

# *Function* Supervising and Regulating Financial Institutions and Activities

*The Federal Reserve promotes the safety and soundness of individual financial institutions and monitors their impact on the financial system as a whole.*

## 5

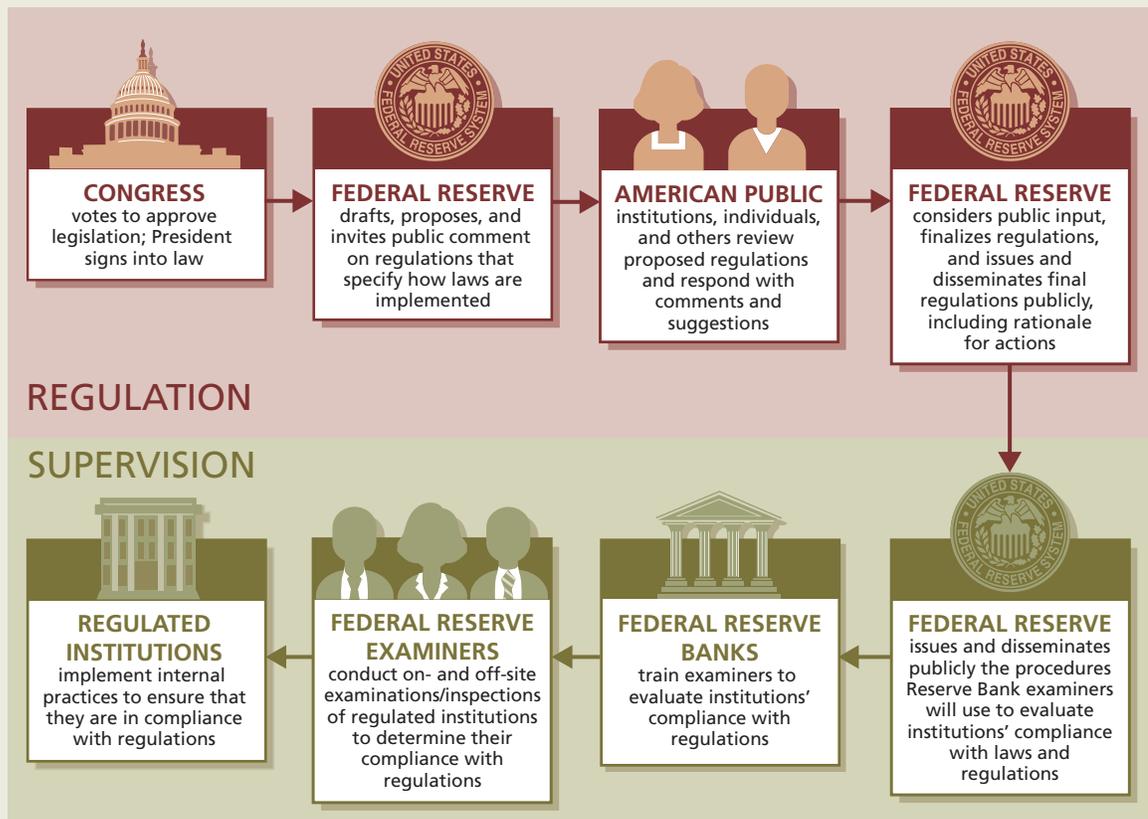
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The Federal Reserve Act of 1913 established the Federal Reserve System to provide the nation with a safer, more flexible, and more stable monetary and financial system. One of the principal functions of the Federal Reserve in achieving this goal is to regulate and supervise various financial entities. It performs this function, in part, through microprudential regulation and supervision of banks; holding companies and their affiliates; and other entities, including nonbank financial companies that the Financial Stability Oversight Council (FSOC) has determined should be supervised by the Board and subject to prudential standards. In addition, the Federal Reserve engages in “macroprudential” supervision and regulation that looks beyond the safety and soundness of individual institutions to promote the stability of the financial system as a whole.

**Figure 5.1. How the regulation and supervision process works**

When Congress passes a law that impacts the financial industry, the Federal Reserve—sometimes in cooperation with other federal agencies—often drafts regulations that determine how the law will be implemented.



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## Regulation versus Supervision

Regulation and supervision are distinct, but complementary, activities (see [figure 5.1](#)). Regulation entails establishing the rules within which financial institutions must operate—in other words, issuing specific regulations and guidelines governing the formation, operations, activities, and acquisitions of financial institutions. Once the rules and regulations are established, supervision—which involves monitoring, inspecting, and examining financial institutions—seeks to ensure that an institution complies with those rules and regulations, and that it operates in a safe and sound manner.

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## Entities the Federal Reserve Oversees

By law, the Federal Reserve is responsible for supervising and regulating certain segments of the financial industry to ensure they employ safe and sound business practices and comply with all applicable laws and regulations (see [figure 5.2](#)).

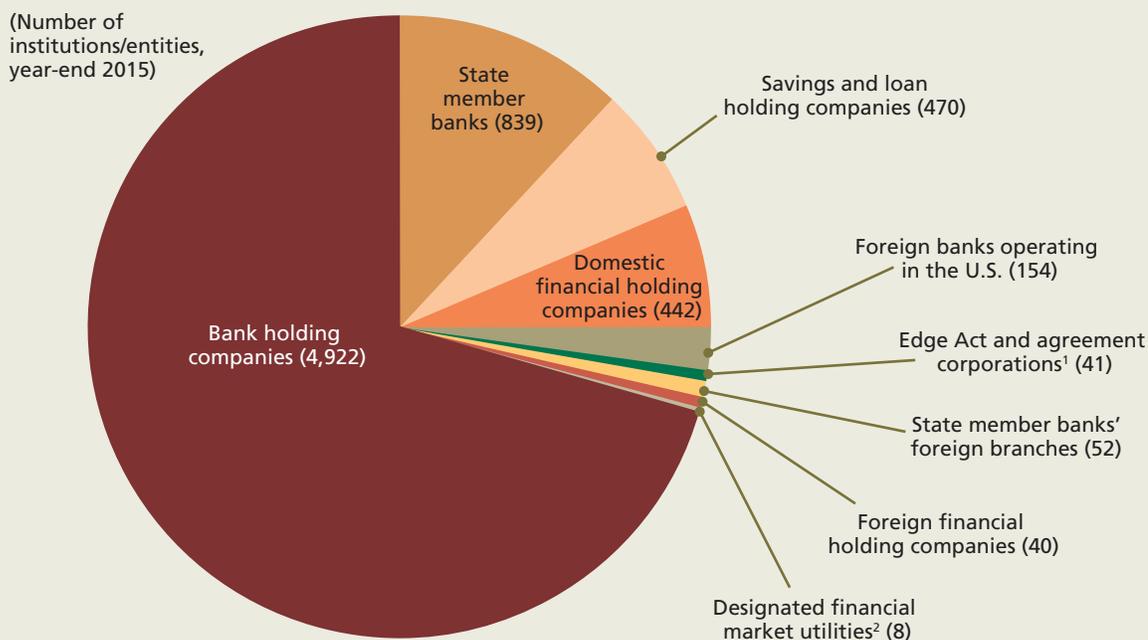
### ***Bank Holding Companies (Including Financial Holding Companies)***

Banks are often owned or controlled by another company, called a bank holding company (BHC). The Federal Reserve has supervisory and regulatory authority for all BHCs, regardless of whether subsidiary banks of the holding company are national banks, state “member” banks, or state “nonmember” banks (see a complete discussion of [“State Member Banks”](#) beginning on page 77). It also has supervisory authority over any nonbank subsidiary of a BHC that is not functionally regulated by another federal or state regulator, such as a leasing subsidiary.

The Gramm-Leach-Bliley Act of 1999 permits BHCs that meet certain criteria to become financial holding companies (also under Federal Reserve supervisory and regulatory authority). These entities may own

### Figure 5.2. The Federal Reserve oversees a broad range of financial entities

Bank holding companies constitute the largest segment of institutions supervised by the Federal Reserve, but the Federal Reserve also supervises state member banks, savings and loan holding companies, foreign banks operating in the United States, and other entities.



<sup>1</sup> Edge Act and agreement corporations are subsidiaries of banks or bank holding companies, organized to allow international banking and financial business.

<sup>2</sup> Financial market utilities (FMUs) are multilateral systems that provide the essential infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and within those systems. The Federal Reserve supervises FMUs, including certain ones that have been designated systemically important by the Financial Stability Oversight Council.

Note: Entities supervised are not mutually exclusive; for example, bank and savings and loan holding companies may own other supervised entities listed.

Source: 2015 Annual Report, "Supervision and Regulation" (available on the Federal Reserve Board's website, [www.federalreserve.gov/publications/annual-report/2015-supervision-and-regulation.htm](http://www.federalreserve.gov/publications/annual-report/2015-supervision-and-regulation.htm)).

(1) broker-dealers engaged in securities underwriting and dealing and  
(2) business entities engaged in merchant banking, insurance underwriting, and insurance agency activities.

When a financial holding company owns a subsidiary broker-dealer or insurance company, the Federal Reserve coordinates its supervisory efforts with those of the subsidiary's functional regulator—for example, the U.S.

Securities and Exchange Commission (SEC) in the case of a broker-dealer, and state insurance regulators in the case of an insurance company.

