer date, the Board will issue formal guidance or notices of proposed rulemaking, as appropriate, taking into consideration any comments received on this notice, to apply the supervisory program in place for BHCs to SLHCs to the fullest extent possible taking into account the unique characteristics of SLHCs and the requirements of HOLA in order to ensure continuous and effective supervision of SLHCs. By this notice, the Board seeks to inform interested persons, including SLHCs, about the Board’s approach to supervision and invites comment on its intended approach in order to help identify issues and matters that may require special attention.

### **Consolidated Supervision**

Consistent with its responsibilities under the Bank Holding Company Act, the

Gramm-Leach-Bliley Act, and the Dodd-Frank Act, the Board supervises BHCs on a consolidated and enterprise-wide basis.<sup>1</sup> The consolidated supervision program, which applies primarily to large and regional BHCs, is aimed at understanding and assessing the BHC on a consolidated basis. The program is applied in a risk-focused manner, and supervisory activities (continuous monitoring,<sup>2</sup> discovery reviews,<sup>3</sup> and testing) vary across portfolios of institutions based on size, complexity, and risk. The framework provides for coordination by the Federal Reserve System with, and reliance on the assessments by, bank and functional regulators of BHC subsidiaries. The consolidated supervision program is not only central to the Board's assessment of risk to individual banking organizations and their depository institution subsidiaries, but also to the Board's assessment of the stability of the broader financial system.

The Board believes that applying the BHC consolidated supervision program to SLHCs is essential to executing its supervisory responsibilities under the Dodd-Frank Act and is consistent with the authorities provided by HOLA. While the Board's BHC consolidated supervision program has some similarities to the current supervisory program employed by the OTS, the Board nevertheless believes that the Board's consolidated supervision program may entail more intensive supervisory activities than under current OTS practice, at least for some SLHCs. For example, the Board's consolidated supervision of SLHCs may entail more rigorous review of internal control functions and consolidated liquidity, as well as the conduct of discovery reviews of specific activities. In addition, the Board's supervisory program may entail heightened review of the activities of nonbank subsidiaries (consistent with applicable law and regulation) and may entail greater continuous supervisory monitoring of larger SLHCs. Nevertheless, the Board does not believe that application of its BHC consolidated supervision program to SLHCs would require any specific action on the part of SLHCs prior to the transfer date or cause undue burden on an ongoing basis.

The Board intends to integrate each SLHC into existing programs that align institutions with various supervisory portfolios (e.g., community banking organizations, regional banking organizations, and large banking organizations) based on their size and

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<sup>1</sup> The Board's consolidated supervision program is set forth in SR letter 08-9/CA letter 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" (SR 08-9). This guidance is currently being reviewed pursuant to changes in the Board's supervisory responsibilities as set forth in the Dodd-Frank Act, including those that apply to the supervision of SLHCs.

<sup>2</sup> "Continuous monitoring activities" are supervisory activities primarily designed to develop and maintain an understanding of the organization, its risk profile, and associated policies and practices. These activities also provide information that is used to assess inherent risks and internal control processes. Such activities include meetings with banking organization management; analysis of management information systems and other internal and external information; review of internal and external audit findings; and other efforts to coordinate with, and utilize the work of, other relevant supervisors and functional regulators (including analysis of reports filed with or prepared by these supervisors or regulators, or appropriate self-regulatory organizations, as well as related surveillance results).

<sup>3</sup> A discovery review is an examination/inspection activity designed to improve the understanding of a particular business activity or control process, for purposes such as addressing a knowledge gap that was identified during the risk assessment process.

complexity. Each portfolio has a supervisory program tailored to the type of institution supervised. The applicable consolidated supervision program is explained in SR 08-9.

### **Small, Noncomplex Holding Companies**

Consistent with a risk-focused approach to supervision, both the Board and OTS have tailored specific supervisory programs for holding companies that are viewed as posing a relatively low level of risk to depository institution subsidiaries and to the financial system. The OTS currently classifies low-risk or noncomplex SLHCs (irrespective of size and as determined by supervisory staff on a case-by-case basis) as “Category I” and subjects these SLHCs to abbreviated, limited-scope onsite examinations.