For a current list of financial holding companies, visit the Banking Information & Regulation section of the Federal Reserve Board's website (Banking Structure section), at [www.federalreserve.gov](http://www.federalreserve.gov).

### ***Savings and Loan Holding Companies***

Savings and loan holding companies directly or indirectly control either a savings association or other savings and loan holding companies. Federal savings associations (those with federal charters) are supervised by the Office of the Comptroller of the Currency (OCC) while state-chartered savings associations are generally supervised by the Federal Deposit Insurance Corporation (FDIC) and their chartering state. Besides owning federal and/or state savings associations, a savings and loan holding company that meets capital and management requirements and elects to be treated as a financial holding company may also (1) operate as or own a broker-dealer engaged in securities underwriting and dealing, (2) engage in merchant banking, and (3) operate as or own an insurance company.

Historically, savings and loan holding companies were regulated by other agencies: at first, the Federal Home Loan Bank Board, and more recently, by the Office of Thrift Supervision (OTS). In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transferred supervisory and regulatory responsibilities for savings and loan holding companies from the now-defunct OTS to the Federal Reserve.

As a result, the Federal Reserve now supervises and regulates all savings and loan holding companies regardless of the charters of the subsidiary savings associations. The Federal Reserve coordinates its supervisory efforts with the appropriate functional regulator(s) for a savings and loan holding company that owns or operates as a broker-dealer or insurance company.

#### **Bank charters affect their supervision**

The current U.S. supervisory system for banks, in which an institution may be either federally or state-chartered, and may belong to the Federal Reserve System or not, has evolved historically. The Federal Reserve shares supervisory and regulatory responsibility for domestic banks with other federal regulators and with individual state banking departments.

### State Member Banks

The Federal Reserve is the primary federal supervisor of state-chartered banks that have chosen to join the Federal Reserve System. Such domestically operating banks are called “state member banks.”

The Federal Reserve shares supervisory and regulatory responsibility for domestic banks with the OCC and the FDIC at the federal level, and with individual state banking departments at the state level.

**Figure 5.3. Oversight of the financial industry is shared among federal regulators**

The primary supervisor of a domestic banking organization is generally determined by the type of institution it is and the governmental authority that granted it permission to commence business.



Note: Figure 5.3 focuses on the federal banking regulators. Other federal regulators oversee the financial industry as well, including the Securities and Exchange Commission, the Commodities Futures Trading Commission, and the Consumer Financial Protection Bureau, among others.

<sup>1</sup> Federal credit unions are not considered part of the banking industry, but offer similar if more limited services than banks.

The primary federal supervisor of a domestic bank (see [figure 5.3](#)) is generally determined by two key factors: (1) whether the bank chooses to operate under a federal or state charter and (2) the governmental authority (federal or state) that then grants it permission to commence business operations.

Banks chartered by a state government entity are referred to as state banks; banks that are chartered by the OCC, an independent bureau of the U.S. Department of the Treasury, are referred to as national banks.

State banks that are not members of the Federal Reserve System (collectively referred to as “state nonmember banks”) are supervised by the FDIC. In addition to being supervised by the Federal Reserve or the FDIC, state banks are also supervised by their chartering state. In contrast, the OCC supervises national banks that choose to charter at the federal level.

### ***Edge Act and Agreement Corporations***

Edge Act and agreement corporations are U.S. financial institutions that carry out international banking and financing operations, some of which the parent banks themselves are not permitted to undertake under existing laws. These corporations, which are examined annually, may act as holding companies, provide international banking services, and finance industrial and financial projects abroad, among other activities.

### ***Financial Market Utilities***

Financial market utilities (FMUs) and financial institutions participating in payment, clearance, and settlement (PCS) activities comprise the nation’s financial infrastructure. This infrastructure supports millions of financial transactions every day and encompasses many transactional elements: small-value retail payment systems (such as credit card and debit card networks) and large-value PCS systems for financial transactions, including central counterparties, foreign-exchange settlement systems, and large-dollar funds transfer systems. The smooth and reliable functioning of this financial infrastructure at all times is vitally

important to the stability of the financial system and the health of the broader economy.

Because their operations are so vital, FMUs can contribute to systemic risk. In other words, problems at one system or institution could spill over to other systems or financial institutions in the form of liquidity or credit disruptions—particularly since FMUs have become increasingly interdependent. For example, today, fewer and larger utilities (such as clearinghouses) support more integrated markets and global financial firms. Moreover, the same large banks participate in all of the major clearinghouses, and the major clearinghouses often rely on similar sets of banks for payment services, funding, settlement, and emergency liquidity. In this environment, problems at one clearinghouse could have significant effects on others, even in the absence of explicit operational links.

**What does “systemically important” mean?**

If the Financial Stability Oversight Council (FSOC) determines that a nonbank financial company’s material financial distress—or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities—could pose a threat to U.S. financial stability, the company is often referred to as being “systemically important.” Similarly, the FSOC may designate certain financial market utilities as systemically important.

For more information on regulation and supervision of the payment and settlement system, see [“Regulating and Supervising the Payment System”](#) on page 142.

***Nonbank Financial Companies***

The Dodd-Frank Act assigned the Federal Reserve the authority and responsibility to supervise and regulate certain nonbank financial companies that the FSOC has determined should be subject to Board supervision and prudential standards pursuant to section 113 of that act.

These firms—whose failure could pose a threat to U.S. financial stability—are subject to comprehensive, consolidated supervision and regulation by the Federal Reserve. This provision of the Dodd-Frank Act addresses an important regulatory gap that existed before the 2007–09 financial crisis.

Because the material distress or failure of a nonbank financial institution supervised by the Federal Reserve can have an outsized effect on the financial sector and the real economy, the Dodd-Frank Act requires the Federal Reserve to reduce the probability of such events through

prudential standards for nonbank financial institutions designated by the FSOC. These heightened prudential standards, stipulated in section 165 of the Dodd-Frank Act and applicable also to the largest U.S. BHCs and foreign banking organizations, become progressively more stringent as the systemic importance of that regulated entity increases and include enhanced risk-based capital and leverage requirements, liquidity requirements, overall risk-management requirements, concentration limits, resolution plan (that is, “living will”) requirements, and credit exposure reporting requirements. In addition to the mandatory heightened standards, the Federal Reserve may establish additional prudential standards for designated nonbank financial companies that the Federal Reserve determines are appropriate.

### ***The Federal Reserve’s Role in the Supervision of Certain Insurance Holding Companies***

The Federal Reserve assumed responsibility as the consolidated supervisor of certain insurance holding companies as a result of the Dodd-Frank Act. In addition to certain nonbank financial companies described above that may have significant insurance activities, the Federal Reserve is responsible for the consolidated supervision of insurance holding companies that are savings and loan holding companies. While the activities of insurance companies may differ from the activities of state member banks and BHCs, the Federal Reserve’s principal supervisory objectives for insurance holding companies remain protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions. To achieve these objectives, the Federal Reserve coordinates supervisory activities with state insurance regulators, who continue to have oversight of insurance legal entities.



## Oversight Councils

Two councils—comprised of federal and state regulators and including Federal Reserve representatives—play important coordinating roles in the supervision and regulation of financial institutions.

### *Financial Stability Oversight Council*

As noted earlier, the FSOC is a formal interagency body established by the Dodd-Frank Act. Its statutory purposes are to

- identify risks to the stability of the U.S. financial system that could arise from the distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies or that could arise outside the financial service marketplace;
- promote market discipline by eliminating expectations on the part of the shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of the company's failure; and
- respond to emerging threats to U.S. financial stability.

Also among its responsibilities are determining whether nonbank financial companies should be subject to Board supervision and prudential standards and designating FMUs as systemically important, as appropriate. The FSOC is also responsible for identifying and working to address gaps in regulation.

### *Federal Financial Institutions Examination Council (FFIEC)*

The FFIEC is a formal interagency body that includes representatives of the Federal Reserve Board, the FDIC, the OCC, the Consumer Financial Protection Bureau (CFPB), the National Credit Union Administration, and the State Liaison Committee.

The FFIEC was created in 1978 to

- prescribe uniform federal principles and standards for the examination of depository institutions,
- promote coordination of supervision among the federal agencies that regulate financial institutions, and
- encourage better coordination of federal and state regulatory activities.

Through the FFIEC, state and federal regulatory agencies may exchange views on important regulatory issues. Among other things, the FFIEC has developed uniform financial reports that federally supervised banks file with their federal regulator.

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## How the Federal Reserve Supervises Financial Institutions

In overseeing the institutions under its authority, the Federal Reserve seeks primarily to promote their safe and sound functioning, as well as their compliance with all applicable laws and regulations that govern their activities.

### Microprudential, Safety-and-Soundness Supervision

As a matter of law and practice, the Federal Reserve and other financial regulatory agencies have traditionally adhered to a microprudential approach to supervision; in other words, the regulator has focused on ensuring the health and soundness of individual financial institutions, particularly insured depository institutions (such as banks).

This approach remains a key component in Federal Reserve supervision. But, as the 2007–09 financial crisis demonstrated, the Federal Reserve and other financial regulatory agencies must also take into account

## Box 5.1. Microprudential versus Macroprudential Supervision

The Federal Reserve takes a two-pronged approach to its oversight of financial institutions:

1. The **microprudential** approach seeks to ensure the safety and soundness of individual institutions and involves in-depth examinations and inspections of the structure, operations, and compliance of individual entities regulated by the Federal Reserve.

2. The **macroprudential** approach focuses on the soundness and resilience of the financial system as a whole and addresses how the actions of one institution, or set of institutions, can impact other institutions and the U.S. economic and financial system overall.

These two approaches to supervision are complementary. The financial

system as a whole is more likely to be stable if its constituent organizations are sound. And traditional, firm-specific oversight provides the knowledge base for a more systemic, macroprudential approach. It is not possible to understand developments in the financial system as a whole without a clear view of developments within key firms and markets.

macroprudential risks to overall financial stability when supervising financial institutions and critical financial infrastructures. A too-narrow focus on the safety and soundness of individual banking organizations makes it harder to assess the broader financial landscape, and to detect and mitigate potential threats to financial stability that cut across many firms and markets.

### *Examinations and Inspections*

The main objective of the Federal Reserve's longstanding microprudential supervisory process is to assess and ensure the overall safety and soundness of individual banking organizations. This evaluation includes an assessment of an organization's risk-management systems, financial condition, and compliance with applicable laws and regulations.

The supervisory process entails both on-site examinations and inspections and off-site scrutiny and monitoring. For the largest financial institutions, the Federal Reserve maintains a continuous supervisory presence, with dedicated teams of full-time examiners.

By statute, state member banks must have an on-site examination at least once every 12 months. Banks that have assets of less than \$1 billion and that also meet certain management, capital, and other criteria may be examined less frequently (once every 18 months). Conversely,

banks that are in troubled condition may be examined more frequently. The Federal Reserve coordinates its examinations of state member banks with those of the chartering state's bank supervisor and it may alternate examinations with the bank's state supervisor.

The objectives of an examination are, essentially, to

1. provide an objective evaluation of a bank's soundness;
2. determine the level of risk involved in the bank's transactions and activities;
3. ascertain the extent of the bank's compliance with banking laws and regulations;
4. evaluate the adequacy of the bank's corporate governance and assess the quality of its board of directors and management; and
5. identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, regulations, and supervisory policies and guidance.

The Federal Reserve generally conducts an annual full-scope inspection of BHCs and savings and loan holding companies with consolidated assets of \$1 billion or greater, as well as smaller bank or savings and loan holding companies that have significant nonbank activities or elevated risk profiles.

In the case of small, noncomplex BHCs and savings and loan holding companies whose consolidated assets are primarily held by subsidiaries, Federal Reserve examiners rely heavily on continuous off-site monitoring and on the results of examinations of the company's subsidiary banks or savings associations by the primary federal or state authorities. This approach minimizes duplication of effort and reduces burden on smaller financial institutions.

#### **Who conducts examinations and inspections?**

Examinations and inspections are conducted by Federal Reserve examiners, professionals who work at local Federal Reserve Banks. They are rigorously trained to keep abreast of ever-evolving laws and regulations to which regulated entities are subject.

## Risk-Focused Approach to Consolidated Supervision

The Federal Reserve takes a risk-focused approach to consolidated supervision, the goal of which is twofold:

1. to identify the greatest risks and emerging risks to a supervised institution; and
2. to assess the ability of the institution's management to identify, measure, monitor, and control these risks.

Consolidated supervision of holding companies encompasses the parent company and its subsidiaries, and allows the Federal Reserve to un-

**Figure 5.4. Federal Reserve committee strengthens supervision of largest, most complex institutions**

The Large Institution Supervision Coordinating Committee is a collaborative body providing Systemwide and cross-disciplinary perspectives on the supervision of selected large and complex domestic bank holding companies, foreign banking organizations, and nonbank financial companies.<sup>1</sup>



<sup>1</sup> For more information on the committees, subgroups, and dedicated supervisory teams that comprise the LISCC governance structure, see SR letter 15-7, Governance Structure of the LISCC Supervisory Program at [www.federalreserve.gov/bankinforeg/srletters/sr1507.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1507.htm).

<sup>2</sup> For a list of firms in the LISCC portfolio, see [www.federalreserve.gov/bankinforeg/large-institution-supervision.htm](http://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm).

derstand the organization’s structure, activities, resources, and risks, as well as to address financial, managerial, operational, or other deficiencies before they pose a danger to the holding company’s subsidiary depository institution(s). Under the risk-focused approach, Federal Reserve examiners focus on those business activities that may pose the greatest risk to the institution. For the largest financial institutions, which have grown in both size and complexity in recent years, this risk-focused approach is typically implemented through a continuous process of on-site supervision rather than through point-in-time examinations.

In 2010, to strengthen its supervision of the largest, most complex financial institutions, the Federal Reserve created a centralized multidisciplinary body called the Large Institution Supervision Coordinating Committee (LISCC) to coordinate the supervision and evaluate the conditions of these supervised institutions, which include

- domestic BHCs that have been designated as G-SIBs (global systemically important banks),
- foreign banking organizations that maintain large and complex operations in the United States, and
- nonbank financial companies that the FSOC has determined should be supervised by the Board.

The LISCC’s primary functions are to provide (1) Systemwide and cross-disciplinary perspectives on the supervision of firms in the LISCC portfolio and (2) advice on the strategic direction of LISCC portfolio supervision to the Board’s Director of Banking Supervision and Regulation, who serves as the Chair of the LISCC.

The LISCC Operating Committee (OC), in consultation with the LISCC, is responsible for setting priorities for and overseeing the execution of the LISCC supervisory program. The OC is a multidisciplinary group comprised of senior officials from various divisions at the Board of Governors and Reserve Banks. The OC is chaired by a senior officer from the Board’s Division of Banking Supervision and Regulation who reports to the division director.

#### **Finding reporting data on institutions supervised by the Federal Reserve**

The National Information Center ([www.ffiec.gov/nicpubweb/nicweb/nichome.aspx](http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx)) is a repository, maintained by the Federal Financial Institutions Examination Council, that provides data about banks and other institutions, including both domestic and foreign banking organizations operating in the United States.

The OC provides direction to the LISCC firms' dedicated supervisory teams and directly oversees several subgroups, described in [figure 5.4](#), which are collectively tasked with execution of the LISCC supervisory program.

One major supervisory exercise conducted by the LISCC each year is the Comprehensive Capital Analysis and Review (CCAR) of the largest U.S. banking firms. Building on supervisory work coming out of the crisis, CCAR was established to ensure that each of the largest U.S. BHCs maintains (1) rigorous, forward-looking capital planning processes that effectively account for the unique risks of the firm and (2) sufficient capital to continue operations throughout times of economic and financial stress.

For more information about CCAR, as well as stress testing required under the Dodd-Frank Act, see [section 4](#), "Promoting Financial System Stability," on page 54, and "[Capital Planning, Stress Testing, and Capital Distributions](#)" on page 112.

In addition to CCAR, major annual, cross-firm supervisory exercises conducted by the LISCC include the Comprehensive Liquidity Annual Review (CLAR) and Supervisory Assessment of Recovery and Resolution Preparedness (SRP). CLAR is the Federal Reserve's program to evaluate the liquidity position and liquidity risk-management practices of LISCC firms. SRP is the Federal Reserve's review of the LISCC firms' options to support recovery and progress in removing impediments to orderly resolution. The LISCC also oversees additional cross-firm initiatives that are developed in support of LISCC priorities.

## Areas and Types of Examination

The Federal Reserve examines institutions for compliance with a broad range of laws, regulations, and other legal requirements to ensure their safe and sound functioning. Further, it supervises for compliance with laws and regulations on focused topics, such as anti-money laundering and consumer protection. For more information on consumer-oriented

supervision, see “[Consumer-Focused Supervision and Examination](#)” on page 154.

### ***Financial Condition: Call Reports, the FR Y-9C, and Other Disclosures***

In conducting examination programs, Federal Reserve examiners and supervisory staff rely on many sources of information about financial institutions and activities, including reports of recent examinations and inspections, public filings with the SEC, other publicly available information, and the standard financial regulatory reports filed by institutions.

The primary financial report for banks and savings associations is the Consolidated Report of Condition and Income (FFIEC 031/041), often referred to as the Call Report. It is used to prepare a Uniform Bank Performance Report, which employs ratio analysis to detect unusual or significant changes in a bank’s financial condition that may warrant supervisory attention. The primary financial report for large BHCs and savings and loan holding companies is the Consolidated Financial Statement for Holding Companies (FR Y-9C).

The number and types of reports that must be filed by a financial institution depend on its size, the scope of its operations, and the types of activities that it conducts either directly or through a subsidiary. The reports filed by larger institutions that engage in a wider range of activities are generally more numerous and more detailed than those filed by smaller entities.

### ***Transactions with Affiliates: An Illustration of Safety-and-Soundness Supervision***

Among many topics covered in a safety-and-soundness review of a financial institution, Federal Reserve examiners evaluate transactions between an insured depository institution and its affiliates to ascertain whether or not the transactions are consistent with sections 23A and 23B of the Federal Reserve Act, which restrict such transactions with the goal of limiting risk to the insured depository institution.

#### **How the Federal Reserve enforces consumer- and community-oriented laws and regulations**

To learn more about the Federal Reserve’s enforcement of consumer protection laws and regulations, see [section 7](#), “Promoting Consumer Protection and Community Development,” on page 152.