Similarly, the Board has a program for BHCs with total consolidated assets of \$1 billion or less (“small shell BHCs”).<sup>4</sup> For noncomplex<sup>5</sup> small shell BHCs where all subsidiary depository institutions have satisfactory composite and management ratings, and where no material outstanding holding company or consolidated issues are otherwise indicated, a Reserve Bank generally assigns only a composite rating and a management rating to the BHC and bases those ratings on the ratings of the lead depository institution (i.e., no onsite work is typically undertaken). For complex small shell BHCs, and for noncomplex small shell BHCs that do not meet the additional conditions noted in the previous sentence, a Reserve Bank generally conducts an offsite review, with targeted onsite review as necessary.<sup>6</sup>

For a noncomplex BHC with total consolidated assets between \$1 - \$10 billion and a satisfactory composite rating, a limited-scope<sup>7</sup> onsite inspection is required every two years (in the case of BHCs with assets between \$1 - \$5 billion, a targeted inspection is acceptable as well) . For a complex BHC with total consolidated assets between \$5 - \$10 billion and a satisfactory composite rating, a full-scope onsite inspection is required annually (in the case of BHCs with assets between \$1 - \$5 billion, this requirement may

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<sup>4</sup> See SR letter 02-1, “Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less” (SR 02-1). See also Federal Reserve Regulatory Service (FRRS) 3-1531 (S-2483, October 7, 1985, as revised by S-2563, May 20, 1994) and FRRS 3-1532.5 (S-2587, November 3, 1997). SR 02-1 also sets forth procedures for BHCs with total consolidated assets of between \$1 - \$5 billion, but these institutions are not considered to be small shell BHCs.

<sup>5</sup> The determination of whether a holding company is “complex” versus “noncomplex” is made at least annually on a case-by-case basis taking into account and weighing a number of considerations, such as: the size and structure of the holding company; the extent of intercompany transactions between insured depository institution subsidiaries and the holding company or uninsured subsidiaries of the holding company; the nature and scale of any nonbank activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley authorized activities (e.g., insurance, securities, merchant banking); whether risk management processes for the holding company are consolidated; and whether the holding company has material debt outstanding to the public.

<sup>6</sup> Targeted inspection activities typically focus intensively on one or two activities.

<sup>7</sup> A limited-scope inspection typically reviews all areas of activity covered by a full-scope inspection, but less intensively.

be satisfied with a limited-scope or targeted review for the onsite portion of the inspection, supplemented by other information sources).

For a noncomplex BHC with total consolidated assets between \$1 - \$10 billion and a less-than-satisfactory composite rating, irrespective of complexity, at least one full-scope onsite inspection and one limited-scope or targeted inspection are required annually. In the case of BHCs with assets between \$1 - \$5 billion, the requirement for an annual full-scope inspection may be satisfied with a limited-scope or targeted inspection for the onsite portion, supplemented by other inspection sources.

For all BHCs with total consolidated assets greater than \$1 billion (i.e., those that are not considered small shell BHCs), complete ratings are assigned in conjunction with inspection activities. Moreover, additional limited-scope or targeted inspection activities may be conducted as needed.<sup>8</sup>

Once Board supervisory staff has become familiar with the structure and financial condition of SLHCs, the Board intends to apply the program for small shell BHCs as set forth in SR 02-1 and supporting documents to SLHCs that meet the same criteria. A Reserve Bank will determine whether an SLHC with assets of \$1 billion or less is complex or noncomplex, and will tailor its supervision as appropriate. For a number of small, noncomplex SLHCs, this may have the effect of reducing burden as onsite examinations/inspections will no longer be required.

### **Holding Company Rating System**

The Board and OTS (together, the “agencies”) have developed rating systems for supervised institutions to provide an assessment of financial and nonfinancial factors based on the findings from examination and inspection activities, as well as to ensure uniform treatment across institutions. Both agencies use a 1-to-5 rating scale, with 1 indicating the highest rating and least degree of supervisory concern, and 5 indicating the lowest rating and highest degree of supervisory concern. These ratings are nonpublic supervisory information and, as such, are shared with the institution being rated but are otherwise generally confidential.