Section 23A limits an insured depository institution's loans (and other extensions of credit, asset purchases, guarantees, and certain other transactions) to any single affiliate to 10 percent of the bank's capital and surplus. It also limits such "covered transactions" with all affiliates in the aggregate to 20 percent of the bank's capital and surplus. Securities lending and borrowing transactions—and derivatives transactions that result in credit exposure—also are subject to the limits prescribed by section 23A.

Section 23A also prohibits an insured depository institution from purchasing low-quality assets from an affiliate, and it requires that an institution's transactions with affiliates be conducted in a safe and sound manner. Section 23B requires that most transactions between an insured depository institution and its affiliates be on terms substantially the same—or at least as favorable to the insured depository institution—as those prevailing at the time for comparable transactions with nonaffiliated companies.

### ***Anti-Money-Laundering Compliance: An Illustration of Safety-and-Soundness***

Banking organizations are expected to maintain compliance with the Bank Secrecy Act (BSA) and anti-money laundering laws and regulations. Federal Reserve examiners also verify an institution's compliance with economic sanctions imposed by Congress against certain countries, as implemented by the Office of Foreign Assets Control. The Federal Reserve has issued regulations to implement the BSA, including regulations that require banking organizations to establish a compliance program. During examinations of state member banks and U.S. branches and agencies of foreign banks (and inspections of BHCs and certain savings and loan holding companies), the Federal Reserve conducts a BSA and sanctions compliance review as part of its regular safety-and-soundness examination program. The Federal Reserve employs a risk-based supervisory approach to assess a regulated financial institutions' compliance with the BSA and economic sanctions using procedures developed jointly with the member agencies of the FFIEC.

### Figure 5.5. U.S. banks operate in more than 60 countries around the world

The Federal Reserve is responsible for examining the international operations of member banks and bank holding companies. As of December 31, 2015, that included operations in the highlighted countries.



Source: Federal Financial Institutions Examination Council (2015), Statistical Release E.16, "Country Exposure Lending Survey and Country Exposure Information Report" (December 31, 2015), [www.ffiec.gov/E16.htm](http://www.ffiec.gov/E16.htm).

Under the BSA, U.S. financial institutions must report large currency transactions and retain certain records, including information about persons and businesses that conduct large currency transactions, purchase certain monetary instruments, and conduct large funds transfers. Furthermore, the BSA requires financial institutions to report suspicious activity related to possible violations of federal law, such as money laundering, terrorist financing, and other financial crimes. Regulations H, K, and Y provide clarification on compliance with suspicious activity reporting requirements with respect to state member banks, Edge and agreement corporations, U.S. offices of foreign banking organizations supervised by the Federal Reserve, and BHCs and their nonbank subsidiaries.

### ***Off-Site Monitoring***

In its ongoing off-site supervision of banks and holding companies, the Federal Reserve uses automated systems to (1) proactively identify institutions with poor or deteriorating financial profiles and (2) help detect adverse trends developing in the banking industry.

For example, the Federal Reserve's Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR) system uses an econometric modeling framework to identify weak and potentially weak banks. By using this system, the Federal Reserve can more effectively direct examiner resources to those institutions needing supervisory attention.

### ***Supervision of U.S. Banks' International Operations***

The Federal Reserve has supervisory and regulatory responsibility for the international operations of state member banks and BHCs (see [figure 5.5](#)). These responsibilities include

- authorizing the establishment of foreign branches of national banks and state member banks, and regulating the scope of their activities;
- chartering and regulating the activities of Edge Act and agreement corporations (as noted earlier, specialized institutions used for international and foreign business);
- authorizing the foreign investments of member banks, Edge Act and agreement corporations, and BHCs, and regulating the activities of foreign firms acquired by such investors; and
- establishing supervisory policies and practices regarding foreign lending by state member banks.

U.S. banking organizations may conduct a wide range of overseas activities. The Federal Reserve has broad discretionary powers to regulate the foreign activities of member banks and BHCs so that, in financing U.S. trade and investments abroad, these U.S. banking organizations can be fully competitive with institutions of the host country without compromising the safety and soundness of their U.S. operations.

The Federal Reserve examines the international operations of state member banks, Edge Act and agreement corporations, and BHCs principally at the U.S. head offices of these organizations. When appropriate, the Federal Reserve conducts examinations at the foreign operations of a U.S. banking organization in order to review the accuracy of financial and operational information maintained at the head office as well as to test the organization's adherence to safe and sound banking practices and to evaluate its efforts to implement corrective measures. Examinations abroad are conducted in cooperation with the responsible host-country supervisor.

### ***Supervision of Foreign Banks' U.S. Operations***

Although foreign banks have been operating in the United States for more than a century, before 1978 the U.S. branches and agencies of these banks were not subject to supervision or regulation by any federal banking agency.

The International Banking Act of 1978 (IBA) created a federal regulatory structure for the activities of foreign banks with U.S. branches and agencies. The IBA also established a policy of "national treatment" for foreign banks operating in the United States to promote competitive equality between them and domestic institutions. This policy generally gives foreign banking organizations operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations that apply to the domestic operations of U.S. banking organizations.

The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) increased the responsibility and the authority of the Federal Reserve to regularly examine the U.S. operations of foreign banks. Under the FBSEA, U.S. branches and agencies of foreign banks must be examined on-site at least once every 12 months, although this period may be extended to 18 months if the branch or agency meets certain criteria. Supervisory actions resulting from examinations may be taken by the Federal Reserve alone or in conjunction with other agencies. Representative offices of these institutions are also subject to examination by the Federal Reserve.

The Federal Reserve coordinates the supervisory program for the U.S. operations of foreign banking organizations with other federal and state banking agencies. Since a foreign banking organization may have both federally chartered and state-chartered offices in the United States, the Federal Reserve plays a key role in assessing the condition of the organization's entire U.S. operations and the foreign banking organization's ability to support its U.S. operations.

In carrying out their supervisory responsibilities, the Federal Reserve and other U.S. regulators rely on two supervisory tools: Strength of Support Assessment (SOSA) rankings and Risk Management, Operational Controls, Compliance, and Asset Quality (ROCA) ratings. SOSA rankings reflect the Federal Reserve staff's assessment of a foreign bank's

**Figure 5.6. Depository institutions and holding companies receive ratings based on the result of examinations and inspections**

Ratings, which are assigned to an institution after an examination or inspection, provide a summary measure of the examination's findings.

Rating system	CAMELS	RFI/C(D)
<b>Entity</b>	Depository institutions	Bank holding company Savings and loan holding company
<b>Components</b>	<ul style="list-style-type: none"> <li>• Capital adequacy</li> <li>• Asset quality</li> <li>• Management</li> <li>• Earnings</li> <li>• Liquidity</li> <li>• Sensitivity to market risk</li> </ul>	<ul style="list-style-type: none"> <li>• Risk management               <ul style="list-style-type: none"> <li>– effectiveness of the banking organization's risk management and controls; board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls</li> </ul> </li> <li>• Financial condition               <ul style="list-style-type: none"> <li>– an assessment of the banking organization's capital, asset quality, earnings, and liquidity</li> </ul> </li> <li>• potential Impact of the parent company and nondepository subsidiaries on the affiliated depository institutions</li> <li>• the consolidated Composite condition of the institution</li> <li>• the CAMELS rating of the affiliated Depository institutions</li> </ul>
<b>Results</b>	For both rating systems, institutions score on a scale of 1 (best) to 5 (worst) for each factor.	

ability to provide support for its U.S. operations; ROCA ratings provide an assessment of its U.S. branch and agency activities. The Federal Reserve also assesses the entirety of a foreign banking organization's U.S. operations through a single U.S. composite rating.

Under the Bank Holding Company Act and the IBA, the Federal Reserve is also responsible for reviewing and monitoring the U.S. nonbanking activities of foreign banking organizations that have a branch, agency, commercial lending company, or subsidiary bank in the United States.

In 2014, the Federal Reserve Board approved a final rule required by section 165 of the Dodd-Frank Act (which also requires enhanced prudential standards for large U.S. BHCs) to strengthen supervision and regulation of foreign banking organizations. The final rule recognized that the U.S. operations of foreign banking organizations had become increasingly complex, interconnected, and concentrated, and established a number of enhanced prudential standards for foreign banking organizations to help increase the resiliency of their operations. The requirements of the final rule will bolster the capital and liquidity positions of the U.S. operations of foreign banking organizations and promote a level playing field among all banking firms operating in the United States. A foreign banking organization with U.S. nonbranch assets of \$50 billion or more is required to establish an intermediate holding company over its U.S. subsidiaries, which will facilitate consistent supervision and regulation of the U.S. operations of the foreign bank. The foreign-owned U.S. intermediate holding company is generally subject to the same risk-based and leverage capital standards applicable to U.S. BHCs. The intermediate holding companies are also subject to the Federal Reserve's rules pertaining to regular capital plans and stress testing.

### ***Supervisory Colleges***

Through participation in supervisory colleges, the Federal Reserve cooperates with foreign banking supervisors, both as the home-country supervisor of U.S. banking organizations with overseas operations and as the host-country supervisor of the U.S. operations of foreign bank-

#### **Finding orders and agreements online**

All formal enforcement orders issued by the Federal Reserve and all written agreements executed by Reserve Banks are available to the public in the News & Events section of the Federal Reserve Board's website, [www.federalreserve.gov](http://www.federalreserve.gov).

## Box 5.2. A Further Evolution: Taking Corrective Action to Address Troubled Institutions

The Federal Deposit Insurance Corporation Improvement Act of 1991 requires regulators to take prompt corrective action (PCA) to address the problems of troubled depository institutions. The intent of PCA is to minimize the long-term cost to the Deposit Insurance Fund of resolving such institutions.

The PCA framework specifies mandatory actions that regulators must take, as well as discretionary actions they must consider taking, when a bank's capital position declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice.

The state of a bank's capital position is based on risk-based capital and leverage ratios derived from the bank's

Call Report data. Based on its levels of these ratios, a bank can be deemed (1) well-capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, or (5) critically undercapitalized. The law provides for increasingly stringent corrective provisions as a bank is placed in progressively lower capital categories.

Undercapitalized and significantly undercapitalized institutions likely would be required to submit and implement an acceptable plan to restore capital. A critically undercapitalized bank faces receivership unless its condition improves and the activities that expose it to risk are restricted.

More recently, the Dodd-Frank Wall Street Reform and Consumer Protec-

tion Act (Dodd-Frank Act) directed the Federal Reserve to promulgate regulations providing for the early remediation of financial weaknesses at bank holding companies with total consolidated assets of \$50 billion or more and nonbank financial companies that the Financial Stability Oversight Council has determined should be subject to Board supervision. More specifically, the Dodd-Frank Act requires the Federal Reserve to define measures of these companies' financial condition, including, but not limited to, regulatory capital, liquidity measures, and other indicators that would trigger remedial action. As the financial condition of a company declines, the stringency of the remedial action requirements increases.

ing organizations. This cooperation involves bilateral and multilateral contacts and formal and informal information-sharing arrangements.

With the growth, in recent years, of the international operations of large global financial institutions, the Federal Reserve and other U.S. and foreign banking supervisors have broadened and formalized cooperative arrangements through these "supervisory colleges." Supervisory colleges are multilateral working groups of relevant supervisors that are formed to promote effective, ongoing consolidated supervision of the overall operations of an international banking group. In this regard, the Federal Reserve—in performing the role of a home-country supervisor—organizes supervisory colleges that include the most significant host supervisors of those U.S. banking organizations with the largest global systemic presence. Similarly, it participates as a host-country supervisor in colleges organized by foreign banking supervisors.

Participation in supervisory colleges enhances the Federal Reserve's communication and collaboration with foreign supervisors and supplements bilateral working relationships with foreign supervisors. These relationships are vitally important to the Federal Reserve's supervision of the overseas operations of U.S. banking organizations and the U.S. operations of foreign banking organizations.

### ***Other Elements of Supervision***

A Federal Reserve examination can focus on a specific functional area within a regulated entity, such as its fiduciary activities, its securities dealing, or its information technology activities. Furthermore, in light of the importance of information technology to the safety and soundness of banking organizations, the Federal Reserve has the authority to examine the operations of certain independent organizations that provide information technology services to supervised banking organizations, and it examines these service providers on a regular basis.

## **Results of an Examination or Inspection**

### ***Supervisory Ratings***

The results of an on-site examination or inspection are reported to the board of directors and management of the bank, BHC, or savings and loan holding company in a confidential report of examination or inspection, which can include a confidential supervisory rating of the condition of the institution. Each state member bank receives a composite rating, which reflects the Federal Reserve's assessment and rating of the bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS). In addition, each BHC receives a composite rating, which reflects the Federal Reserve's assessment and ratings of the company's risk management, financial condition, and potential impact on affiliated depository institutions (RFI/C(D)). Ratings range from "1" to "5," with "1" being the best (see [figure 5.6](#)).

The CAMELS supervisory rating for banks and other depository institutions is a tool that all federal and state banking agencies use to convey to financial institutions the agencies' assessment of the institution and

to identify institutions whose operations raise concern or require special attention.

### ***Examination Report***

In addition to assigning a rating, examiners also prepare a detailed report that, besides formally communicating the rating, (1) describes the institution's activities and management structure, (2) assesses the institution's performance, and (3) recommends changes or improvements in certain policies and procedures.

### ***Enforcement***

If the Federal Reserve determines that a supervised institution has problems that affect its safety and soundness, or that the institution is not in compliance with applicable laws and regulations, the Federal Reserve may, by law, take action to ensure that the institution undertakes corrective measures.

**Informal supervisory actions.** Informal supervisory actions are used to address less-significant deficiencies or problems that the Federal Reserve believes a bank's board of directors or management can correct without the need for more extensive regulatory intervention. For example, the Federal Reserve may address issues detected during the supervisory process by requesting that the institution's board adopt a resolution or enter into a memorandum of understanding to correct potentially unsafe or unsound practices or other deficiencies that do not require elevation to a formal supervisory action.

**Formal supervisory actions.** If an institution fails to remedy an unsafe or unsound practice or to comply with banking laws, or if the practices or violations are so widespread or serious that recourse to informal supervisory methods is not appropriate or sufficient, the Federal Reserve may take a formal supervisory action, which may compel the institution to take specific actions and which can be enforced in court.

Formal enforcement actions may include

- imposing orders directing the financial institution or its institution-affiliated parties to cease and desist from engaging in the improper or prohibited conduct;
- directing the firm to take certain actions to return to safe and sound banking practices;
- requiring the firm to make restitution or provide reimbursement, indemnification, or guaranty to third parties harmed by the wrongful conduct;
- removing an institution-affiliated party from the banking institution and prohibiting the party from participating in banking at other financial institutions; and
- assessing civil money penalties against either the offending institution or an institution-affiliated party.

## Macroprudential Supervision and Monitoring

Ensuring the safe and efficient functioning of the nation's banking system requires that the Federal Reserve consider more than the safety and soundness of individual organizations.

This duty requires that the Federal Reserve also consider factors that can affect the stability of the entire financial system, including the interactions between firms and markets. In other words, the Federal Reserve's supervision includes a macroprudential aspect that focuses on promoting overall financial stability. In this regard, the Dodd-Frank Act explicitly directs the Federal Reserve to routinely factor macroprudential considerations into its supervisory and regulatory activities.

As part of its effort to improve macroprudential supervision, the Federal Reserve Board created the Division of Financial Stability (see [section 4](#), "Promoting Financial System Stability," on page 54). This multidisciplinary division coordinates Federal Reserve efforts to identify and analyze potential risks to financial institutions, the broader financial system, and the economy, and helps develop and evaluate policies to promote financial stability. It also acts as the Board's liaison to the FSOC.

The Federal Reserve also monitors (1) risks that can arise because of substantial interconnections among financial firms and (2) risks that can develop more broadly in the financial system, including at other financial institutions, in financial markets, and in the general market infrastructures.

Financial imbalances can arise, for example, from leverage and maturity mismatch at financial intermediaries, stretched asset valuations, and lax loan-underwriting standards. In addition, the Federal Reserve conducts research to develop measures of systemic risk and to develop a better understanding of how distress at individual firms or sectors can be transmitted to the broader financial system and the economy.

### ***Crisis Management Groups***

The Federal Reserve participates in crisis management groups with other state and U.S. regulatory agencies and foreign banking supervisors responsible for the oversight of large cross-border banking groups. The purpose of crisis management groups is to enhance preparedness for, and facilitate the management and resolution of, a financial crisis affecting a large global banking group. Crisis management groups typically include supervisors, central banks, resolution authorities, and other public authorities from jurisdictions with significant operations in the international banking group or respective foreign economy. Similar to supervisory colleges, the Federal Reserve—in performing the role of a home-country supervisor—organizes crisis management groups that include the most significant host supervisors of those U.S. banking organizations with the largest global systemic presence. Similarly, it participates as a host-country supervisor in crisis management groups organized by foreign banking supervisors where U.S. operations of those groups are significant and where the home supervisor has invited the Federal Reserve to participate. This cooperation involves bilateral and multilateral contacts and formal and informal dialogue focused on the development of a framework for early intervention triggers around recovery efforts and resolution planning.

Participation in crisis management groups also furthers the Federal Reserve's communication and collaboration with foreign supervisors and supplements bilateral working relationships with foreign supervisors. These relationships are vitally important to the Federal Reserve's supervision of the overseas operations of U.S. banking organizations and the U.S. operations of foreign banking organizations.



## Overseeing the Structure of the Banking System

The Federal Reserve exerts an important influence over the structure of the U.S. banking system by administering several federal statutes that govern the formation, acquisition, and mergers of BHCs, member banks, savings and loan holding companies, and foreign banking organizations.

Under these statutes, the Federal Reserve has authority to approve or deny a variety of proposals that directly or indirectly affect the structure of the U.S. banking system at the local, regional, and national levels; the international operations of domestic banking organizations; or the U.S. banking operations of foreign banks.

Specifically, the Federal Reserve administers several federal statutes that apply to BHCs, financial holding companies, member banks, and foreign banking organizations, including the Bank Holding Company Act (BHC Act), the Bank Merger Act, the Change in Bank Control Act of 1978 (CIBCA), the Federal Reserve Act, and the IBA. As a result of the Dodd-Frank Act, the Federal Reserve also administers section 10 of the Home Owners' Loan Act (HOLA) that applies to savings and loan holding companies, and for administering the CIBCA with respect to savings and loan holding companies.