The OTS rating system for SLHCs is known as “CORE.”<sup>9</sup> The Board’s rating system for BHCs is known as “RFI/C(D)”<sup>10</sup> (commonly referred to as “RFI”). Given the similarities between the CORE and RFI rating systems, and the general goal of rationalizing supervisory processes for all institutions, the Board is considering

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<sup>8</sup> Requirements for BHCs with special characteristics (e.g., those that are formed to acquire an existing bank, have undergone a change in control, or are de novo and have been organized to acquire a de novo bank) may differ from the guidelines described here. See section 5000 of the Federal Reserve Board’s *Bank Holding Company Supervision Manual*.

<sup>9</sup> See *Holding Companies Handbook*, Office of Thrift Supervision, March 2009. See also OTS CEO Letter 266 (December 20, 2007) and 72 FEDERAL REGISTER 72442 (2007).

<sup>10</sup> See Board Supervision and Regulation (SR) letter 04-18, “Bank Holding Company Rating System,” and 69 FEDERAL REGISTER 70444 (2004).

transitioning SLHCs to the RFI rating system as the Board conducts its own independent supervisory assessment of the condition of the SLHC after the transfer date. The Board does not anticipate that any existing CORE ratings will be converted to RFI ratings until such a review is conducted.

Based on analyses of the CORE and RFI rating systems by the agencies, the Board believes there is substantial overlap between the two rating systems. However, there are some areas where the CORE and RFI rating systems differ. Under the CORE rating system, SLHCs generally are assigned individual component ratings<sup>11</sup> for capital (C), organizational structure (O), risk management (R), and earnings (E), as well as a composite rating that reflects an overall assessment of the holding company enterprise as reflected by consolidated risk management and consolidated financial strength.

Under the RFI rating system, BHCs generally are assigned individual component ratings<sup>12</sup> for risk management (R), financial condition (F), and impact (I) of nondepository entities on subsidiary depository institutions. The risk management rating is supported by individual subcomponent ratings for board and senior management oversight; policies, procedures, and limits; risk monitoring and management and information systems; and internal controls. The financial condition rating is supported by individual subcomponent ratings for capital adequacy, asset quality, earnings, and liquidity. An additional component rating is assigned to generally reflect the condition of any depository institution subsidiaries (D), as determined by the primary supervisor(s) of those subsidiaries. An overall composite rating (C) is assigned based on an overall evaluation of a BHC's managerial and financial condition and an assessment of potential future risk to its subsidiary depository institution(s).

A primary difference between the two rating systems is that, unlike the RFI rating system, the CORE rating system does not explicitly take account of asset quality.<sup>13</sup> Asset quality is one of a number of elements that is taken into account in assigning a composite BHC rating. However, the Board does not believe that assigning a rating for asset quality is likely to result in material changes to composite ratings because, under CORE, a review of asset quality is subsumed into other rating elements (it is taken into account indirectly in assessing the capital and earnings components).

Additionally, as discussed in more detail below, in contrast to BHCs, SLHCs currently are not subject to regulatory capital requirements. As one element of its overall assessment of capital adequacy, the (F) component of the RFI rating system does take into account regulatory capital requirements for BHCs. The (C) component of the CORE rating system takes into consideration both a qualitative and quantitative supervisory capital assessment that can be found in OTS guidance. With the exception of the

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<sup>11</sup> The OTS does not require individual component ratings to be assigned to noncomplex and low-risk holding companies.

<sup>12</sup> A simplified version of the rating system that includes only the risk management component and a composite rating is applied to noncomplex BHCs with assets of \$1 billion or less.

<sup>13</sup> Although liquidity is not rated separately under the CORE system, it is nevertheless taken into account in both the organizational structure and earnings components.

regulatory capital requirement for BHCs, the methods used by the agencies to determine capital adequacy for purposes of establishing a supervisory rating are similar. Until such time as consolidated capital standards for SLHCs are finalized by the Board, the Board anticipates that it will assess SLHC capital using supervisory quantitative and qualitative methods similar to those currently employed by the OTS.

The Board notes that changes to the RFI rating system guidance and policies may be necessary to accommodate SLHCs and differences in their statutory and regulatory framework. The Board is reviewing this guidance to determine where adjustments may be necessary.