### ***Bank Holding Company Formations and Acquisitions***

Under the BHC Act, a firm that seeks to become a BHC must first obtain approval from the Federal Reserve. The act defines a BHC as any company that directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of the voting shares of a bank; controls in any manner the election of a majority of the directors or trustees of a bank; or is found to exercise a controlling influence over the management or policies of a bank. A BHC must obtain the approval of the Federal Reserve before acquiring more than 5 percent of the shares of an additional bank or BHC. All BHCs must file certain reports with the Federal Reserve System.

When considering applications to acquire a bank or a BHC, the Federal Reserve is required to take into account the likely effects of the acquisition on competition, financial stability, the convenience and needs of the communities to be served, the financial and managerial resources and future prospects of the companies and banks involved, and the effectiveness of the company's policies to combat money laundering. In the case of an interstate bank acquisition, the Federal Reserve also must consider certain other factors and may not approve the acquisition if the resulting organization would control more than 10 percent of all deposits held by insured depository institutions. When a foreign bank seeks to acquire a U.S. bank, the Federal Reserve also must consider whether the foreign banking organization is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor.

### ***Savings and Loan Holding Company Formations and Acquisitions***

Under HOLA, a firm that seeks to become a savings and loan holding company must first obtain approval from the Federal Reserve. HOLA defines a savings and loan holding company as any company that directly or indirectly controls a savings association or that controls any other company that is a savings and loan holding company.

Once formed, a savings and loan holding company must receive Federal Reserve approval before acquiring or establishing additional savings associations. Savings and loan holding companies generally may engage in only those business activities that are specifically enumerated in HOLA or which the Board has previously determined by regulation to be closely related to banking under section 4(c)(8) of the BHC Act. Depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.

In general, a company controls a savings association if one or more persons directly or indirectly owns, controls, or has the power to vote more than 25 percent of the voting shares of the savings association, or controls in any manner the election of a majority of the directors of the savings association. A savings and loan holding company must obtain approval of the Board before acquiring more than 5 percent of the voting shares of an additional savings association or savings and loan holding company.

### ***Formation and Activities of Financial Holding Companies***

As authorized by the Gramm-Leach-Bliley Act, the Federal Reserve Board's regulations allow a BHC or a foreign banking organization to become a financial holding company and engage in an expanded array of financial activities if the company meets certain capital, managerial, and other criteria. In addition, a savings and loan holding company may elect to be treated as a financial holding company if it meets the same criteria that apply to BHCs and financial holding companies under the BHC Act. Permissible activities for financial holding companies include conducting securities underwriting and dealing, serving as an insurance agent and underwriter, and engaging in merchant banking. Other permissible activities include those that the Federal Reserve Board, after consulting with the Secretary of the Treasury, determines to be financial in nature or incidental to financial activities. Financial holding companies also may engage to a limited extent in a nonfinancial activity if the Board determines that the activity is complementary to one or more of the company's financial activities and would not pose a substantial risk

to the safety or soundness of depository institutions or the financial system.

### ***Bank Mergers***

Another responsibility of the Federal Reserve is to act on proposed bank mergers when the resulting institution would be a state member bank. The Bank Merger Act of 1960 sets forth the factors to be considered in evaluating merger applications. These factors are similar to those that must be considered in reviewing bank acquisition proposals by BHCs. To ensure that all merger applications are evaluated in a uniform manner, the act requires that the responsible agency request reports from the Department of Justice and from the other approving banking agencies addressing the competitive impact of the transaction.

### ***Federal Reserve Act Proposals***

Under the Federal Reserve Act, a member bank may be required to seek Federal Reserve approval before expanding or materially modifying its operations domestically or internationally. State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities-related and insurance agency-related activities.

### ***Changes in Bank Control***

The CIBCA authorizes the federal bank regulatory agencies to act on proposals by a single “person” (which includes an individual or an entity), or several persons acting in concert, to acquire control of an insured bank, BHC, or a savings and loan holding company. The Federal Reserve is responsible for approving changes in the control of BHCs, savings and loan holding companies, and state member banks; the FDIC and the OCC are responsible for approving changes in the control of insured state nonmember and national banks, respectively. In

## Figure 5.7. Federal Reserve regulations by topic

The Federal Reserve maintains and ensures compliance with the following regulations, which implement federal banking laws and govern the operations of regulated institutions.

Topic	Regulation (by letter and name)	Description
Banks and banking	<b>F</b> Limitations on Interbank Liabilities	Prescribes standards to limit the risks that the failure of one depository institution would pose to another
	<b>H</b> Membership of State Banking Institutions in the Federal Reserve System	Defines the requirements for membership of state-chartered banks in the Federal Reserve System; sets limitations on certain investments and requirements for certain types of loans; describes rules pertaining to securities-related activities; establishes the minimum ratios of capital to assets that banks must maintain and procedures for prompt corrective action when banks are not adequately capitalized; prescribes real estate lending and appraisal standards; sets out requirements concerning bank security procedures, suspicious-activity reports, and compliance with the Bank Secrecy Act; and establishes rules governing banks' ownership or control of financial subsidiaries
	<b>I</b> Issue and Cancellation of Federal Reserve Bank Capital Stock	Sets out stock-subscription requirements for all banks joining the Federal Reserve System
	<b>K</b> International Banking Operations	Governs the international banking operations of U.S. banking organizations and the operations of foreign banks in the United States
	<b>L</b> Management Official Interlocks	Generally prohibits a management official from serving two non-affiliated depository institutions, depository institution holding companies, or any combination thereof, in situations where the management interlock would likely have an anticompetitive effect
	<b>O</b> Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks	Restricts credit that a member bank may extend to its executive officers, directors, and principal shareholders and their related interests
	<b>Q</b> Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks	Establishes minimum capital requirements and overall capital adequacy standards for bank holding companies, savings and loan holding companies, and state member banks
	<b>R</b> Exceptions for Banks from the Definition of Broker in the Securities Exchange Act of 1934	Defines the scope of securities activities that banks may conduct without registering with the Securities Exchange Commission as a securities broker and implements the most important exceptions from the definition of the term broker for banks under section 3(a)(4) of the Securities Exchange Act of 1934
	<b>S</b> Reimbursement for Providing Financial Records; Recordkeeping Requirements for Certain Financial Records	Establishes rates and conditions for reimbursement to financial institutions for providing customer records to a government authority and prescribes recordkeeping and reporting requirements for insured depository institutions making domestic wire transfers and for insured depository institutions and nonbank financial institutions making international wire transfers

Topic	Regulation (by letter and name)	Description
<b>Banks and banking</b> (continued)	<b>W</b> Transactions Between Member Banks and Their Affiliates	Implements sections 23A and 23B of the Federal Reserve Act, which establish certain restrictions on and requirements for transactions between a member bank and its affiliates
	<b>KK</b> Swaps Margin and Swaps Push-Out	Implements the prohibition against federal assistance to swap entities
	<b>NN</b> Retail Foreign Exchange Transactions	Sets standards for banking organizations regulated by the Federal Reserve that engage in certain types of foreign exchange transactions with retail consumers
	<b>VV</b> Proprietary Trading and Certain Interests in and Relationships with Covered Funds	Establishes prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds by certain banking entities
<b>Federal Reserve Bank activities</b>	<b>J</b> Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire	Establishes procedures, duties, and responsibilities among (1) Federal Reserve Banks, (2) the senders and payors of checks and other items, and (3) the senders and recipients of Fedwire funds transfers
	<b>N</b> Relations with Foreign Banks and Bankers	Governs relationships and transactions between Federal Reserve Banks and foreign banks, bankers, or governments
<b>Holding companies and nonbank financial companies</b>	<b>Y</b> Bank Holding Companies and Change in Bank Control	Regulates the acquisition of control of banks and bank holding companies by companies and individuals, defines and regulates the nonbanking activities in which bank holding companies (including financial holding companies) and foreign banking organizations with U.S. operations may engage, and imposes capital planning requirements on large bank holding companies
	<b>LL</b> Savings and Loan Holding Companies	Regulates the acquisition of control of savings associations, defines and regulates the activities of savings and loan holding companies, and sets forth procedures under which directors and executive officers may be appointed or employed
	<b>MM</b> Mutual Holding Companies	Regulates the reorganization of mutual savings associations to mutual holding companies and the creation of subsidiary holding companies of mutual holding companies, defines and regulates the operations of mutual holding companies and their subsidiary holding companies, and sets forth procedures for securing approval for these transactions
	<b>OO</b> Securities Holding Companies	Outlines the procedures and requirements for securities holding companies to elect to be supervised by the Federal Reserve
	<b>QQ</b> Resolution Plans	Requires large, systemically significant bank holding companies and nonbank financial companies to submit annual resolution plans
	<b>RR</b> Credit Risk Retention	Requires sponsors of securitization transactions to retain risk in those transactions
	<b>TT</b> Supervision and Regulation Assessments of Fees	Establishes an annual assessment of fees on certain bank holding companies, savings and loan holding companies, and nonbank financial companies supervised by the Federal Reserve

Topic	Regulation (by letter and name)	Description
Holding companies and nonbank financial companies (continued)	<b>WW</b> Liquidity Risk Measurement Standards	Establishes a minimum liquidity standard for certain Board-regulated institutions on a consolidated basis
	<b>XX</b> Concentration Limits	Establishes a financial sector concentration limit that generally prohibits a financial company from merging or consolidating with, or acquiring, another company if the resulting company's liabilities would exceed 10 percent of the aggregated liabilities of all financial companies
	<b>YY</b> Enhanced Prudential Standards	Implements the enhanced prudential standards mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act for large bank holding companies
Federal Reserve Credit	<b>A</b> Extensions of Credit by Federal Reserve Banks	Governs borrowing by depository institutions and others at the Federal Reserve discount window
Monetary policy and reserve requirements	<b>D</b> Reserve Requirements of Depository Institutions	Sets uniform requirements for all depository institutions to maintain reserves either with their Federal Reserve Bank or as cash in their vaults
Securities credit transactions	<b>T</b> Credit by Brokers and Dealers	Governs extension of credit by securities brokers and dealers, including all members of national securities exchanges (see also Regulations U and X)
	<b>U</b> Credit by Banks and Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock	Governs extension of credit by banks or persons other than brokers or dealers to finance the purchase or the carrying of margin securities (see also Regulations T and X)
	<b>X</b> Borrowers of Securities Credit	Applies the provisions of Regulations T and U to borrowers who are subject to U.S. laws and who obtain credit within or outside the United States for the purpose of purchasing securities

Note: For a list of consumer and community affairs-related regulations, see [figure 7.2](#), “Federal consumer financial protection laws and regulations applicable to banks,” on page 158. For a list of regulations governing the U.S. payment system, see [figure 6.11](#), “Federal Reserve regulations governing the payment system,” on page 143.

considering a proposal under CIBCA, the Federal Reserve must review several factors, including the financial ability, competence, experience, and integrity of the acquiring person or group of persons; the effect of the transaction on competition; and the adequacy of the information provided by the acquiring party.

### ***Overseas Investments by U.S. Banking Organizations***

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Most foreign investments involve only after-the-fact notification to the Federal Reserve, but large and other significant investments require prior approval.

### ***International Banking Act Proposals***

The IBA, as amended by the Foreign Bank Supervision Enhancement Act, requires foreign banks to obtain Federal Reserve approval before establishing branches, agencies, commercial lending company subsidiaries, or representative offices in the United States.

An application by a foreign bank to establish such offices or subsidiaries generally may be approved only if the Federal Reserve determines that the foreign bank and any foreign-bank parents engage in banking

## **Box 5.3. Significant Financial Industry Reform Legislation**

Throughout the Federal Reserve's history, Congress has enacted, repealed, and amended significant banking industry laws that have dramatically changed the landscape of the industry. The Federal Reserve has been instrumental in ensuring that these laws are carried out.

For example, during the savings and loan crisis of the 1980s and 1990s, Congress enacted several laws to improve the condition of individual institutions and of the overall banking and thrift industries, including the Competi-

tive Equality Banking Act of 1987; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and the Federal Deposit Insurance Corporation Improvement Act of 1991. These legislative initiatives restricted banking practices, limited supervisors' discretion in dealing with weak banks, imposed new regulatory requirements—including prompt corrective action (described above)—and strengthened supervisory oversight overall.

A few years later, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which significantly reduced the legal barriers that had restricted the ability of banks and bank holding companies to expand their activities across state lines. In 1999, Congress passed the Gramm-Leach-Bliley Act, which repealed certain Depression-era banking laws and permitted banks to affiliate with securities and insurance firms within financial holding companies.

business outside the United States and are subject to comprehensive supervision or regulation on a consolidated basis by their home-country supervisors. The Federal Reserve may also take into account other factors.

### *Public Notice of Federal Reserve Decisions*

Certain decisions by the Federal Reserve that involve an acquisition by a BHC or savings and loan holding company, a bank merger, a change in bank control, or the establishment of a new U.S. banking presence by a foreign bank are made known to the public by an order or an announcement.

Orders state the Federal Reserve's decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are reported publicly in the Board's weekly H.2 statistical release. Information about orders and announcements is available on the Federal Reserve Board's website, [www.federalreserve.gov](http://www.federalreserve.gov).

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## Regulation: Keeping Pace with Innovation and Evolution

Regulation of the financial system must continuously evolve in response to changing laws and conditions in the marketplace in order to ensure that supervised institutions operate in a safe and sound manner.

The Federal Reserve is empowered, therefore, to issue regulations, rules, and policy statements or other forms of supervisory guidance to supervised institutions. Regulations can be restrictive (limiting the scope of an institution's activities), prescriptive (requiring institutions to take certain actions), or permissive (authorizing institutions to engage in certain activities).

### **How do capital and liquidity differ?**

Capital acts as a financial cushion to absorb unexpected losses and generally is the difference between all of a firm's assets and its liabilities. Liquidity is a measure of the ability and ease with which a firm's assets can be converted to cash. To remain viable, a financial institution must have enough liquid assets to meet its near-term obligations, such as withdrawals by depositors and short-term debt obligations that are coming due.

### Figure 5.8. International evolutions: The Basel Capital Accords

With other federal banking agencies, the Federal Reserve drafts and finalizes rules to implement the capital adequacy standards set by the Basel Committee. Since 1988, there have been three iterations of the Basel Capital Accords; each iteration is phased in over a multiyear period.

Basel I	Basel II	Basel III
1988	2004	2009–11
<ul style="list-style-type: none"> <li>• Increased capital requirements for internationally active banking organizations.</li> <li>• Reduced international competitive inequities.</li> <li>• Increased comparability of institutions' capital positions.</li> <li>• Introduced measures for market risk for institutions with trading activities of \$1 billion or more.</li> </ul>	<p>Building on Basel I, Basel II introduced a three-pillar framework for assessing capital adequacy:</p> <ul style="list-style-type: none"> <li>• <b>Pillar 1:</b> Minimum regulatory capital requirements more closely align banking organizations' capital requirements with their underlying risks, including operational risk.</li> <li>• <b>Pillar 2:</b> Supervisory oversight requires supervisors to evaluate banking organizations' capital adequacy and to encourage better risk-management techniques.</li> <li>• <b>Pillar 3:</b> Market discipline calls for enhanced public disclosure of banking organizations' risk exposures.</li> </ul>	<p>Building on Basel II, and in the wake of the 2007–09 financial crisis, Basel III included measures to</p> <ul style="list-style-type: none"> <li>• improve the quality of regulatory capital to include instruments that are fully able to absorb unexpected losses, with a particular focus on common equity;</li> <li>• increase the minimum quantity of capital that banking organizations are required to hold as a proportion of their risk-weighted assets and provide incentives for banking organizations to conserve capital; and</li> <li>• require global systemically important U.S. and foreign banks to hold additional capital based on measures of their systemic importance.</li> </ul>

New regulations may be added, or existing ones revised, in response to new laws enacted by Congress or because of evolving conditions in the financial marketplace. If Congress adopts a legislative change—perhaps in response to a past crisis or problem, or to help adapt the nation's banking laws to respond to changes in the marketplace—the Federal Reserve might issue regulations or rules to ensure that institutions comply with the new law (see [figure 5.7](#) for a list of Federal Reserve regulations and the topics they address).

### Evolutions under the Dodd-Frank Act

In 2010, for example, the enactment of the Dodd-Frank Act—the most comprehensive statutory effort to reshape the financial industry since the Great Depression—ushered in many regulatory reforms that help strengthen the financial system and reduce the likelihood of future financial crises. The act calls for consolidated supervision of all nonbank financial companies supervised by the Federal Reserve; requires that

such nonbank financial companies, large BHCs, and foreign banking organizations be subject to enhanced prudential standards; and provides for the strengthened supervision of systemically important payment, settlement, and clearing utilities.

The Dodd-Frank Act also required the Federal Reserve and other federal regulatory authorities to translate the law's provisions into workable rules, regulations, and guidelines that will achieve the necessary reform to ensure the financial system's stability and sustainability.

Since 2010, the Federal Reserve, often in cooperation with other regulators, has finalized or proposed dozens of new rules to implement provisions of the Dodd-Frank Act. These rules touched on topics ranging from residential mortgages and credit scores to risk-based capital requirements and risk-management standards for certain FMUs designated as systemically important.

## Promoting Capital Adequacy and Planning

A key goal of banking regulation is to ensure that banks maintain sufficient capital to absorb unexpected losses.

### *The Basel Accords: Global Standards for Capital Adequacy*

Because of the interconnectedness of the global banking system, the United States is a participating member in the Basel Committee on Banking Supervision, the primary global standard-setter for the prudential regulation of banks. The Basel Committee's mandate is to strengthen the regulation, supervision, and practices of banks worldwide for the purpose of enhancing global financial stability.

Members of the Basel Committee work together to formulate broad supervisory standards and guidelines and to recommend best practices in the expectation that those individual national authorities will take steps to implement them in their respective jurisdictions, as appropriate (see [figure 5.8](#)). Basel Committee members strive to ensure that banks

### **Financial disclosures by state member banks**

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Federal Reserve administers these requirements and has adopted financial disclosure regulations for state member banks that are substantially similar to the Securities and Exchange Commission's regulations for other public companies.

are held to consistently high standards and are competing on a level playing field.