The Board is seeking comment on all aspects of this approach. Specifically, the Board requests comment with regard to:

1. The burden of these potential modifications to supervisory activities on SLHCs; and
2. Whether there are any unique characteristics, risks, or specific activities of SLHCs that should be taken into account when evaluating which supervisory program should be applied to SLHCs and what changes would be required to accommodate these unique characteristics.

### **Capital Adequacy**

One material difference between the OTS and Board supervisory programs for holding companies is the assessment of capital adequacy. Currently, SLHCs are not subject to minimum regulatory capital ratio requirements. The OTS instead applies both a qualitative and quantitative supervisory capital assessment to SLHCs that is based in guidance.

Section 171 of the Dodd-Frank Act requires that BHCs and SLHCs be subject to minimum leverage and risk-based capital requirements that are not less than the generally applicable leverage and risk-based capital requirements applied to depository institutions.<sup>14</sup> Small BHCs that are subject to the Small Bank Holding Company Policy Statement (Appendix C of 12 CFR Part 225) are exempt from these requirements. Section 171 of the Act did not expressly provide a similar exemption for small SLHCs.

Pursuant to the Dodd-Frank Act and the Basel Committee on Banking Supervision's "Basel III: A global regulatory framework for more resilient banks and banking systems" report ("Basel III"),<sup>15</sup> the Board, together with the other Federal banking agencies, is reviewing consolidated capital requirements for all depository

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<sup>14</sup> Under section 171 of the Dodd-Frank Act, the "generally applicable" leverage and risk-based capital requirements are those established by the appropriate Federal banking agencies to apply to insured depository institutions under prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act.

<sup>15</sup> The Basel III text can be found at: <http://www.bis.org/publ/bcbs189.htm>

institutions and their holding companies. The Board is considering applying to SLHCs the same consolidated risk-based and leverage capital requirements as BHCs to the extent reasonable and feasible taking into consideration the unique characteristics of SLHCs and the requirements of HOLA. The Board, together with the other Federal banking agencies, expects to issue a notice of proposed rulemaking in 2011 that will outline how Basel III-based requirements will be implemented for all institutions, including any relevant provisions needed to comply with the Dodd-Frank Act. It is expected that the Basel III notice of proposed rulemaking also would address any proposed application of Basel III-based requirements to SLHCs. The Board expects that final rules establishing Basel III-based capital requirements would be finalized in 2012 and implementation would start in 2013, in accordance with the international agreement. The Board invites SLHCs to monitor and participate in the Basel III capital rulemaking process.

Although the Board believes it is important for SLHCs generally to be subject to the same consolidated leverage and risk-based capital requirements as BHCs, it recognizes that SLHCs have traditionally been permitted to engage in a broad range of nonbanking activities that were not contemplated when the general leverage and risk-based capital requirements for BHCs were developed. The Board is seeking specific comment with respect to any unique characteristics, risks, or specific activities of SLHCs the Board should take into consideration when developing consolidated capital requirements for SLHCs based on Basel III. What specific provisions, consistent with the Dodd-Frank Act, should be incorporated in the proposed rule in order to address such unique characteristics, risks, and/or specific activities? Additionally, the Board is seeking comment on the following:

3. What instruments that are currently includable in SLHCs' regulatory capital would be either excluded from regulatory capital or more strictly limited under Basel III? 3(a) How prevalent is the issuance of such instruments? Please comment on the appropriateness of the Basel III transitional arrangements for non-qualifying regulatory capital instruments. Provide specific examples and data to support any proposed alternative treatment.
4. Are the proposed Basel III-based transition periods appropriate for SLHCs and, if not, what alternative transition periods would be appropriate and why?

Finally, the Board is seeking specific comment with respect to what methods the Board should consider implementing for assessing capital adequacy for SLHCs during the period between the transfer date and implementation of consolidated capital standards for SLHCs. The Board also anticipates providing additional notice or issuing specific formal guidance or rules with regard to supervisory capital assessment after the transfer date and providing further opportunity for comment.

By order of the Board of Governors of the Federal Reserve System, April 15, 2011.

Robert deV. Frierson (signed)

Robert deV. Frierson

Deputy Secretary of the Board.