Reforms resulting from such cooperative efforts generally aim to address (1) weaknesses or gaps in bank-level regulation, in order to promote resilience of individual banking institutions during periods of stress, (2) systemwide risks that can build up across the banking sector, and (3) the pro-cyclical amplification of these systemwide risks over time.

More recently, the Basel III reforms were designed in part to address weaknesses in the regulatory capital framework for internationally active banking organizations that became apparent during the 2007–09 financial crisis. Basel III includes changes that increase the minimum risk-based capital requirements, introduce a minimum common equity tier 1 capital ratio and a minimum international leverage ratio, and establish a capital conservation buffer designed to limit capital distributions and certain discretionary bonus payments if a banking organization’s risk-based capital ratios fall below certain levels.

### ***Capital Requirements under the Dodd-Frank Act***

The Dodd-Frank Act requires the Federal Reserve, as well as the other federal banking agencies, to establish minimum leverage and risk-based capital requirements on a consolidated basis for

- insured depository institutions,
- BHCs and savings and loan holding companies that are organized in the United States (including any such company that is owned or controlled by a foreign organization), and
- nonbank financial companies supervised by the Federal Reserve.

The act further requires that the minimum leverage and risk-based capital standards established for these institutions cannot be less than the “generally applicable” capital requirements that apply to insured depository institutions, regardless of their total consolidated assets or foreign financial exposure. Thus, the generally applicable capital requirements serve as a floor for a banking organization’s capital ratios.

The minimum capital requirements that are determined using the standardized approach for calculating risk-weighted assets under the agencies' revised regulatory capital framework are the generally applicable capital requirements.

### ***Capital Planning, Stress Testing, and Capital Distributions***

Since the 2007–09 financial crisis, the Federal Reserve has worked to ensure that large, complex financial institutions strengthen their capital positions. One aspect of this has been working with firms to bolster their internal processes for assessing capital needs.

Since early 2011, the Federal Reserve has developed and implemented a regular supervisory review of the capital plans of 30 of the largest banking organizations, including in the review any plans the institutions had for increasing dividends or buying back common stock. Through its capital-plan rule, the Federal Reserve requires each U.S. BHC with over \$50 billion in total consolidated assets to submit a capital plan annually for review. The Federal Reserve reviews these plans to evaluate institutions' capital adequacy, internal capital adequacy processes, and capital distribution plans. A key objective of this evaluation, officially known as the Comprehensive Capital Analysis and Review, is to ensure firms' capital processes are sufficiently comprehensive and forward-looking.

Part of CCAR is the routine use of stress testing by regulated banking organizations and the Federal Reserve to assess whether an institution will continue to hold sufficient capital to remain a viable financial intermediary even after absorbing the increased losses and reduced earnings associated with stressful economic conditions. If a company is unable to meet its capital requirements under stress tests, or if the company does not have strong processes for managing its capital and evaluating its risks, the Federal Reserve places restrictions on the company's dividends and stock repurchases.

CCAR incorporates aspects of the supervisory and company-run stress tests conducted under the Federal Reserve's Dodd-Frank Act stress test

rules. Under the stress test rules, the Federal Reserve conducts annual supervisory stress tests on all BHCs with \$50 billion or more in assets, and requires these companies, along with all other Federal Reserve-regulated companies with over \$10 billion in assets, to conduct their own internal stress tests. Each year, the Federal Reserve and the companies disclose information about the results of the CCAR and the Dodd-Frank Act stress tests in order to provide valuable information to the public and to promote market discipline.

### *Liquidity Standards*

While adequate capital is essential to the safety and soundness of financial institutions and the financial system as a whole, adequate liquidity is also vitally important. Capital adequacy and liquidity are interdependent, particularly in times of stress.

For example, an institution that is perceived to be undercapitalized may have difficulty borrowing the money it needs to fund itself, while an institution that is illiquid may be in danger of failing regardless of its capital level.

The 2007–09 financial crisis highlighted the importance of adequate liquidity risk management. Many solvent financial institutions experienced significant financial stress during the crisis because they had not managed liquidity in a prudent manner. For example, some institutions had relied excessively on volatile wholesale short-term funding sources and were overly exposed when those funding sources were disrupted.

To address such scenarios, the Federal Reserve and other federal banking agencies issued in 2010 joint guidance on sound practices for managing funding and liquidity risks. This guidance re-emphasizes the importance of sound liquidity-risk management that appropriately identifies, measures, monitors, and controls funding and liquidity risks. The guidance also highlights the importance of cash-flow projections, diversified funding sources, liquidity stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan as primary tools for managing liquidity risk.

As a result of the Dodd-Frank Act, the Federal Reserve also established heightened prudential standards for large BHCs, as well as foreign banking organizations with significant U.S. operations it supervises. Regulation YY prescribes heightened liquidity requirements and subjects these institutions to qualitative liquidity risk-management standards generally based on the interagency liquidity risk-management guidance issued in 2010.

These standards would, furthermore, require these institutions to maintain a minimum liquidity buffer based on the institutions' internal 30-day liquidity stress tests. The standards also establish specific related responsibilities for boards of directors and risk committees, require firms to establish specific internal quantitative limits to manage liquidity risk, and impose specific monitoring requirements.

In 2014, the federal banking agencies created a standardized minimum liquidity coverage ratio, or LCR, for large and internationally active firms. Regulation WW requires large and internationally active firms meeting certain criteria to hold high quality, liquid assets that can be converted easily and quickly into cash. The ratio of the firm's liquid assets to its projected net cash outflow is its LCR. To review large firm practices and risk areas not entirely captured in the LCR, the Federal Reserve also conducts its annual Comprehensive Liquidity Analysis and Review, which also serves to evaluate large firms' liquidity positions and risk-management practices.

## **Margin Requirements: Regulating the Extension of Credit for Securities Purchases**

The Securities Exchange Act of 1934 requires the Federal Reserve to regulate the extension of credit used in connection with the purchase of securities.

Through its regulations, the Federal Reserve establishes the minimum amount the buyer must put forward when purchasing a security. This minimum amount is known as the margin requirement. Regulation T

limits the amount of credit that may be provided by securities brokers and dealers; meanwhile, Regulation U limits the amount of securities credit extended by banks and other lenders.

These regulations generally apply to credit-financed purchases of securities traded on U.S. securities exchanges and when the credit is collateralized by such securities. In addition, Regulation X prohibits borrowers who are subject to U.S. laws from obtaining such credit overseas on terms more favorable than could be obtained from a domestic lender.

Compliance with the Federal Reserve's margin regulations is enforced by several federal regulatory agencies. The federal agencies that regulate financial institutions check for compliance with the Federal Reserve's Regulation U during examinations. The Federal Reserve checks for Regulation U compliance by securities credit lenders not otherwise regulated by another federal agency. Compliance with Regulation T is verified during examinations of broker-dealers by the securities industry's self-regulatory organizations under the general oversight of the SEC.

## **Supervision and Regulation Letters and Guidance**

Besides issuing regulations, the Federal Reserve also develops public supervision and regulation (or SR) letters, and other policy statements and guidance for examiners and financial institutions.

The Federal Reserve often works closely with other supervisors in crafting these policy statements and guidance. For example, it participates in supervisory and regulatory forums, provides support for the work of the FFIEC, and participates in international forums such as the Basel Committee on Banking Supervision and the Financial Stability Board.

One example of interagency policy development was the 2013 guidance on troubled debt restructurings. This guidance addresses certain issues related to the accounting treatment, and regulatory credit risk grade or classification of commercial and residential real estate loans that have undergone troubled debt restructurings. In addition, the

guidance notes that the agencies encourage financial institutions to work constructively with borrowers and view prudent modifications as positive actions that can mitigate an institution's credit risk.

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## Promoting Market Discipline: Public Disclosure and Accounting Policy Requirements

Public disclosure helps market observers and participants assess the strength of individual financial institutions, and the Federal Reserve's role in this regard is a critical element in promoting market discipline. Market discipline, likewise, is an important complement to supervision.

Improved safety and soundness is often realized by heightened market discipline achieved through improved financial reporting and disclosure requirements. Such requirements can serve both institution-specific and macroprudential purposes.

Market discipline can help to restrain imprudent risk-taking by limiting funding of institutions perceived to be relatively risky, and in this way can complement the efforts of supervisors.

Accordingly, the Federal Reserve plays a significant role in promoting sound accounting policies and meaningful public disclosure by financial institutions. Through its supervision and regulation functions, the Federal Reserve seeks to strengthen the accounting, audit, and control standards related to financial institutions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 emphasized the importance of such standards for financial institutions. In addition, the Sarbanes-Oxley Act of 2002 sought to improve

the accuracy and reliability of corporate disclosures and to detect and prevent significant weaknesses in internal control over financial reporting (including the detection of fraud). The Federal Reserve has issued guidance to its supervised institutions to address the requirements under these statutory mandates.

The Federal Reserve also is involved in the development of international and domestic accounting and financial disclosure standards. In its mission to improve financial accounting and reporting, the Financial Accounting Standards Board (FASB) has focused on making improvements to simplify the standard-setting process and guidance. Additionally, the FASB and the International Accounting Standards Board continue to work toward converging major accounting standards through joint projects. The Federal Reserve actively participates in the accounting standard-setting process.